ACCOUNTING FOR ISLAMIC FINANCE

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Malaysian Institute of Accountants

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About Malaysian Institute of Accountants (MIA)

Established under the Accountants Act 1967, MIA is the national accountancy body that regulates, develops, supports and enhances the integrity, status and interests of the profession in Malaysia. MIA accords the Chartered Accountant Malaysia or C.A.(M) designation to a professional in accountancy, business and finance with a recognised qualification and relevant work experience.

Working closely alongside businesses, MIA connects its membership to an unmatched range of information resources, events, professional development and networking opportunities. Presently, there are more than 36,000 members making their strides in businesses across all industries in Malaysia and around the world.

MIA's international outlook and connections are reflected in its membership of regional and international professional organisations such as the ASEAN Federation of Accountants (AFA), and the International Federation of Accountants (IFAC).

MIA's Purpose

MIA's purpose is to requlate and develop the accountancy profession to support economic growth and nation building.

MIA's Vision

To be a globally recognised Professional Accountancy Organisation (PAO) in regulating and developing the profession for nation building.

MIA's Values

Integrity, Mutual Trust & Respect, Professionalism, Accountability, Commitment, Teamwork, Sustainability

Strategic Objectives

- Develop and enhance the competency of accountancy professionals to stay relevant to business and market demand.
- Nurture professional values and ethics of members to uphold a strong accountancy profession.
- Regulate and develop the practice of the accountancy profession consistent with global standards and best practices.
- Promote the value proposition of accountancy profession and continuously uplift global recognition.

About Malaysian Accountancy Research and Education Foundation (MAREF)

The Malaysian Accountancy Research and Education Foundation (MAREF) is a trust body sponsored by the Malaysian Institute of Accountants (MIA). MAREF was established in 1990 with the following objectives:

- To encourage and promote the advancement and development of accountancy profession in Malaysia.
- To provide monetary assistance in the form of scholarship, educational loans or grants.
- To organise and/or promote programmes and/or activities for the enhancement and improvement of the teaching and/or training of accountants.
- To carry out such other legally charitable activities and/or programmes for the advancement of the education and training in the Profession.
- To co-operate with other bodies and institutions approved by the Director General of Inland Revenue, Malaysia with similar aims and objectives for the exchange and professional knowledge.
- To publish and disseminate literature in advancement of the Profession.
- To encourage and promote the advancement and development of examinations for the Profession.
- To fund and/or conduct research, conferences, seminars, workshops or other similar programmes as well as surveys or development of databases that would assist in the development and advancement of the Profession.

MAREF received its certificate of registration as a corporate body under the Trustees (Incorporation) Act 1952 on 26th July 1993 from The Prime Minister's Department. On 14 February 1992, MAREF was gazetted as an approved organization under section 44(6) of the Income Tax Act 1967 which regards any monetary donation towards the funds of this foundation as tax exempted.

MOVING FORWARD TO GLOBAL ACCOUNTING RESEARCH

VISION

To be the leading Research and Educational Foundation for the Accountancy Profession in Malaysia.

MISSION

- To be the leading Research and Educational Foundation for the Accountancy Profession in Malaysia.
- To promote, support & conduct research and educational programmes for the benefit of the Accountancy Profession.
- To be in the forefront in identifying and developing new knowledge and issues related to accounting in general Malaysian accounting practices in particular.

OBJECTIVES

The objectives of MAREF are:

- To encourage and promote the advancement and development of accountancy in Malaysia;
- To carry out such legally charitable purposes for the advancement of education and training in the profession;
- To carry out research and to promote development of accounting and auditing standards;
- To publish and disseminate literature in the advancement of the accounting profession.

FOREWORD

Dr Nurmazilah Dato' Mahzan

Chief Executive Officer of
Malaysian Institute of Accountants

En Mohd Muazzam Mohamed

Chairman
Islamic Finance Committee of MIA

In our efforts to strengthen sustainable development and the accountancy profession's continuing relevance and contributions to nation building, MIA is continually alert to opportunities to share our unique expertise. Under the auspices of the MIA Islamic Finance Committee (IFC), we are delighted to present this textbook on accounting for Islamic Finance (IF) transactions. This textbook is a first of its kind and is specifically designed to fill a pedagogical void, as there is currently no published textbook in the market that focuses on IF from the perspective of MFRS.

We trust that this textbook will help enrich the current corpus of IF learning materials and provide useful reference materials for the use of universities and institutes of higher learning in teaching the application of MFRS on IF transactions. In addition, this textbook supports the IF industry by providing a convenient point of reference that explains and clarifies the rationale behind current applications of MFRS for IF.

In terms of its scope, this textbook focuses on applications within the Malaysian context as Malaysia is a forerunner and leader in the international advancement and advocacy of IF, acknowledged for our legal and regulatory frameworks, systems and operating models, depth of experience in IF, and ease of doing business. Malaysia has consistently emerged as one of the leading destinations in Islamic finance, particularly in the Islamic banking, sukuk and Islamic equities markets.

By highlighting the latest products and developments within the Malaysian IF landscape, this textbook delivers the current knowledge of accounting and MFRS for IF, written in a suitable tone for tertiary-level audiences and above. This will help prepare students and graduates adequately for existing and emerging roles in the growing IF sector, particularly those serving in finance and accounting roles. Other than augmenting competencies and building capacity of the talent pipeline, this textbook can also serve as a useful reference for the market on MFRS applications in IF, and spark greater participation, engagement and consensus on issues affecting the industry.

Importantly, Islamic finance institutions (IFIs) can use this textbook as a resource to enhance their financial statement disclosures to improve comparability for users of financial statements and better facilitate their assessment of the IFIs' financial position, performance and Shariah compliance.

Undoubtedly, IF has grown in leaps and bounds thanks to the power of global collaboration and the appetite of the ummah or Muslim nation for Syariah-compliant finance. Likewise, this textbook could not have been produced without the concerted efforts of numerous parties. In particular, we wish to recognise and thank Y Bhg Dato' Mohammad Faiz Azmi, the former President of MIA for his visionary leadership in initiating and driving this project. We would also like to extend our utmost gratitude to the Malaysian Accountancy Research and Education Foundation (MAREF) for collaborating on this project. Many thanks are also due to the leading accountancy firms and industry experts who consulted and lent their time and expertise to this project. Last but not least, we wish to acknowledge and thank the authors involved in researching and writing the text, including members of the IFC and MIA technical staff, without whom this book could not have come to fruition.

We are delighted to share that this textbook will be distributed on a complimentary basis to all public and private universities accredited by MIA as well as other relevant stakeholders for the purpose of knowledge sharing and as a reference material. The public will be able to download a free e-book version, which will facilitate access by students, academicians and MIA members and practitioners who wish to use the book as a reference material for upskilling and compliance.

It is our hope that this textbook can be a catalyst in driving further harmonisation of Islamic finance standards and financial reporting across the world, while widening the scope of the IF discourse to ensure the sustainable and diversified growth of the global IF sector. At a more macro and holistic level, we trust that this textbook can contribute to enriching the practical applications of IF, in order to address the unmet needs of the world's Muslim population for Shariah-compliant financial services and to heighten financial inclusion.

Thank you.

PREFACE

This book is an effort to document the application of the Malaysian Financial Reporting Standards (MFRS) on Islamic finance transactions in Islamic banking, takaful entities and Islamic asset management in Malaysia.

There are 15 chapters in this book which are divided into four parts. Part I, which covers Chapters 1 to 3, provides a background on Islamic finance development in Malaysia and sets the scene to the rest of the chapters in this book. Chapter 1 discusses the differences between Islamic and conventional financial institutions which comprise banking, takaful and asset management companies. Chapter 2 explains Malaysia's journey on Islamic banking where, among others, it entails discussion on development of regulatory requirements on Islamic finance since 1983 and using accrual accounting for Islamic finance transactions. While Chapter 3 focuses on the adoption of accounting standards by the Islamic financial institutions and its implications on Islamic finance.

Parts II to IV that cover 12 chapters, discuss the application of MFRSs on assets, liabilities, income, expenses and equity of Islamic banks, takaful entities and Islamic asset management companies. The discussion on assets, liabilities and equity look at definition/nature, recognition, measurement as well as presentation and disclosure of the items in the financial statements of these entities.

Parts II and III that cover Islamic banking and takaful entities respectively, also include an introduction chapter on understanding of Islamic banks' and takaful entities' financial statements as well as a brief discussion on future consideration of accounting standards for those entities, given the continuous development of the accounting standards affecting them.

It is our hope that this book would instil the knowledge of applying MFRSs on Islamic finance transactions among the students of universities and institute of higher learning as well as provide useful reference materials in teaching the application of MFRS on Islamic finance transactions. In addition, this book could be a point of reference that explains and clarifies the rationale behind current applications of MFRS for Islamic finance either for Islamic financial institutions or other industries.

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CHAPTER 1

OVERVIEW ON ISLAMIC FINANCIAL INSTITUTIONS AND DIFFERENCES WITH CONVENTIONAL FINANCIAL INSTITUTIONS

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LEARNING OBJECTIVES

The chapter aims to:

i. provide an understanding of the basis of Islamic finance and the sources of Shariah in Islamic commercial businesses
ii. explain the roles of and expectation on Islamic Financial Institutions in ensuring the requirements of Shariah are met in their day to day operations; and
iii. explain the differences between Islamic Financial Institutions and conventional financial institutions.

1.0 INTRODUCTION

Islam is a religion that provides comprehensive rules and guidelines that oversee a believer's way of life. There is very clear guidance from the two primary sources; the *Quran* which is to Muslims the word of God, and the *Sunnah* which is the traditions of the Prophet Muhammad (peace be upon him - pbuh). In addition, there is another important secondary source which is the *Hadith*, a very rich source of understanding the life of the Prophet (pbuh) and his way of living through narrations by the companions of the Prophet (pbuh). This guidance relates to both Ibadah and *Muamalat* - *Ibadah* are the methods of conduct between Allah and man, while *Muamalat* is the code of conduct amongst men, which includes business dealings.

It is an important objective in economics and finance to ensure that the wealth and well-being of man are managed under certain rules and regulations aimed to avoid hoarding, corruption, monopolistic endeavours, and oppressive practices towards consumers. This also applies to Islamic economics with an additional layer of control, which is the Shariah. By definition, Shariah means to lead to water, which implies that Shariah promotes the right way of Muamalat. Shariah is therefore deemed as the laws that have been codified based on the primary sources of guidance, interpretated and implemented by Shariah Advisors who issue fatwas or learned opinions on a particular issue needing to be resolved.

In Islamic economics, there are emphasises on contractual relationships acceptable by Islamic scholars, involvements in Shariah compliant economic activities, concepts of fairness and justice, requirements of transparency and adherence to certain rules when an unacceptable event happens. These considerations by Shariah scholars[1] provide a clear distinction between a conventional economic model, and the values that is proposed by Islamic economics.

Over the few years following the Global Financial Crisis, one of the main ideas for a possible solution is the greater involment of Islamic economics in the overall market. Practitioners in Islamic economy take the elements of *Maqasid Shariah* (objectives of Shariah) as the guiding principles for all its economic activities. *Maqasid Shariah*, as defined by Imam al-Ghazaali states that the objectives of Shariah is to promote well-being of all mankind, which lies in safeguarding their faith (*din*), their human self (*nafs*), their intellect (*'aql*), their posterity (*nasl*) and their wealth (*mal*) and whatever that ensures the safeguard of these five objectives to serves public interest is desireable.

[1] Shariah Scholars are individuals that sit on a Shariah Supervisory Board as an independent body of specialised jurists in fiqh al-mu'amalat (Islamic commercial jurisprudence). The scholars, if sitting for the Board of Islamic Financial Institutions are also commonly known as Shariah Advisors of the Islamic Financial Institutions.

Islamic financial institutions, which are expected to undertake elements of the *Maqasid Shariah* as one of its business objectives, attempt to embed the objectives into their business which is originally based on the structures of conventional financial institutions. Islamic financial institutions[2] are entities that conduct the following business or activity:

i. Islamic banking business
ii. International Islamic banking business
iii. Islamic financial intermediation activities
iv. Islamic factoring business
v. Islamic leasing business
vi. Any business, service or activity in relations to a financial service as and Islamic financial advisory business.

For Islamic financial institutions, rules that prohibits usury (*Riba'*) either marginally or excessively, plays an important influence on how Islamic economic policies are structured. Business practices that adopt rules such as avoidance of uncertainty (*Gharar*) provide enhanced transparency on products and services. Equally, businesses that avoid excessive-risk elements akin to gambling (*Maisir*) encourage products to be designed with the protection of consumer rights in mind

The above consideration is challenging to be fully realised, as the mandate of maximising profits is a key objective of many economic entities such as Islamic Financial Institutions. Profits are what drive a business forward, and to have businesses where the *Maqasid Shariah* is also emphasised requires a fine balancing act.

This is especially true in certain countries in the middle-east and Malaysia where dual financial systems thrive side by side; for example, conventional banking models operating together with Islamic banking models, sometimes where Islamic banking entities are direct subsidiaries of the conventional banking entities. There may be conflict of interests where organisational strategies and objectives of the Islamic banking entity may differ and are pressured to be aligned with the conventional bank's strategies and objectives. Faced with this dilemma, the fraternity in the Islamic economy recognised the concerted effort needed to be aligned across Islamic Financial Institutions by having a global standard. This will help in providing guidance to Islamic Financial Institutions that are set up solely to offer Shariah-compliant financial solutions to clients.

This effort for standardisation is important as it provides stability in a growing industry. The traditional bank has undergone constant changes of its rules and regulations. There is also strong coordination in the implementation of various global standards such as Basel Accords[3] and Anti-Money Laundering and Terrorist Financing[4] regulations which are also adopted by most financial institutions across the globe. Consequently, Islamic financial institutions must comply with all the global and local standards as well.

[2]*Extracted from the Islamic Financial Services Act 2013, Section 3(a)*
[3]*The Basel Accords are three series of banking regulations (Basel I, II and III) set by the Basel Committee on Bank Supervision (BCBS). The committee provides recommendations on banking regulations, specifically, concerning capital risks, market risks, and operational risks. The accords ensure that financial insituitutions have enough capital on account to absorb unexpected losses.*
[4]*Anti-Money Laundering, Anti Terrorism Financing and Proceeds of Unlawful Activities Act 2001; "An Act to provide for the offence of money laundering, the measures to be taken for the prevention of money laundering and terrorism financing offences and to provide for the forfeiture of property involved in or derived from money laundering and terrorism financing offences, as well as terrorist property, proceed of an unlawful activity and instrumentalities of an offence, and for matters incidental thereto and connected there with".*

For Islamic financial institutions, the additional dimension of Shariah rules requires similar levels of standardisation. This can be seen with efforts coming from organisations such as the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), the International Islamic Liquidity Management Corporation (IILM) and the Islamic Financial Services Board (IFSB) and various initiatives by the country's Central Bank to standardise the Shariah understanding. However, there are flexibilities in interpretation of Shariah rules to cater for specific local conditions or customs (Urf) with consideration of public interest (Maslahah). This will continue to support efforts by the industry to achieve the same level of standardisation seen in traditional banks.

2.0 THE TRADITIONAL BANKS

The traditional banks, often referred to as conventional financial institutions, started with humble beginnings as deposit takers and money lenders to meet the demands of merchants involved in trade. They evolved over time from merely financial record-keeping organisations into financial intermediaries which cater to broader types of products and services. While products and services have expanded, the main source of income was still derived from the lending activities that encompassed "interest" earnings.

The first form of banking began in the areas of Assyria and Babylonia in the year 2000 BC, and then expanded to the Roman Empire's temples where loans were offered with interest and taking of deposits from worshippers and exchange of monies. There was also evidence of early banking in countries like India and China, where emphasis was on money lending when it expanded the original concepts to encompass deposit taking and money lending. Early financial institutions were set up to only cater for specific local requirements but lack the products and services that is currently available in modern banking and finance.

Financial institutions have quickly evolved into systematic, organised and regulated intermediaries offering financial solutions to meet the demand of customers. They now offer products and services that have specific solutions to the requirements of the modern economy. They operate based on fractional reserve banking, where financial institutions are able to hold only a small reserve in their respective Central Bank but allowed to lend out substantially bigger sums. This model allows for the significant growth in the financial industry with tight regulations to ensure the bank's capital risks and the minimum capital requirements are managed.

3.0 ISLAMIC FINANCIAL INSTITUTIONS: MOVING AWAY FROM TRADITIONAL BANKING MODELS

Islamic financial institutions includes all types of Shariah-based intermediaries i.e. Islamic banking and financial institutions, Takaful companies, Islamic cooperatives, as well as Islamic asset management companies. The guiding principles of the operations of these intermediaries adhere to Shariah rules and regulations, revolving around the principles of fairness, transparency and justice. These principles must ideally be present in all Islamic Financial Institutions products, policies, and operational behaviour.

High expectations are placed on this banking model to be the better alternative to traditional banking models. Due to the Islamic principles of fairness and justice, the Islamic Financial Institutions are expected to be more benevolent in its way of doing business with its customers. Yet, Islamic financial institutions must remain profitable to survive in order to continue providing Shariah-compliant products and services to the public. If its earnings and returns are insufficient to pay for expenses and provide profit to shareholders and depositors, the Islamic Financial Institutions will be hard pressed to remain economically viable.

4.0 IS ISLAMIC FINANCIAL INSTITUTION THE RIGHT SOLUTION?

The main attraction for Islamic Financial Institutions is that they are perceived to provide a more socially acceptable model for financial intermediation. For many years, the conventional financial institutions have been criticised for their profit driven policies, which include stiff penalties and strong-handed management of delinquent accounts, as well as hidden fees and charges that were unfair to consumers. There is a strong correlation between risks and the pricing charged by the conventional financial institutions which may not be in the best interest for the consumers. With greater attention to risks as those espoused by Basel accords, the standards and policies introduced were designed to safeguard the banking sectors more than protecting the interests of the individual consumers. The senselessness of protectionism predisposition towards financial institutions pushed consumers to continue seeking better alternatives. That alternative is perceived to be Islamic banking and finance.

Ultimately, Islamic Financial Institutions still need to make profit to compete with the conventional financial institutions in the long run. Salaries need to be paid, as well as shareholders returns on their investments. Re-investment into their infrastructure needs to be made and this is only possible when there are enough retained earnings available for such investment. If Islamic Financial Institutions are merely poorer versions of their conventional counterpart, they will not be of any use to the industry and community as they are not growing into a significant financial force.

The balance between being profitable while offering financial solutions that remain within the parameters of Shariah must be achieved. The Shariah expectation is to ensure operational compliance to the rules of Shariah in all banking activites, including approvals of structural designs and documents of Islamic products and services, and decisions against clear Shariah prohibitions. This may include elements of Shariah consideration in the Islamic Financial Institution's pricing policies, funding and balance sheet management. Without this element, Islamic Financial Institutions will remain profit-driven and returns-maximisation driven as long as they do not explicitly breach the rules of Shariah.

5.0 THE ROLE OF SHARIAH ADVISORS

The role of Shariah advisors has gained prominence in the past few years as the public demands greater transparency of the decisions and deliberations when learned opinions (fatwa) are issued. There is an increasing number of scholars, practitioners and academicians entering the market, discussions resulting in fatwas have become robust and in-depth especially in its application in the real world. There is greater understanding of the challenges faced by Islamic Financial Institutions where practical solutions are required from Shariah advisors for problems that have become more complicated.

As the world becomes borderless, standardisation of fatwas have also attained greater importance as cross-border transactions become more regular. Organisations such as AAOIFI, IILM and the IFSB now cater for new problems that did not exist a decade ago, especially as more digital innovations happen across the globe. Concepts such as blockchain, cryptocurrencies, smart contracts and exchange of digital goods and services require a rethink on how they impact the existing understanding of Shariah contracts. The Shariah advisors sitting in such organisations have to become technically conversant in these areas to resolve new problems.

Countries like Malaysia have also placed greater responsibilities to Shariah Advisors, as well as the Board of Directors, in their oversight function of the Islamic financial institution's operation. After the introduction of the Islamic Financial Services Act 2013 (IFSA 2013), the role of Shariah Advisors has been placed under greater scrutiny by Bank Negara Malaysia (BNM) as to their responsibilities to derive at a right decision or fatwas. The consequences of a decision must be fully understood by Shariah Advisors for failure to adhere to the rulings of BNM's Shariah Advisory Council's decisions wil be deemed as a breach in Shariah compliance. Stiff penalties for non-compliance are introduced under IFSA where upon conviction, the person is liable to imprisonment for a term not exceeding eight years or a fine not exceeding twenty-five million ringgit or both.

Accordingly, Shariah Advisors must be well-versed with the documents issued by the BNM and understand its contents and implications to Islamic financial institutions. BNM regularly issues policy documents, standards and guidelines, with the consultation of BNM's Shariah Advisory Council to ensure these documents meet the minimum requirements expected by Shariah. The role of Shariah Advisors in determining whether the Islamic financial institution's internal policies comply with the requirements of Shariah has become increasingly significant and important. The capabilities of Shariah Advisors must therefore be improved to keep abreast with the latest developments in the industry.

6.0 DEVELOPMENT OF SHARIAH FOR ISLAMIC FINANCIAL INSTITUTIONS

With the development of the Islamic financial market and industry, the laws governing the market must evolve to address the increasing levels of market sophistication. Shariah Advisors must fully utilise the tools that are available to them; from academic research facilities to regulatory support to enhancement in law to practitioners' discourse. More importantly, a re-look at the main sources of Islamic law must be made to expand on their understanding and application to current problems.

As mentioned earlier, the main sources of Islamic law are derived from the *Quran* and *Sunnah*, supported by *Hadith*. The Quran itself has proven to be a significant source of materials where the laws are derived, deliberated and codified while the *Sunnah* provides valuable acceptable practices, including commercial practices to be interpretated and expanded to apply into modern Islamic commerce. Authenticated *Hadith* also provides a treasure trove of implied injunctions where it is adopted to guide modern Islamic commerce. What is acceptable in Islamic commerce can be referenced to the *Hadith* in its modern application and becomes the basis of further concensus of Scholars' opinion (*Ijma' Ulamak*), analogical deductions (*Qiyas*) and consideration of reason (*Istihsan*) that is faithful to the spirit of Shariah.

Further to the above, Shariah law was expanded by the great works of the respectable Imams of Islamic Jurisprudence (*Fiqh*). Most of the laws seen coming into the current legal landscapes are further derivation of codified laws deliberated within the 4 main schools of thought founded by these prominent Imams, namely:

1. Imam Abu Hanifa
2. Imam Malik
3. Imam Shafie
4. Imam Ahmad bin Hanbal

To ensure the continued development of Islamic banking, Shariah Advisors need to dive into a more holistic and in-depth research and deliberation to common issues based on the laws expanded by the 4 main schools of thought. As modern banking issues evolve into more sophisticated or unknown territory, the ability to see the bigger picture and provide relevant solutions becomes more important to Islamic Financial Institutions. With new fatwas being issued, re-visited and re-issued, Shariah Advisors need to constantly look at earlier-made decisions to assess its continuing practicability in the new world of banking. Shariah Advisors also have an important role in understanding the operational requirements outlined in the policy documents issued by BNM to ensure the minimum regulatory expectations are met.

7.0 WHY IS SHARIAH IMPORTANT IN THE OPERATIONS OF ISLAMIC FINANCIAL INSTITUTIONS?

What makes financial institutions such a significant component of an economy is its reliability. As financial institutions are now heavily governed and regulated by the Central Bank of their respective domicile, consumers take confidence that the financial institutions are able to manage, retain and grow their capital based on the expertise of these financial institutions. The trust that financial institutions have built over the years ensure that financial institutions remain the foremost option to consumers when it comes to their financial requirements.

Shariah compliance places another level of trust and surety. For consumers that prefer the concept of financial services compliant to Shariah, it has become the responsibility of Islamic Financial Institutions to ensure the rules of Shariah are adopted and adhered to. Consumers rely on the confirmation that the operations, investment and income of the Islamic financial institutions are derived from Shariah-approved sources. This reliance also puts the responsibility on the shoulders of the Shariah Advisors to ensure the structures are Shariah-compliant.

8.0 ISLAMIC FINANCE: FUNDAMENTAL DIFFERENCES

In essence, there are many similarities between the concept of banking and financial services in conventional financial services and Islamic financial services. The idea of deposit collection and deployment of funds into economic activities are very much similar. Functions such as credit consideration, funding requirements and their costs, accounting, auditing, risks, compliance and operations are similar with minor adjustments required.

However, the major differences between an Islamic financial institution and conventional financial institution, while not exhaustive, can be identified in these few aspects:

8.1 Shariah Requirements
8.2 Contractual Relationship
8.3 Prohibited Business Activities & Products
8.4 Underlying Transactions
8.5 Shariah Oversight

8.1 Shariah requirements

For all the products and services offered by an Islamic financial institution, adherence to the rules of Shariah is the utmost important aspect for an Islamic Financial Institution to comply with. This includes staying away from practices that involve Usury or Interest (*Riba*), prohibition in practice and actions resulting in Uncertainty (*Gharar*), and avoiding activities akin to Gambling (*Maisir*). This is then followed by other prohibitive principles of Islamic Financial Institutions such as unlawful business activities dealing with pork, alcohol and entertainment prohibited by Shariah.

a) Prohibition of Usury (*Riba'*)

In the Quran, the clear prohibition of Usury or commonly known as interest, is found as follows:

> *"Those who eat Riba (usury) will not stand (on the Day of Resurrection) except like the standing of a person beaten by Shaitan (Satan) leading him to insanity. That is because they say: "Trading is like Riba (usury)," whereas Allah has permitted trading and forbidden Riba (usury)." (Surah Al Baqarah Verse 275).*

This verse confirms that usury is a major sin for a person either as a lender, borrower and even recorder of such transactions and it is with such vigour that Shariah scholars define the instances and conditions relating to usury in a manner than can be identified in everyday transactions. This single injunction is responsible in launching the whole Islamic finance industry as there is a need to comply with the prohibition of usury as demanded by the Muslim community.

Interest, in its simplest structure, refers to any excess or increment charged on a loan. The Islamic definition of a loan is a principal amount which is lent and to be repaid in the future at the same amount without any increment obliged on it (*Qardhul Hassan* or benovelent loan). Any amount which is in excess of the lent amount is deemed as *Riba'* or interest where the excess amount arises due to the lending of money. Interest is charged due to stipulations demanded during the time of entering into the loan contract, or due to the delay in payment of the loan or any delay in meeting the financial obligation where an additional charge is imposed as penalty.

Additionally, there are also specific rules when it comes to trading where the prohibition also covers exchange of goods and currency. In one of the most established Hadith by the Prophet Muhammad (peace be upon him) referencing the trading of *Ribawi* items, he described the following:

> *"The selling of gold for gold is Riba except if the exchange is from hand to hand and equal in amount, and similarly, the selling of wheat for wheat is Riba unless it is from hand to hand and equal in amount, and the selling of barley for barley is Riba, unless it is from hand to hand and equal in amount, and the selling of dates for dates is Riba, unless it is from hand to hand and equal in amount"-(Compilation of Hadith by Imam Bukhari Chapter 34 Sales and Trade)*

As illustrated above, usurious practices are not just defined as excess over the original loan amount, but also includes exchange of specific goods under a defined rule that shall not be breached. It is the responsibility of Shariah Advisors to assess, identify and prohibit any implicit or explicit usurious practices in the modern transactional guise of banking and commerce. Some structures have many underlying layers of transactions which is not immediately visible. Therefore, it is a challenge for Shariah Advisors to decipher the elements of such structures especially involving transactions that are programmable, layered and hidden, automated and extremely fast.

It is also noteable that other major religions prohibit “interest” transactions for its followers of faith. In Texts from Judaism and the Bible contain prohibition of interest-based lending[5] and the charging of interest, regarded as a major sin. Even the early Hindu scriptures, similar text on prohibitive usurious practices[6] can be found. However, over-time the prohibition and its definition have been diluted and separated from modern commerce; perhaps deemed to be no longer relevant based on re-interpretation.

b) Prohibition of Uncertainty *(Gharar)*

One of the main requirements of Islamic commerce is to provide fairness and justice in its transactions and dealings. Transactions must contain clear elements to avoid disputes and unfair dealings, with the tenets of the underlying transactions agreed by all transacting parties. Certainty in contracts means all parties are aware of their roles and responsibilities in the contract they execute.

The prohibition of uncertainty in contractual arrangements and business transactions covers a wide range of business practices. Examples of such practices may include sale of items with defective features not disclosed, lack of disclosures resulting in defective information, uncertainties in ownership or rights to ownership, lack of deliverability of goods promised, misrepresentation, intention to fraud or even deliberately hiding key terms in the depths of the terms and conditions document. Failure to disclose sufficiently the key elements in the contractual arrangement may render the transaction invalid which may result in the income being declared unlawful and to be given away to charity. For example, in a Tawarruq (sale with profit) transaction where customers have purchased a commodity with the Islamic financial institutions, but do not know what and how the transaction took place due to lack of documentation or information by the Bank. Shariah requires customers to understand the contract they are taking, and if the commodity information is uncertain at the point of Aqad, the whole transaction may be rendered invalid by the Shariah Advisors, depending on whether the uncertainty is deemed as a major or minor uncertainty. If the transaction is deemed invalid due to the uncertainty of the commodity being used, the Islamic financial institution must enable restitution on the completed Aqad (with customer’s consent) or be penalised on earning an income from an incomplete transaction. The income must then be reversed and given to charity.

The change in terms and conditions after it has been agreed by all parties may also fall under the guise of gharar, especially if such a change in terms and conditions is made unilaterally and advantageous to only one party without the consent of the other. Taking advantage through deceit or misinformation is also an element of gharar as decisions may have been made without full disclosure by all parties. In a Hadith by the Prophet Muhammad (peace be upon him), the Prophet said, *“Whoever sells a defective commodity without disclosing it remains in Allah’s wrath”. (Sunan Ibn Majah 2873)*

This outlines the prohibition of uncertainty in transactions where details are concealed and thus Shariah emphasises the need for full disclosure in Muamalat transactions. Even in the conventional financial world, being transparent has become an important requirement to ensure fairness and avoid contractual disputes in the name of protecting consumer interest.

[5]*Leviticus 25 Verses 35-37 “If any of your fellow Israelites become poor and are unable to support themselves among you, help them as you would a foreigner or a stranger, so they can continue to live among you. Do not take any interest or any profit from them but fear your God so that they may continue to live among you. You must not lend them money at interest or sell them food at a profit”, and Exodus 22 Verse 25 “If you lend money to one of my people among you who is poor, you must not act as a creditor to him; you are not to charge him any interest”, and Deuteronomy 23:19 “Do not charge your brother interest on money, food, or any other type of loan”. Also mentioned in Nehemiah 5:7, Psalm 15:5, Proverbs 28:8, Ezekiel 18:8 & 18:13.*

[6]*Hindu Sutra (700-100 BC) and Buddhist Jatakas (600-400 BC) make references to interest and the expression of disdain for the practice. Laws of Manu (200 AD) “stipulated interest beyond the legal rate being against the law, cannot be recovered, they call that a usurious way”.*

c) Prohibition of Gambling (*Maisir*)

The definition of gambling can easily be interpreted as the zero-sum game where a crowd of losing gamblers "fund" the winnings of a lucky few. It is a winner-takes-all structure designed to promise the dream of winning big via a small investment. This is can be seen in structures where elements of uncertainty lead to a high risk of losses, without proper disclosures on the potential of losses. Some financial derivatives structures carry these elements, but the same elements may also be present in other financial structures.

It can also be seen in transactions where there are no underlying assets but based purely on money lending and borrowing for the expectation of returns. It is value creation without the basis of actual goods being traded. Islamic financial institutions must ensure that the transactions, products design and stay away from elements that can be defined as gambling-related. Proper risk mitigation is needed to manage the potential losses from unnecessary chances taken.

d) Other Shariah Principles – Ethical, Fair and Just

As the alternative to traditional banking, the key proposition of Islamic Financial Institutions is to offer products and services that are ethical, fair and just to customers. The first step is to ensure the Islamic Financial Institutions are transparent in all dealings to customers. Customers must be made to understand the contracts they are entering into and their responsibilities as a party to the contract. More importantly, Islamic Financial Institutions must ensure that practices such as penalties[7], legal terms, indemnities, and default clauses should embed the ethical, fair and just contents.

Also included is the principle of fairness where Islamic Financial Institutions are prohibited from earning excessive profits that do not reflect the level of risks undertaken by Islamic Financial Institutions. Islamic principles encourage the taking and sharing of risks for economic returns that commensurate with the risks that Islamic Financial Institutions are willing to bear based on the contracts entered in. An Islamic Financial Institution is prohibited to earn a significant return from a customer when all the risks for the contract are solely borne by the customer.

It is equally important that Islamic Financial Institutions' earnings be based on actual activity evidenced by efforts and justifiable costs. This protects the consumer from excessive and arbitrary charges, fees or penalties which can be construed as the prohibitive *"Riba"*. For example, the services of printing financial statements may only incur costs relating to paper, ink and minimal effort and thus, any charge of such printing services can only be justified according to the actual effort. The element of fairness demands that income is justified by the efforts undertaken to earn that income.

[7] *The penalties generally practiced by Islamic Financial Institutions involve financing arrangement where customers do not adhere to agreed arrangements resulting in a breach in promise or actual loss to the Islamic Financial Institution. Penalties imposed are usually viewed as a preventative measure rather than punitive, to ensure discipline in the financial arrangement is maintained. Examples of approved penalties include late payment charges to deter customers from deferring payments, break funding penalties where Islamic Financial Institutions have committed certain funds for a certain period and costs but the customer has backed-out of the arrangement, or failure for the customer to meet certain pre-agreed arrangements. Treatment for the penalties varies from entities to entities, depending on the final deliberations and approvals of the Shariah Advisors.*

Consideration is also given to Urf (common practice) on the levels of earnings that are acceptable by the Islamic financial industry. There could be certain types of earnings that seem excessive but are commonly acceptable. An example would be the treatment of bank guarantee where guarantee fees charged by an Islamic Financial Institution may not be reflective of the work involved in the issuance of the bank guarantee. However, the Urf for charging the fees reflects similarly to the charges commonly imposed and accepted by the industry benchmarked by the fees charged by conventional banking institutions. The main consideration by Shariah is that earnings must reflect the risks taken by the various parties and equally reflect the level of risks. This ensures an ethical and just treatment by Islamic Financial Institutions towards the public.

8.2 Contractual Relationship

Another fundamental difference is the existence of defined contractual relationships that are embedded into each Islamic contract. Relationships are important for Islamic products and services as roles and responsibilities for all transacting parties must be clearly defined to avoid confusion, uncertainties and disputes. It goes beyond the simple lender-borrower relationship typically seen in a conventional bank, where it may not necessarily be just about profit from "debt". Profit can be derived from various means such as trading, leasing or provision of services.

a. Relationship in Contracts

There are many types of contracts used in Islamic banking transactions, and they closely resemble trading and exchange activities where the contracting parties have very defined relationships. For example, some of the relationships in Islamic contracts are as follows:

i. *Murabahah* (Sale of Goods at Profit) – Relationship: Buyer & Seller,
ii. *Istisna'* (Construction Sale) – Relationship: Buyer, Seller & Developer
iii. *Kafalah* (Guarantee) – Relationship: Guarantee and Guarantor,
iv. *Wa'd* (Promise to transact) – Relationship: Promissee & Promissor
v. *Al Ijarah Thumma Al Bai* (Hire Purchase) – Relationship: Lessee & Lessor / Buyer & Seller,
vi. *Bai Al Sarf* (Exchange of Currencies) – Relationship: Buyer & Seller
vii. *Tawarruq* (Monetisation via Commodity Sale) – Relationship: Buyer & Seller
viii. *Qard* (Loan) – Relationship: Lender & Borrower
ix. *Mudarabah* (Profit Loss Sharing Venture) – Relationship: Funder & Manager/ Entrepreneur
x. *Musharakah* (Partnership) – Relationship: Equity Partners

Additionally, it is common to have a hybrid mix of Islamic contracts or a linkage between multiple Islamic contracts, and each of the contract outlines a specific relationship, either interlinked or standalone depending on the Shariah requirement. For example, the *Musharakah Mutanaqisah* (Diminishing Partnership) contract introduced in Malaysia is an amalgamation of multiple contracts such as *Musharakah* (Partnership), *Wa'd* (Promise), *Ijarah* (Leasing), *Wakalah* (Agency) and even *Istisna'* (Construction); each of these contracts is either linked to one another or can stand on its own. To avoid confusion of all the interlinked contracts, transparency and full disclosure of terms and conditions must be provided lucidly to ensure the customers are fully aware of their roles and responsibilities in each contract.

b. Components and Tenets in Contracts

Another difference between Islamic structures compared to conventional offerings is the need to fullfil the requirements of Shariah in terms of the underlying tenets in a contract. Tenet refers to basic elements that must be present to ensure the validity of a contract. For example, in a sale transaction there must be an actual asset or goods to be traded as trading of a non-existing asset or goods is impermissable. The asset or goods must be real, have value, be tradeable and transferable. It must become one of the logical tenets to ensure the sale is valid.

Murabahah	*Ijarah*	*Istisna'*
1. Buyer	1. Lessor	1. Buyer
2. Seller	2. Lessee	2. Seller
3. Price	3. Rental	3. Price
4. Asset	4. Asset	4. Asset Specifications
5. Offer Acceptance	5. Usufruct	5. Delivery Terms
	6. Offer Acceptance	6. Offer Acceptance

Table 1: Examples of Tenets in an Islamic Contract

c. Sanctity of contract

Much like what is seen in judicial courts, the validity and enforceability of a contract becomes the basis of all transactional relationships. If the validity of a contract cannot be relied upon, the impact on the transaction and its resolution becomes ungoverned and unlawful. For the customer, the transaction may result in customers paying for more than what they agreed. For the Islamic Financial Institutions, a defective contract represents risks on their capital, business and reputation. For the Shariah community, a problematic contract results in a loss of trust for Islamic Banking business and operations.

Therefore, Shariah puts a lot of concern to the sanctity of a contract to allow for a business endeavour to be executed with certainty and fairness. As such, contracts will only be valid when:

i. The objectives of the contracts are made known to all parties
ii. The terms and conditions are defined without any ambiguity
iii. The relationship(s) of the contracting parties are outlined
iv. The roles and responsibilities are clearly highlighted
v. The tenets of the contracts are present and comply with Shariah requirements
vi. The contract is entered without duress or under fraudulent circumstances
vii. The transaction does not give rise to any prohibited practices or outcomes
viii. The Aqad (offer and acceptance) is codified in either writing or other acceptable means by all parties, accepting the validity of the contract

The above is largely consistent with the applicability of contracts in a conventional judicial court but more emphasis is placed on the requirements of Shariah based on established Islamic laws.

8.3 Prohibited Business Activities & Products

A key differentiator of Islamic Financial Institutions is the type of businesses in which institutions are allowed to be involved. Similar to the traditional financial intermediaries, Islamic Financial Institutions should not be involved in, support or fund any illegal business activities or transactions. Additionally, Islamic Financial Institutions should not be involved in, support or fund any prohibited or Shariah non-compliance business activities or transactions.

There are many variations of prohibited business activities or transactions, maintained by various organisations from different Shariah considerations, and they generally cover the:

a. Business activities
b. Goods & services traded
c. Financial ratios

8.3.1 Business Activities

The basic rule about the involvement of Islamic Financial Institutions in the market and industry is that *"what is not prohibited, is permissible"*. With this guidance, Shariah scholars had clearly defined the activities that is prohibited for reference of practitioners. In general, Islamic Financial Institutions agree on a broad scope of businesses that is prohibited, including (but not limited to) the following:

i. Conventional banking activities
ii. Conventional insurance activities
iii. Gambling and gambling-related activities
iv. Liquor and liquor-related activities
v. Pork, pork-products and pork-related activities
vi. Non-Halal food and beverages
vii. Shariah non-compliant entertainment centres and activities
viii. Tobacco and tobacco-related products and activities
ix. Interest income from conventional accounts and instruments
x. Dividends from Shariah non-compliant investments
xi. Other activities deemed non-compliant to Shariah

The above listing of activities is not extensive but generally strictly prohibited by Shariah and avoided by Islamic financial institutions. However, it is worth noting that some Islamic Financial Institutions do consider dealing with these businesses with the consideration that the prohibited income contribution is insignificant as compared to the overall earnings of the business. This is based on the view that the nature of businesses in the modern world could not avoid getting involved in non-Shariah compliant elements or could not identify which elements are prohibited.

Some scholars agree on a certain benchmark for the earnings contribution deemed as insignificant to be not classified as involved in activities non-compliant to Shariah. The degree of benchmark differs from one Shariah advisor to another but the overall objective is to safeguard the minimum requirements of Shariah. For example, in a business that offers goods that are *halal* and *non-halal*, if the income proportion of the non-halal goods is 4% of the total income of the business, Shariah scholars may have a view that the income of the 4% is permissible (deemed as insignificant on the benchmark) or be given as charity or donation (cleansing of the income).

Good guidance on the benchmark used to determine whether the business is Shariah-compliant or otherwise can be found from Malaysia's Securities Commission periodic publications[8], which defines which securities in Malaysia is deemed as Shariah-compliant. For companies with the above business activities, the Securities Commission will only accept companies where the contribution to the group/company's profit before taxation does not exceed the five-percent (5%) benchmark for the group/company to remain listed as Shariah-compliant entities.

The Securities Commission goes on further to outline another category of income that is considered less Shariah non-compliant. A twenty-percent (20%) benchmark is applicable if the business activities are as follows:

i. Share trading
ii. Stockbroking business
iii. Rental received from Shariah non-compliant activities

There are also prohibitions on scope of activities that an Islamic Financial Institution is allowed to do, involving the capital markets and treasury activities. Products such as derivatives and money market instruments may have elements that may result in the institutions being involved in Shariah non-compliant activities. Careful review of structures by Shariah Advisors is greatly encouraged.

8.3.2 Goods and Services Traded

A business involved in trading of consumer goods is generally deemed Shariah-compliant as it engages in the buying and selling of consumer goods. However, closer examination of the business activities, may identify further the types of goods involved in the buying and selling activities. There may be instances where traded goods fall into non-permissable category of goods. The list[9] of goods is quite comprehensive on types and the derivation of goods.

For example, a trading company that trades in food items may outright not be deemed as dealing in prohibited goods if there is no trading of pork, pork-products and pork related activities. However, there are many derivation of prohibited goods related to specific prohibited goods such as live swine, meat of swine (fresh, chilled or frozen), pig fat free of meat, ham, shoulder and cuts, bones, pork bellies, bacon, salted pork, pig bristles and hair, lard, swine raw hides and skins. The specific goods may be a small portion of the business; and so, care must be given when financing specific types of goods especially in a trade financing transaction.

It is the responsibility of the Islamic Financial Institution to ensure that the goods purchased, sold or transacted are not prohibited as the income derived from such prohibited goods will be deemed illegal and the transaction invalid. The subject matter for a transaction is crucial as the test to validate the transaction is not a fabrication or a trick (*hilah*).

[8]Benchmark outlined in "List of Shariah-Compliant Securities by the Shariah Advisory Council of the Securities Commission Malaysia". The listing is published every half-yearly in May and November each year.
[9]The Guidelines on Accepted Bills-i were issued by BNM. Table A – Listed Goods under AB-I transactions in the guidelines outlines the types of prohibited goods and their derivation which are avoided by Islamic Financial Institutions.

8.3.3 Shariah Compliance Financial Ratio Benchmark

Other than setting a benchmark on the percentage of income for Shariah Non-Compliant income, financial ratios assess the involvement of a company in Non-Shariah compliant financial activities as well. The common areas where concerns are normally raised include how big is the proportion of Non-Shariah compliant borrowing a company have in their balance sheet. Companies can still be deemed as Shariah Compliant if the amount of either cash or debt over total assets is within a certain limit.

Referencing to the criteria outlined by Malaysia's Securities Commission in its periodic publication[10], the financial ratio benchmark are determined by the following:

a. Cash over total assets – the deposits placed with conventional financial institutions must not be more than 33% of the overall financial position of the entity.
b. Debt over total assets – the debts taken under interest bearing facilities must not be more than 33% of the overall financial position of the entity.

As a source of reference, the Financial Ratio Benchmark is outlined by the Securities Commission general screening methodology in determining the Shariah-compliant nature is to assess the financial ratios according to the following:

Benchmark Criteria	Ratio
Business Activity Benchmark	<5% Non Shariah Income/Activities Benchmark in: i. Conventional banking ii. Conventional insurance iii. Gambling iv. Liquor and liquor-related activities v. Pork and pork-related activities vi. Non-Halal food and beverages vii. Shariah non-compliant entertainment viii. Interest income from conventional accounts and instruments ix. Tobacco and tobacco-related activities. <20% Non Shariah Income/Activities Benchmark in: x. Hotel and resort operations xi. Share trading. xii. Stockbroking business xiii. Rental Received from Shariah non-compliant activities xiv. Other activities deemed non-compliant according to Shariah.
Financial Ratio Benchmarks	Cash over Total Assets. Cash placements in conventional banking and instruments do not exceed 33% of the total assets Debt over Total Assets. Debts that are interest bearing debt do not exceed 33% of the total debts.

Table 2: Benchmark for Shariah Compliant Securities

[10] Benchmark outlined in "List of Shariah-Compliant Securities by the Shariah Advisory Council of the Securities Commission Malaysia". The listing is published every half-yearly in May and November each year

8.4 Underlying Transactions

One of the overarching requirements of Islamic Finance is that income and profit creation must be crystalised via an economic transaction. This is the evidence to demonstrate Islamic Finance is directly involved in the economy. Under a conventional banking structure, the main activity of the bank is money lending, where the subject matter is money or cash. To create earnings, the amount of actual money is given an interest. Interest is created or charged based on events, passage of time and changes in terms. If there are any assets or goods involved in the money lending structure, it will be likely taken as a collateral to secure the whole loan rather than as an underlying asset in a transaction.

For Islamic structures, there is clear differentiation when it comes to financial products that rely on certain contracts and services offered. Each financial product requires clear identification of the relevant Shariah contract e.g. *Murabahah, Tawarruq* or *Ijarah*. As mentioned earlier, each Shariah contract has specific tenets that are required to ensure the validity of the contract, which may include certain transactions to be completed. For the transactions to be valid, a subject matter must be present to allow for the completion of the *Aqad* (formalisation of Offer and Acceptance). The requirement to have an underlying asset remains one of the main considerations in an Islamic Banking transaction.

Underlying Asset	Conventional Banking	Islamic Banking
Required for Aqad for Transaction	No	Yes. Asset may be used as a subject matter in an economic transaction.
Required for Collateral Booking	Yes. Asset is taken as Collateral for the loan.	Yes. Asset is taken as Collateral for the financing.

Table 3: Status of Underlying Asset

8.5 Shariah Oversight

The oversight function of Shariah advisors is one of the defining differences on what an Islamic Financial Institution has to offer. The function of the Shariah advisors is to oversee the design, development, launch and implementation of the products and services as approved by the Shariah advisors. There is a significant responsibility placed on the shoulders of the Shariah Advisors in ensuring the products, processes, operations and functions within an Islamic financial institution meet the requirements of the Shariah and implemented consistently across the various departments within the Islamic Financial Institution.

In the conventional world, there is no involvement from any external parties on the day to day operations of the bank except by regulators for example, the Central Bank of Malaysia. For Islamic financial institutions, Shariah advisors have the authority to oversee the operations of Islamic Financial Institutions and intervene if necessary, to ensure the rules of Shariah are met.

Shariah advisors are responsible to escalate issues or business practices that do not meet the requirements of the Shariah. If a Shariah issue is not satisfactorily resolved or addressed, the Shariah Advisors must be allowed access all the way to the Islamic Financial Institution's Board of Directors (BOD) for further deliberation and resolution.

The Shariah advisors must also remain independent throughout the process. There should not be any undue influence or blockage from the Islamic Financial Institution's Senior Management or BOD on matters of Non-Shariah compliance.

For Shariah Advisors to have sufficient oversight on the operations of a Islamic Financial Institution in ensuring compliance to Shariah requirements, the Shariah Advisors must be allowed the following:

a. Understanding internal processes and controls

Shariah Advisors have the authority to seek understanding of internal processes and operational controls to gain assurance that the requirements of Shariah is practiced and implemented sufficiently in the Islamic financial institution. With sufficient understanding of how Islamic Financial Institutions work, the Shariah advisors are able to make right decisions and recommend suitable actions to be implemented.

b. Commitment from Senior Management

Shariah Advisors must obtain continuous support and commitment from senior management of the Islamic Financial Institution to meet Shariah requirements in all its day to day functions. Frequently, there are conflicts between a Shariah Advisor's decision with the senior management's views on certain aspects of the business requirements. The commitment to meet Shariah requirements remains crucial as the business tries to grow.

9.0 DIFFERENCES IN THE AREAS OF TAKAFUL

Takaful, which comes from the Arabic root kafala, which means "guarantee" or "mutually guaranteeing" has long been the insurance companies equivalent in the conventional space. While insurance is the surety of a payout in the turn of events, *Takaful* indicates a mutual or joint guarantee coming from a group of people. it is a common pool of funds that members contribute in order to share a certain risk and to help each other (not to make profit).

In essence, there are fundamental differences between *Takaful* (Mutual Assistance) and conventional insurance especially how Takaful is organised. *Takaful* is organised based on the concept of mutual assistance which means under *Takaful*, a group of "contributors" pool their funds together to invest and protect each other. In events such as death and permanent disabilities, Takaful utilises the contribution received from their investors to help the needy.

Among the common understanding of the difference between *Takaful* and conventional insurance can be seen in the operating module, where the key understanding is that *Takaful* works more as an investment entity where the returns are monies to be re-distributed to the contributors in times of need. A summary of the normal *Takaful* structure in the market sees the Islamic Financial intermediary working more as an investment company with the objective of building the funds for profit and protection.

Some of the differences in the *Takaful* structure are as follows:

9.1 Cooperative risk sharing

- Essentially in conventional insurance, the customer is asking the insurance company to accept the complete risk of the customer. By accepting the offer, the risk is transferred from one party to another, where it is ultimately aimed to benefit the customer.
- With *Takaful*, risk is shared among the members of the fund. For example, if an event occurs that causes harm or damage to one member, all members bear the brunt of that event and contribute to overcoming it (members cooperate based on equality, solidarity, social responsibility and honesty).

9.2 Mutual Protection

- This principle has been practiced at least since the time of the Prophet Muhammad (pbuh) Historically in ancient tribes, the tribes created a blood money system that offered such protection to every tribe member.
- Each member participates in protecting all the other members against loss or damage. This is a typical *Takaful* function in Islamic banking, and similar to conventional insurance.

9.3 Solidarity among participants

- People who choose to contribute to a Takaful fund share common interests. There is intrinsic desires and ambition to protect themselves and all other members from harm deriving from loss or damages.
- This instils a sense of being part of the community by sharing common responsibilities i.e the allevation of suffering via mutual assistance and sharing of risks.

9.4 Parties in a Takaful Business

i. Stockholders (shareholders)

- Stockholders are the owners of Takaful business enterprise by investing equity into the business. The shareholder's intention is to run the business requiring management and administration, marketing and managing operating expenses, incurred usually at the time of startup and for the ongoing-concern of the business.
- Stockholders are paid explicit fees on an ongoing basis and receive a cut of the company's profit consistently.

ii. *Takaful* Operator

- *Takaful* operator manages the fund similar to how a fund manager manages the portfolio of its shares. *Takaful* operator's primary job is to manage policyholders' fund.
- In conventional insurance, members or policyholders do not participate in an insurance fund, an insurance company's primary work is to invest premiums, investigate claims, determine appropriate pay outs and maximise profits.

iii. Shariah Advisors

- Shariah Advisors make sure the company is making Shariah-compliant investments, approve new products and also determine whether the business activities are Shariah-compliant.

iv. Policyholders (*takaful* fund contributors)

- Policyholders have the right to receive a share of any surplus funds that exists at the end of financial year.
- Company determines the surplus amount after paying all its expenses and distributing profits to the stockholders.
- If a deficit occurs, the stockholders of the fund alleviate the deficit by offering the fund an interest-free loan. In the following year, the fund is expected to pay back this loan and deduct the amount from any surplus it has in that financial year. If there is a deficit for two or more years in a row, contributors should expect their contributions amount to increase in subsequent years.

9.5 Features of Takaful

i. A *Takaful* company exists for reasons other than to maximise profit for its stockholders

- In conventional insurance, the insurance company's primary goal is to maximise profits.
- Instead the *Takaful* company focuses on helping its member mitigate their risks, thereby potentially reducing the risk facing any one individual member.

ii. *Takaful* stockholders are paid fees in addition to sharing profits

- Investors in conventional insurance companies receive dividends, Takaful stockholders are paid a fee from the fund, in addition to getting a share of any profit.
- This explicit fee covers the setup costs as well as the operating expenses and investments related expense that the stockholders provide on an ongoing basis.

iii. *Takaful* companies must make Shariah compliant investments

- The funds in a Takaful company need to be invested in Shariah compliant assets via Shariah compliant investment options, including equity funds and sukuk (the Islamic alternative to conventional bonds).

iv. Takaful companies are governed by Shariah advisors

- A Takaful company must have a Shariah advisor that supervises company operations and approves new product developments.
- There are significant ways in which Takaful products meet Shariah compliance, such as:

  a. Policyholders join the pool and cooperate among themselves for their common good (mutual assistance).
  b. Policyholders do not financially benefit from other policyholders' money.
  c. When a Takaful company invests any of the funds it collects from its policyholders, it selects only Shariah-compliant investment vehicles.

SUMMARY

- Islamic Financial Institutions differentiate themselves from the practices of conventional banks by adhering to the guidance provided by Shariah, especially in the prohibition on Usury, Uncertainty, Gambling and other prohibited goods and business activities. By avoiding the prohibited elements, the Islamic transaction will be acceptable.

- Once the prohibited items are avoided, the next requirement is to fulfil the Aqad requirements. Each contract has its tenets and strict adherence is expected from the Islamic financial institutions to ensure all the tenets are fulfilled and the contract is valid. Some transactions by Islamic financial instituions must involve an underlying asset to complete the Aqad. For example, for a sale transaction without asset, the transaction and its corresponding profit may not be recognised as a valid income for the Islamic Financial Institutions. The requirements must be met, and Shariah Advisors hold a significant responsibility in ensuring the Shariah requirements are met.

- The role and responsibilities of Shariah Advisors are also discussed in this chapter where Shariah Advisors have to ensure compliance to the policy documents, and the Central Bank's expectations of how an Islamic Bank should operate.

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CHAPTER 2

MALAYSIA'S JOURNAL ON ISLAMIC FINANCE

MALAYSIA'S JOURNEY ON ISLAMIC FINANCE

LEARNING OBJECTIVES

The chapter aims to:

i. Provide understanding of Malaysia's journey on Islamic finance from 1963 to 2015
ii. Provide understanding on the impetus of developing Islamic finance in Malaysia

Malaysia started its journey way back in the 1960s immediately after obtaining independence from Great Britain in 1957 to rebuild and develop the Islamic finance industry. The Islamic finance industry in Malaysia was introduced purely from a developmental agenda perspective where at a time of adverse political and economic environment, the Malaysian Government boldly decided to build it. After more than 50 years, we are now seeing the regulatory, legal and legislative model established in Malaysia being used as a universal model for the industry and is emulated by many jurisdictions all over the world.

It is crucial to understand the origin of Islamic finance in order to appreciate the historic development and achievements of Islamic finance in Malaysia. Islamic finance is a comprehensive financial system that adheres to the principles provided under the Quran, the Sunnah and Hadith, known as Shariah.

Islamic finance was the financial system of the known world of Islam such as under the reign of the Muawiyad and the Abbasid Empires (661 to 850), Andalusia (1031), Granada (1492), the Malacca Sultanate (1511) and the Ottoman empire (1918).

When Malaysia declared its independence from the Great Britain in 1957, the country's population was segregated from an economic wealth perspective. The Malay Muslims were found to be primarily poor and economically challenged. This was mainly due to the fact that a majority of Malay Muslims could not and would not participate in the conventional financial system based on their religious belief. Many were unbanked and kept their money at home. Some saved their monies in the post office or banks but were reluctant to receive any returns in the form of interest. This resulted in a stagnant wealth and economy.

A solution to resolve the situation was vital and it was found that an Islamic finance industry could be the answer. The Malaysian Government quickly moved this agenda forward as it was imperative to the future growth of Malaysia.

The beginning of Islamic finance in Malaysia started in 1963 when Tabung Haji or the Pilgrimage Fund was founded. For the first time, the Malay Muslims could save their money in a formal Islamic finance institution and enjoy good returns on their investments. This has resulted in billions of ringgit being pumped into the formal economy rather than being kept at home and many Malay Muslims participated in the nation's economic activities. However, the newer generation of Malay Muslims needed a much more sophisticated financial market. Tabung Haji was merely a savings institution for hajj purpose and accordingly, was not able to provide such sophistication.

A comprehensive financial market that adheres to Shariah but within the nation's financial market framework is crucial in order to provide the Malay Muslims full access to financing, investment opportunities and appropriate financial advice. It is imperative for Islamic finance and conventional finance to co-exist in Malaysia given the mixture of religious believes and practices of its population.

The Islamic Banking Act was finally enacted in 1983 which saw the immediate establishment of the country's first Islamic bank – Bank Islam. It was then followed by the enactment of the 1984 Takaful Act and establishment of the country's first takaful company – Syarikat Takaful Malaysia in the same year. In virtue of this, the Malay Muslims were able to obtain various financial solutions that are Shariah compliant for both personal and business such as home financing, car financing, personal financing as well as 'insurance coverage'.

After 10 years into its journey in Islamic finance, the Malaysian Government realised that Islamic finance not only can co-exist with conventional finance but could be part of the broader financial system. Islamic finance also became increasingly popular with the non-Muslim customers and has resulted in the introduction of the Islamic Banking Window Scheme or *Skim Perbankan Tanpa Faedah* in 1993 through the amendments to the Banking and Financial Institutions Act 1989. Such a scheme allows all conventional banks to offer Islamic financial products and services where the Islamic finance business operates as a "bank within a bank" and maintain separate financial statements to ensure segregation of the two businesses.

The introduction of the Islamic Banking Window Scheme has enabled the existence of an Islamic inter-bank money market and Islamic financial institutions were able to gain a bigger market share from 1% in the first 10 years of the introduction of Islamic finance in Malaysia to approximately 6% after 1 year of the introduction of the scheme. This has brought about the need for more competent Islamic bankers which was facilitated through the establishment of BIMB Islamic Banking Research and Training Institute (now known as the Islamic Banking and Finance Institute of Malaysia or IBFIM) in 1994.

As the Islamic finance industry grew during this period, there were concerns over the certainty of Shariah application within the industry as there are more players in the market. Accordingly, the National Syariah Advisory Council was established in 1997 in Bank Negara Malaysia (BNM) to ensure a more effective management of Shariah in the Islamic banking sector. A standard list of generic names for Islamic banking products using indicators of 'i' affixed at the end of the products or services was also introduced. This move further spurred the industry's growth with the increased demand for Islamic financial products and services in Malaysia. The second Islamic bank – Bank Muamalat Malaysia Berhad was formed in 1999.

In the pursuit of a greater development of the Islamic finance industry, the conventional banks with Islamic Banking Window Scheme were encouraged to establish standalone Islamic banking subsidiaries in line with the 10-year Financial Market Masterplan for the industry that was launched in 2001.

As Islamic banking and takaful proved to be an important component of the overall financial market in Malaysia, it was time for the Islamic capital market to be introduced in order to have a full spectrum of Islamic financial products and services.

With the enactment of the Government Investment Act 1983, the world's formal modern-day Islamic debt capital market was introduced where BNM issued the world's first Islamic treasury bill or sovereign sukuk. This was followed by Shell MDS – the Malaysian subsidiary of Shell who issued the world's first corporate sukuk of RM150 million. In the 1990s, the Islamic equity market commenced with the introduction of the world's first Islamic index by the Government. In 1992, Bank Islam became the first Islamic bank listed on the Malaysian stock exchange.

In the mid-2000s, as there were higher demand for Islamic finance, it was critical to ensure that Islamic finance activities have similar transaction costs as conventional finance activities in order to remain competitive and sustainable in the long run. A tax neutrality policy was announced which is a form of tax incentive whereby a relief is given to the tax charges that was supposed to be imposed on the Islamic financial transactions. This measure has promoted a level playing field between conventional and Islamic financial products[1].

[1] *MIA, 2012, Tax Treatment on Islamic Finance in Malaysia*

Since the introduction of Islamic finance in Malaysia in 1983, the Islamic banking assets in Malaysia has grown tremendously from RM370 million to RM535 billion in 2015.

Year	Total Assets (RM million)	Year	Total Assets (RM million)
1983	370	2007	157,158
1988	1,134	2008	192,810
1993	2,009	2009	233,656
1999	36,136	2010	267,631
2000	47,014	2011	328,649
2001	59,353	2012	375,954
2002	68,070	2013	433,563
2003	82,196	2014	487,158
2006	131,908	2015	535,368

Diagram 1: Malaysian Islamic Banking Sector Statistics
Source: Bank Negara Malaysia

In 2011, Malaysia became the largest sukuk issuer where it represents 69% of the world's sukuk issuance[2]. Sukuks outstripped conventional bonds with more than 50% share of total outstanding bonds in Malaysia. Malaysia is also home to the first and largest Islamic stock exchange in the world with more than 85% of companies listed on Bursa Malaysia being Shariah compliant.

The Islamic asset management industry has also seen exceptional development in the Malaysian market. Over the years, Islamic asset management has expanded from merely offering unit trust to include alternative investments such as private equity funds, property funds, infrastructure funds, hedge funds etc. As at end of 2015, out of 75 fund managers, there were 20 full-fledged Islamic fund managers and 27 operated Islamic windows with a combined Islamic asset under management (AUM) of RM132.4 billion out of RM667.9 billion. The share of Islamic unit trusts against total net asset value (NAV) of the unit trust industry was RM346.6 billion (15% of total NAV) in 2015. Similar to Islamic banking and takaful, the investors of Malaysia's Islamic unit trusts extend beyond the traditional base of Muslim investors where it was evidenced that participation of non-Muslim is in excess of 30% between 2010 and 2015[3].

Another milestone in the Islamic finance industry in Malaysia is the introduction of the Islamic Financial Services Act (IFSA) in 2013 where one of the objectives is to strengthen the regulatory framework for Islamic financial institutions. The Act provides a legal platform for the development of Islamic finance in Malaysia which is reflected upon a comprehensive regulatory framework on specificities of the various Islamic financial contracts and supports on the effective application of Shariah financial contracts in the offering of Islamic financial products and services.

[2] *Investvine, 2013, Asian demand to drive Qatar sukuk*
[3] *Securities Commission, 2017, Islamic Fund and Wealth Management Blueprint*

The Financial Services Act (FSA) was also issued at the same time. The issuance of both FSA and IFSA were to cater the growing market of the country's financial industry. The sophisticated Malaysian financial industry running both the conventional and Islamic finance in a parallel financial system called for a more stable regulatory framework. The new laws are envisioned to modernise the current conduct of and supervision of financial institutions in Malaysia[4].

After more than 50 years since it began in 1963, the Islamic finance industry in Malaysia has completed the full spectrum of a finance industry as it comprises the banking sector, interbank money market, debt and equity capital markets, asset management, takaful, other non-banking financial institutions as well as a derivatives market. Such success can be attributed to key factors which includes sound and effective legislative, regulatory, legal and shariah framework as well as a strong market infrastructure. Nevertheless, there is more to be done and Malaysia will continue to develop the Islamic finance industry beyond borders.

[4] *Ibid*

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CHAPTER 3

HISTORY OF FINANCIAL REPORTING FRAMEWORK IN MALAYSIA

HISTORY OF FINANCIAL REPORTING FRAMEWORK IN MALAYSIA

LEARNING OBJECTIVES

The chapter aims to:

i. explain the history of standard setting for financial reporting in Malaysia;
ii. explain the journey to adopt IFRS;
iii. explain key policy decisions taken by MASB regarding Islamic financial reporting; and
iv. explain the difference between IFRSs and AAOIFI

1.0 INTRODUCTION

Financial reporting is a formal record of transactions and activities of an entity and is often prepared in the form of financial statements. Financial statements provide financial information about the economic/financial impact of transactions or events to a wide range of users. A set of financial statements consists of a statement of financial position (also known as balance sheet), statement of profit or loss (also known as income statement), a statement of changes in equity, a cash flow statement as well as notes accompanying those statements.

The production of financial statements involves various activities such as:

a. Identifying the transactions/events to be recorded and/or to be derecognised;
b. To record, measure and classify/reclassify various transactions and events; and
c. To present financial information in a manner that presents a true and fair view of the financial position and financial performance of an entity.

An entity prepares financial statements based on generally accepted accounting framework so as to provide a wide range of users such as lenders, creditors, investors (existing and potential) with different interest, on the necessary financial information for them to make their economic decisions. One of the pertinent questions that this Chapter is trying to explore is whether there is merit for a religious-based accounting framework/standard to record Islamic financial transactions or events.

2.0 THE HISTORY OF STANDARD SETTING FOR FINANCIAL REPORTING IN MALAYSIA

The demand for financial reporting standards in Malaysia started way back before the establishment of the Malaysian Accounting Standards Board (MASB) in 1997. Such demand was triggered by the investors and other stakeholders such as lenders, suppliers, and customers who require reliable financial information to assist them in making economic decisions. The need for corporate information was then satisfied minimally by the introduction of the Companies Act 1965.

The Companies Act 1965 then established reporting requirements, rules and regulations on accounting, especially the requirements contained in the Ninth Schedule. At this point, the format and content of financial statements were not specifically prescribed by the Ninth Schedule.

The Companies Act 1965 was further amended in 1985 to incorporate a revised Ninth Schedule and to further strengthen the requirements on financial reporting, specifically to require financial statements to include a profit and loss account, a balance sheet, a statement of source and application of funds as well as notes to the accounts.

2.1 The Malaysian Institute of Certified Public Accountants

Slightly less than a year after Malaya gained its independence in 1957, a number of local accountants came together to establish the Malayan Association of Certified Public Accountants (MACPA) in 1958 and was subsequently renamed as the Malaysian Institute of Certified Public Accountants (MICPA). MICPA is an accountancy body that regulates the practices of its members. MICPA introduced its own examination system for those who want to be admitted as its member.

MICPA then issued the first accounting guidance in 1968 and included a specimen company accounts which was drawn up based on the requirements of the Ninth Schedule. In 1978, MICPA began adopting the International Accounting Standards (IASs) after being admitted as a member of the International Accounting Standards Committee (IASC). The first Malaysian Accounting Standard 1 *Earnings per Share* (MAS 1) was then issued in 1984.

2.2 The Malaysian Institute of Accountants

The Malaysian Institute of Accountants (MIA) was established in 1967 under the Accountants Act 1967. MIA was established as a body to maintain adequate control of the accountancy profession in the country and establish a register of qualified accountants. MIA continued to be inactive until 1987 where its operation was elevated to that of a national accountancy body.

The Councils of MICPA and MIA then decided to collaborate through having a joint secretariat. Their committees operated together, while all technical standards for the accountancy profession in the country were jointly developed and issued as joint statements. Following that, MIA and MICPA jointly issued MASs until the establishment of the MASB in 1997.

MIA continued to play a significant role in assisting MASB regarding the application of financial reporting standards through the establishment of the Financial Reporting Standards Implementation Committee (FRSIC). FRSIC's main mandate is to provide local implementation guidance to its members where there is a divergence or potential divergence in applying the requirements of the standards. The local implementation guidance documents issued by FRSIC are known as FRSIC Consensuses. In addition, FRSIC also issued Guidance on Special Matter as well as Frequently-Asked Questions (FAQs) for MIA members to refer as guidance.

Since its establishment in 2010, FRSIC had admitted and deliberated on 70 issues, issued 31 FRSIC Consensuses, 2 Guidance on Special Matter and 5 sets of FAQs, consisting of 50 questions on MFRS 9 *Financial Instruments,* MFRS 15 *Revenue from Contracts with Customers* and Malaysian Private Entities Reporting Standards (MPERS)[1].

[1]*Refer to: https://www.mia.org.my/v2/frsic/frsic.aspx*

2.3 The Malaysian Accounting Standards Board

In 1997, the Financial Reporting Act was introduced. The Financial Reporting Act 1997 establishes the following:

1. Financial Reporting Foundation (FRF), whose main function is to oversee the performance of the MASB; and
2. MASB as the standard-setting body of the FRF which carries the following main obligations:

    - To issue new accounting standards as approved accounting standards;
    - To issue, approve, review, amend, substitute, suspend, defer, withdraw or revoke any statement of principles, any technical and other releases relating to financial reporting;
    - To sponsor or undertake development of possible accounting standards; and
    - To monitor the operation of approved accounting standards to assess their continued relevance and their effectiveness.

Following the establishment of FRF and MASB, Companies Act 1965 was further amended to require companies to assert compliance with approved accounting standards as issued by the MASB, effective from 1 September 1998. Accordingly, companies in Malaysia are required to insert mandatory compliance with the approved accounting standards under the statue.

MASB had then adopted all the financial reporting standards that were previously issued by the MIA and MICPA and gave these standards the status of approved accounting standards. These standards were then renamed as MASB Standards.

1958	Establishment of MICPA (MACPA) as an accountancy body.
1965	Introduction of the Companies Act, including Ninth Schedule.
1967	Establishment of MIA to maintain adequate control of accountancy profession and establish a register of qualified accountants in Malaysia.
1968	• MICPA issued the first accounting guidance. • Included a specimen of company account.
1978	MICPA adopted IASs.
1984	The first Malaysian Accounting Standard 1 *Earnings* per Share (MAS 1) was issued.
1985	Amendments to Companies Act 1965 which requires financial statements to include profit or loss account, balance sheet, statement of source and application of funds and notes to account.
1987	MIA and MICPA jointly issued MASs accounting standards.
1997	• Establishment of FRF and MASB. • MASB adopted all accounting standards issued by MIA and MICPA and renamed it to MASB standards. • Amendments to Companies Act 1965 for companies to assert compliance to approved accounting standards

Diagram 1: The history of standard setting function in Malaysia

3.0 THE JOURNEY TO ADOPT IFRS IN MALAYSIA

3.1 Establishment of the International Accounting Standards Board

IASC was founded in 1973 by the professional accounting bodies of Australia, Canada, France, Germany, Japan, Mexico, Netherlands, United Kingdom/Ireland and the United States for cross-border listings[2]. The IASC established a Standing Interpretations Committee (SIC) in 1996 with the main objective to prepare interpretations of the IASs. IASC however, only opened its meeting for public observation in 1999.

In 2000, the IASC agreed to restructure itself into a full-time International Accounting Standards Board (IASB), where IASB then started to adopt IASC Standards in 2001. In 2003, IASB completed priority reforms for standards that they inherited or adopted from IASC in preparation for first-time adoption by major jurisdictions, following recommendation from G7 countries (Canada, France, Germany, Italy, Japan, United Kingdom and United States) and the International Organisation of Securities Commission (IOSCO) for internationally agreed accounting standards to strengthen the international financial system and cross-border listing. The first ever standard was issued in the same year by IASB, which was the IFRS 1 *First-time Adoption of International Financial Reporting Standards* in preparation for first-time adoption by major jurisdictions. Since then, IASB has performed intensive work to address various issues highlighted in IOSCO's 2000 Assessment Report, including convergence efforts with national standard setters around the world.

Finally, in 2005, IOSCO made an official statement to reaffirm its support for the development and use of IFRS as a set of high-quality international standards in cross-border offerings and listings[3].

4.0 MALAYSIA'S CONVERGENCE

As noted in an earlier section of this Chapter, Malaysia had adopted IASs as issued by the IASC and MASs as issued jointly by the MIA and MICPA. When MASB was created, the accounting standards were renamed as MASB Standards and these standards were in substance similar to the IASs, except for MASs as adopted.

In 2004, MASB initiated a broad strategic direction to align its accounting standards to those issued by the IASB and as a first step, the standards issued by MASB were renamed as the Financial Reporting Standards (FRSs) and renumbered to be in line with standards issued by IASB. In 2005 and 2007, the standards were revised to be virtually identical with IASB standards, except for the effective dates and some transitional provisions[4].

MASB officially announced the intention to bring Malaysia to full convergence with IFRS Standards in 2008, to join other jurisdictions around the world such as Australia, Hong Kong, Canada, New Zealand and South Africa. At that time, there were 22 IASB technical pronouncements that had yet to be adopted under the FRS Framework.

As part of the convergence effort, MASB introduced a new IFRS-compliant framework, which is the Malaysian Financial Reporting Framework (MFRS Framework) in November 2011. MFRS Framework is word-for-word IFRS[5] with effective date on 1 January 2012 for all entities except transitioning entities (TE)[6], which still applied FRS Framework until 1 January 2018.

[2]Information available at: https://www.ifrs.org/about-us/who-we-are/#history.
[3]Refer to: https://www.ifrs.org/-/media/feature/about-us/our-history/2005-iosco.pdf?la=en
[4]Refer to: http://masb.org.my/pages.php?id=229
[5]As MFRS are word-for-word IFRS, the reference made to IFRS are also applicable to MFRS.
[6]Transitioning entities are entities that are subject to the application of MFRS 141 Agriculture and/or IC Interpretation 15 Agreements for the Construction of Real Estate.

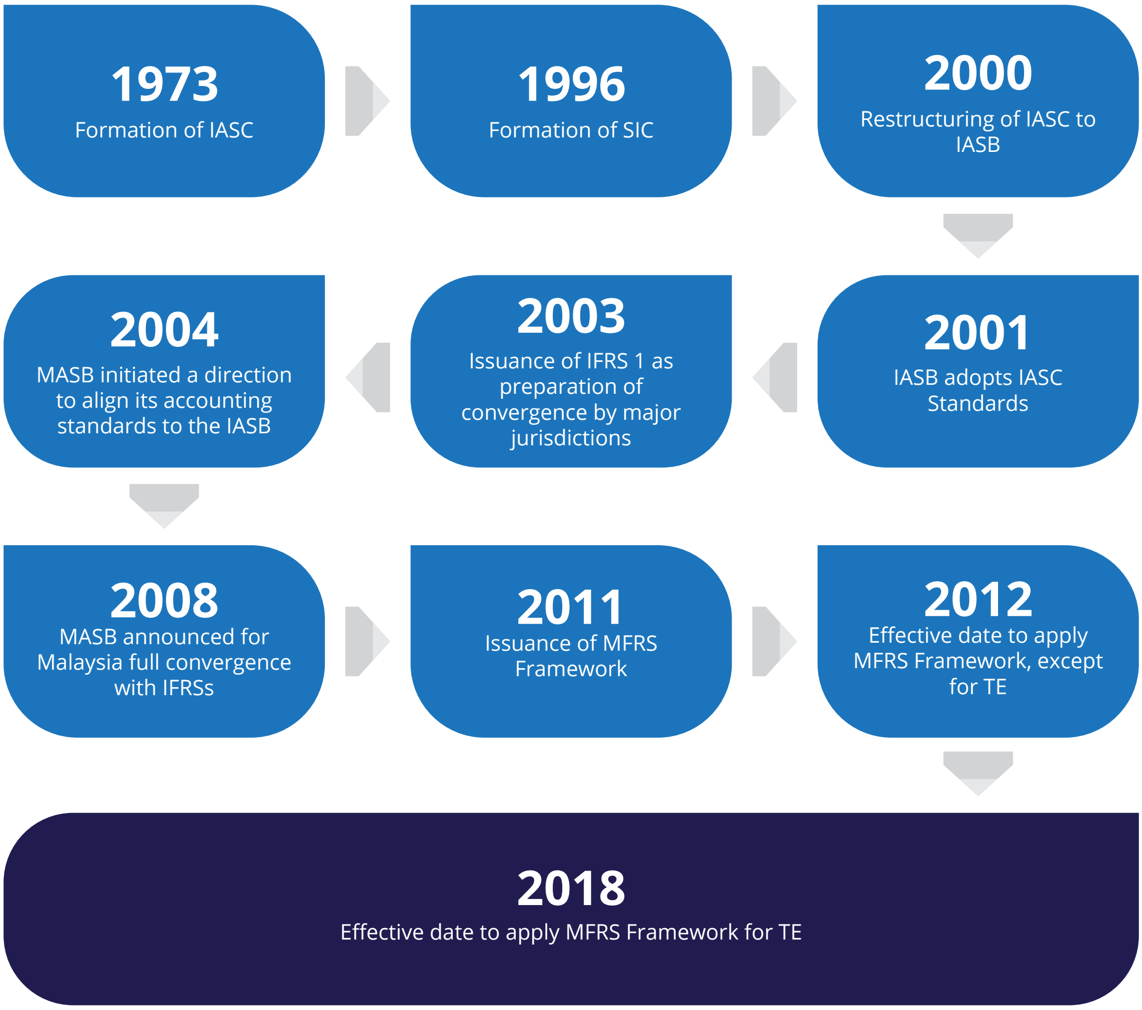

Diagram 2: Development of IFRS and MFRS

4.1 Financial reporting framework in Malaysia

Following the announcement by MASB's broad strategic direction to fully converge with IFRS, one of the convergence hurdles was on managing the issues faced by agriculture and real estate industries. As for the real estate industry, the main concern was whether applying the new framework and standards, particularly on IC Interpretation 15, would change the existing accounting policy under the local technical pronouncement, FRS 201_{2004} *Property Development Activities* while for the agriculture industry, the main concern was on the requirement for entities to use a fair value approach in measuring all types of biological assets. As a result, MASB introduced a "two-tier" financial reporting framework for entities other than private entities for application from 2012 to 2018.

While for private entities[7], MASB introduced the MPERS in February 2014 which is word-for-word the IFRS for *Small and Medium-Sized Entities* (IFRS for SMEs) issued by the IASB, except for the requirements in Section 34 *Specialised Activities* in relation to property development activities. MPERS is applicable for private entities for financial statements with annual periods beginning on or after 1 January 2016. Private entities in Malaysia also have an option to apply MFRS as their financial reporting framework. Prior to the application of MPERS, private entities in Malaysia had applied Private Entities Reporting Standards (PERS) which were developed based on the 2003 version of IFRSs/IASs.

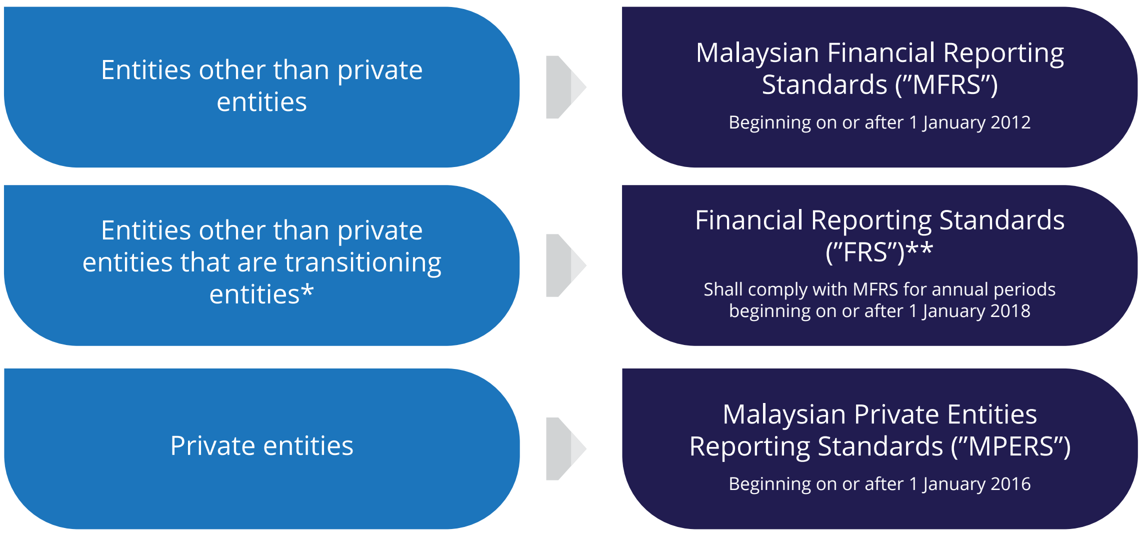

Diagram 3: Financial reporting framework in Malaysia

[7]A private entity is a private company as defined in Section 2 of Companies Act 2016 that itself is not required to prepare or lodge any financial statements under any law administered by the Securities Commission Malaysia or BNM; and is not a subsidiary or associate of, or jointly controlled by, an entity which is required to prepare or lodge any financial statements under any law administered by the Securities Commission Malaysia or BNM. Notwithstanding to that, a private company that is itself, or is a subsidiary or associate of, or jointly controlled by, an entity that is a management company as defined in section 2 of the Interest Schemes Act 2016 is not a private entity. Refer to: http://www.masb.org.my/pages.php?id=20

5.0 KEY ACCOUNTING POLICY DECISIONS BY MASB ON ISLAMIC FINANCIAL REPORTING

The MASB's initiative on Islamic financial reporting started since its establishment in 1997 with the initial thought or view to issue a separate and stand-alone set of Islamic standards to reflect and report on Islamic transactions and events. Based on that initial view, MASB issued MASB *i*-1 *Presentation of Financial Statements of Islamic Financial Institutions* (the Standard was then renamed as FRS *i*-1 following the convergence initiative).

Extensive research and consultation were conducted since then and it appeared that conventional accounting concepts and generally accepted accounting principles could also be applied to Islamic financial transactions and events. Following that, MASB decided to cease its policy of issuing Islamic accounting standards on Islamic financial transactions and focused on issuing other technical documents that discuss the application of MASB approved accounting standards to Islamic transactions or events.

The decision on the applicability of MASB approved accounting standards to Shariah compliant financial transactions and events was then reaffirmed through the issuance of Statement of Principles *i*-1 *Financial Reporting from an Islamic Perspective* (SOP *i*-1). The SOP *i*-1 states that the following factors had been considered by MASB in its assessment to derive to the stand that conventional accounting concepts and generally accepted accounting principles could also be applied to Islamic financial transactions and events:

a. Users and their information need.
b. Objective of financial statements.
c. The underlying assumptions and qualitative characteristics of financial statements.
d. The elements of financial statements and their recognition and measurement.
e. The concept of capital and capital maintenance.

From the assessment of the factors above, MASB then decided to apply the framework for Islamic reporting using the established principles in conventional accounting thought except for those that violate Shariah principles. This decision is consistent with Shariah legal maxim of "*permitted unless prohibited*".

MASB however, acknowledges that the conventional framework is lacking in dealing with the treatment of Shariah compliant financial transactions and events as well as on the display of information which are deemed important from an Islamic perspective. As such, MASB had decided to provide complementary guidance in compliance with Shariah precepts in addition to the conventional framework when there is a need to do so.

6.0 THE ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS AND ITS ROLE IN ISLAMIC FINANCE

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is a Bahrain non-profit organisation founded in 1991 with the main objective of the developing and issuancing of standards for the global Islamic finance industry. Consistent with this objective, AAOIFI has issued a total of 100 standards in the area of Shariah, accounting, auditing, ethics and governance for the use of Islamic financial institutions. The founding members of AAOIFI are the Islamic Development Bank, Dallah Al-Baraka, Faysal Group, Al-Rajhi Banking & Investment Corporation, Kuwait Finance House and Al-Bukhary Foundation.

As at the date this book is written, the countries and jurisdictions adopting AAOIFI standards (either in full, partially or as guidance) are as follows[8]:

	Country/Jurisdiction	Shariah standards	Accounting standards	Auditing, governance and ethics
1.	Afghanistan	√	√	√
2.	Bahrain	√	√	√
3.	Dubai International Financial Centre	√	x	√
4.	Iraq	√	√	x
5.	Islamic Development Bank Group	√	√	x
6.	Jordan	√	√	√
7.	Krygyz Republic	√	√	√
8.	Lebanon	√	√	x
9.	Libya	√	√	x
10.	Mauritius	√	√	x
11.	Nigeria	√	√	√
12.	Oman	√	√	√
13.	Palestine	√	√	x
14.	Pakistan	√	√	√
15.	Qatar	√	√	√
16.	Qatar International Financial Centre	√	√	√
17.	Sudan	√	√	√
18.	Syria	√	√	√
19.	United Arab Emirates	√	x	x
20.	Yemen	√	√	√

[8]*Refer to: http://aaoifi.com/adoption-of-aaoifi-standards/?lang=en*

7.0 DIFFERENCES BETWEEN AAOIFI ACCOUNTING FRAMEWORK AND MFRS/IFRS

The following table compares the differences between the financial reporting framework under AAOIFI and MFRS in order to give readers some overview of the differences:

<table>
<tr><th></th><th>MFRS/IFRS</th><th>AAOIFI</th></tr>
<tr><td>Objective of general purpose financial statements</td><td>To provide financial information about the reporting entity that is useful to existing and potential investors, lenders and other creditors in making decisions about providing resources to the entity.</td><td>To provide information:
i. On entity's compliance with Shariah and its objectives and to establish such compliance and information regarding the manner in which prohibited earnings and expenditures were recorded and dealt with.
ii. On entity's economic resources and related obligations and the effect of transactions, other events and circumstances on entity's resources and obligation.
iii. To assist in the determination of zakat.
iv. About entity's discharging of its fiduciary responsibilities.
v. About entity's discharging of its social responsibilities.</td></tr>
<tr><td>Qualitative characteristics of useful financial information</td><td>a. Fundamental characteristics
i. Relevance
ii. Materiality
iii. Faithful representation
b. Enhancing characteristics
i. Comparability
ii. Verifiability
iii. Timeliness
iv. Understandability
c. The cost constraint on useful financial reporting</td><td>i. High quality
ii. Relevance
iii. Reliability
iv. Comparability
v. Prudence
For preparation and presentation of accounting information:
i. Materiality
ii. Cost of information</td></tr>
<tr><td>Elements of financial statements</td><td>a. Asset
b. Liability
c. Equity
d. Income
e. Expense</td><td>a. Asset
b. Liability
c. Equity of investment accountholders
d. Owners' equity
e. Off-balance sheet items
f. Income
g. Expenses and losses
h. Return on investment accounts
i. Net income (net loss)</td></tr>
</table>

	MFRS/IFRS	AAOIFI
Recognition	• Only items that meet the definition of an asset, a liability or equity are recognised in the statement of financial position and items that meet the definition of income and expenses are recognised in the statement of financial performance. • An asset or liability is recognised only if recognition of that asset or liability and of any resulting income, expenses or changes in equity provides users of financial statements with information that is useful, i.e. with: a. Relevant information about the asset or liability and about any resulting income, expenses or changes in equity; and b. A faithful representation of the asset or liability and of any resulting income, expenses or changes in equity.	a. Asset and liability – when they satisfy certain criteria. b. Revenue – recognised when earned. c. Expense – occurrence either because the expense relates directly to the earning of revenues that have been realised and recognised or because it relates to a certain period covered by the income statement. d. Gains and losses – depend on the completion of reciprocal or a non-reciprocal transfer; and the availability of sufficient competent evidential matter indicating reasonably measureable appreciation or depreciation in the values of recorded assets or liabilities.
Measurement concepts	a. Historical cost b. Current value: • fair value • value in use and fulfilment value • current costs	a. Historical cost b. Fair value In addition, concept of accounting measurement also consists of measurement attributes and the matching concept.
Accounting assumptions	a. Unit of account b. Going concern assumption	a. Accounting unit concept b. Going concern concept

While most of the generally accepted accounting principles are welcomed by AAOIFI, the two contentious concerns are mainly on:

a. Substance over form

The Conceptual Framework for Financial Reporting of IFRSs[9] (the Conceptual Framework) considers the importance of substance over form in determining the accounting treatment of a transaction. This is emphasised in paragraph 4.59 of the Conceptual Framework where it states "*The terms of a contract create rights and obligations for an entity that is a party to that contract. To represent those rights and obligations faithfully, financial statements report their substance. In some cases, the substance of the rights and obligations is clear from the legal form of the contract. In other cases, the terms of the contract or a group or series of contracts require analysis to identify the substance of the rights and obligations.*" This guidance emphasises that an entity should account for a transaction or event so as to reflect its economic substance, regardless of its legal form.

Most of the Islamic financial transactions are built based on a series of closely inter-related component transactions. This is to ensure such transactions are Shariah compliant and accordingly, the income generated from such financial transactions are permissible (*halal*). For instance, the *Al-Ijarah Thumma Al-Bai'* (AITAB) financing is structured based on Islamic concepts of *ijarah* (lease) contract, *wa'd* (promise), *bai* (sale), *hibah* (gift), '*urbun* (earnest money) and others. The structure becomes more interesting as the Shariah requirements require two separate contracts to be entered on the sale and lease transactions and to be entered at a different time and sequence. Failure to observe the Shariah requirements would render the whole financing transaction as void and hence, the return is Shariah non-compliance.

Having said this, a faithful representation of the economic substance of AITAB financing may require all the contracts involved to be considered as a single transaction – a financing transaction to facilitate the acquisition of an asset by a customer. If the overall economic substance is ignored and the focus is solely on the legal form of the individual contracts in isolation, an entity would then record a lease transaction at the beginning and a sale transaction on expiry of the lease arrangement.

Interestingly, because the balance sheet and income statement of such transactions may be virtually indistinguishable from conventional loans, including the yield, there have been a proposal to create alternative recognition and measurement principles for Islamic transactions to differentiate them from conventional transactions. This approach is believed to be able to provide clarification of the contract used and making a distinction between the two.

The Conceptual Framework for Financial Reporting by Islamic Financial Institution published by the AAOIFI acknowledges the substance over form concept whereby it states: *'If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with its substance and economic reality as well as its legal form. Financial reporting involves consideration of the substance of an economic phenomenon as well as its legal form.'* However, AAOIFI did not put importance on one over the other but rather, the two are indeed relevant and have somewhat equal relevance. It was further explained that:

[9]*The Conceptual Framework for Financial Reporting 2018*

"The Shariah principles envisage that form is not devoid of substance and neither can override the other. Financial reporting thus should recognise the delicate balance that exists between the concepts of form and substance. There might indeed be circumstances where the legal form disregards substance in a court of law. There might also be circumstances where the Shariah scholars may view substance independent of form. In a transaction involving the transfer of a house, in certain jurisdictions, the registrar's records might indeed be the final proof of title of ownership. Shariah scholars might view the contracts entered into as proof of ownership disregarding the registrar's records. The concept of beneficial ownership is quite relevant too. It was also emphasised and deliberated by the Board members that the term substance should not be interpreted in the context of conventional standard, for instance as the term is being commonly interpreted for Ijarah transactions. Thus, basing an accounting policy or practice on purely legal form may indeed be misleading and may be insufficient."

In Malaysia, the concept of substance over form is welcomed by the Shariah Advisory Committee (SAC) of BNM, documented through BNM Shariah Resolutions in Islamic Finance[10]. In that document, SAC agreed that in principle, substance and form are equally important and highly taken into consideration by the Shariah. It was further explained that the Shariah emphasises that substance and form must be consistent and shall not contradict one another and in the event of inconsistency between the two due to certain factors, the Shariah places greater importance on substance rather than form. The basis of such a decision is as follows:

In current Islamic finance contexts, most of the underlying contracts in financial products, especially financing products, are contemporary contracts (`uqud mustajiddah). These new contracts contain collective elements derived from different traditional contracts (`uqud musammа) and the elements are binding on one another in a certain manner. The absence of any of the elements would curtail the objective of the contract. Independent reporting of a series of transactions involved in this new contemporary contract would raise ambiguity in the overall transactions. Therefore, there is a need to record the series of transactions involved in the new contract as one transaction only. This is based on the application of "substance over form" principle. The aforesaid consideration is also in line with the following fiqh maxim and the objective of the Shariah:

الأمور بمقاصدها	***"Matters are determined according to intentions"***
العبرة في العقود للمقاصد والمعاني لا للألفاظ والمباني	***"In contracts, effect is given to intention and meaning and neither words nor forms"***

[10]*Shariah Resolutions in Islamic Finance (2nd Edition) accessible at: http://www.bnm.gov.my/microsite/fs/sac/shariah_resolutions_2nd_edition_EN.pdf*

b. Time value of money

In the IFRSs world, the time value of money concept is explained as *'the element of interest that provides consideration for only the passage of time*[11]*.'* This is on the presumption that RM1 today has a higher value than RM1 in 5 years' time. In Malaysia, the time value of money concept is permissible and approved by the SAC of BNM. However, such concept is only permissible for exchange of contracts that involve deferred payment and is strictly prohibited in debt-based transaction (*qard*). This is based on the view by Al-Sarakhsi which states that '*certainly something which is deferred is lower in terms of value as compared to something which is on spot*.' It shows that the present time is higher in value as compared to the future and accordingly, pricing in deferred sale should be marked up so as to ensure justice to the contracting parties particularly the seller who has to sacrifice the present consumption of money as the payment is not made in cash.

However, the time value of money concept is not well accepted in AAOIFI as AAOIFI believes that money does not have a time-value. Accordingly, the pattern of profit recognition does not need to be related to the amount of principal outstanding[12]. This was stated in FAS (2) *Murabaha and Murabaha to the Purchase Orderer* where it states that for credit sale exceeding the current financial period, the preferred method is to recognise profit proportionate to the period of credit. Otherwise, the profit is to be recognised as and when instalments are received.

As such, a set of financial statements prepared under IFRS and AAOIFI can give a vastly different result from each other.

[11]Paragraph B4.1.9A of MFRS 9 Financial Instruments
[12]Refer to A Word about Islamic Finance: Part 1 (November 2012) available at: http://www.masb.org.my/pdf.php?pdf=A%20Word%20about%20Islamic%20Finance-Part%201%20Nov.pdf&file_path=pdf

8.0 OTHER CONSIDERATIONS

8.1 Bank Negara Malaysia (BNM)

In Malaysia, BNM plays an important role in shaping the financial reporting of Islamic financial institutions. First and foremost, BNM issues various policy documents to govern the Islamic finance products of the Islamic financial institutions. Islamic financial institutions are expected to follow and comply with such policy documents in structuring their financial products, which is then subjected to BNM's approval before it can be launched and offered in the market. As at the date this Chapter is written, BNM has issued policy documents on the following Islamic concepts[13]:

	Title of the policy document	Issuance date	Effective date
1.	Mudarabah	20 April 2015	1 June 2016*
2.	Musyarakah	20 April 2015	1 June 2016
3.	Murabahah	23 December 2013	1 January 2014
4.	Tawarruq	28 December 2018	28 December 2018
5.	Istisna'	23 December 2015	1 July 2016*
6.	Ijarah	29 June 2018	1 August 2018*
7.	Qard	26 February 2018	31 July 2018*
8.	Wakalah	24 June 2016	1 July 2018*
9.	Kafalah	13 April 2017	1 January 2018*
10.	Hibah	3 August 2016	31 July 2018*
11.	Wadiah	3 August 2016	31 July 2018*
12.	Wa'd	2 February 2017	1 January 2019
13.	Investment account	10 October 2017	14 March 2014*
14.	Bai' al-Sarf	11 April 2018	1 April 2019*
15.	Rahn	18 July 2018	1 August 2019*

**certain requirements need to be applied earlier*

The above policy documents issued by BNM govern the Shariah requirements and operational practices, including requirements that should be included in the terms and conditions/contracts when Islamic financial institutions plan to issue those products.

[13]*Refer to http://www.bnm.gov.my/index.php?ch=en_policy&pg=en_policy_banking*

Secondly, BNM also plays a role in issuing a financial reporting policy document for Islamic financial institutions. The policy document sets the minimum expectations for the application of the MFRS to an Islamic financial institution as well as to ensure adequate disclosures to better facilitate the assessment of an Islamic financial institution's financial position, performance and Shariah compliance. The policy document also emphasises that an Islamic financial institution shall prepare its financial statements in accordance with MFRS, subject to certain modification or exceptions. These modification or exceptions, however, will only become necessary in circumstances where alternative prudential measures would not be adequate to promote the financial resilience of the Islamic financial institution or address threats to financial stability[14]. The following are the policy documents issued by BNM with regard to financial reporting:

	Title of the policy document	Issuance date	Effective date
1.	Financial Reporting for Islamic Banking Institutions	2 February 2018	1 January 2018*
2.	Financial Reporting for Takaful Operators	2 February 2018	1 January 2018*

**certain requirements need to be applied earlier/later*

8.2 Securities Commission of Malaysia

Securities Commission (SC) of Malaysia was established on 1 March 1993 under the Securities Commission Act 1993 (SCA). The SC has a direct responsibility for rule-making, enforcing regulations pertaining to the capital market, ensuring sustainable market growth and development, supervising capital market activities and market institutions including the exchanges, clearing houses and registered market operators, and regulating all entities and persons licensed under the Capital Markets and Services Act 2007[15].

The SC has also established a dedicated Islamic Capital Market Department (ICMD) to carry out research and development activities including formulating and facilitating a long-term plan to further strengthen the Islamic capital market in Malaysia. Similar to BNM, SC also issued Resolutions of the Securities Commission Shariah Advisory Council with regard to Islamic financial transactions.

However, unlike BNM, SC does not issue specific guidelines with regard to financial reporting for Islamic capital market players. However, SC does issue certain parameters and guidelines which are relevant to Islamic capital market such as Shariah Parameters on Islamic Exchange-Traded Fund based on Gold and Silver and Guidelines on the Offerings of Asset-Backed Securities.

[14]Paragraphs 1.2 and 1.3 of BNM Policy Document on Financial Reporting for Islamic Banking Institutions, accessible at: http://www.bnm.gov.my/index.php?ch=57&pg=137&ac=28&bb=file and BNM Policy Document on Financial Reporting for Takaful operators, accessible at: http://www.bnm.gov.my/index.php?ch=57&pg=140&ac=97&bb=file
[15]Refer to: https://www.sc.com.my/about/about-the-sc

SUMMARY

- This chapter provides readers an understanding of the development of financial reporting standards internationally and in Malaysia.
- In addition, readers are given an understanding of key policy decisions taken by MASB in deciding the financial reporting framework applicable to Islamic financial transactions in Malaysia.
- This chapter also provides readers with an understanding on the roles of other regulators in shaping the Islamic financial landscape in Malaysia.

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CHAPTER 4

UNDERSTANDING THE FINANCIAL STATEMENT OF ISLAMIC BANKS

UNDERSTANDING THE FINANCIAL STATEMENTS OF ISLAMIC BANKS

LEARNING OBJECTIVES

The chapter aims to:

i. provide understanding of the general differences in the financial statements between banks and other businesses;
ii. provide understanding of the general differences in the financial statements between Islamic and conventional banks;
iii. provide an overview of presentation and disclosures of Islamic banks;
iv. and provide an overview of major accounting standards impacting Islamic banks

1.0 INTRODUCTION

This chapter discusses the essence of an Islamic bank's financial statements by first, looking at the general differences with the financial statements of banks (i.e. both Islamic and conventional banks) and other businesses. Then, it analyses the line-by-line items in the financial statements of Islamic banks resulting from the unique features of Islamic banks.

The objective of financial statements is to provide financial information about an entity's assets, liabilities, equity, income and expenses that is useful to users of financial statements in assessing the prospects for future net cash inflows to the entity and in assessing management's stewardship of the entity's economic resources[1]. Such information is provided in a set of financial statements comprises:

a. a statement of financial position at the end of the financial period;
b. a statement of profit or loss and other comprehensive income for the period;
c. a statement of changes in equity for the period;
d. a statement of cash flows for the period; and
e. notes to the financial statements.

In discussing the essence of Islamic banks' financial statements, this chapter will focus on the first two items above i.e. the statement of financial position and the statement of profit or loss and other comprehensive income.

The statement of financial position comprises assets, liabilities and equity which is represented by the accounting equation below:

Assets = **Liabilities** + **Equity**

[1]*MASB, 2018, MASB Conceptual Framework for Financial Reporting*

The statement of financial position is structured based on the accounting equation above as illustrated below.

Statement of Financial Position	Note	20X1 RM'000	20X0 RM'000
Assets			
Cash and short term funds		xxx	xxx
Deposits and placements with financial institutions		xxx	xxx
Investment accounts placement - financing		xxx	xxx
Financial assets		xxx	xxx
Financing and advances		xxx	xxx
Statutory deposits with Bank Negara Malaysia		xxx	xxx
Investment in subsidiaries		xxx	xxx
Investment in associates		xxx	xxx
Property, plant and equipment		xxx	xxx
Total assets		xxx	xxx
Liabilities			
Islamic deposits from customers		xxx	xxx
Investment accounts of customers		xxx	xxx
Deposits and placements of banks and other financial institutions		xxx	xxx
Investment accounts due to designated financial institutions		xxx	xxx
Financial liabilities		xxx	xxx
Provision for zakat and taxation		xxx	xxx
Total liabilities		xxx	xxx
Shareholder's equity			
Share capital		xxx	xxx
Reserves		xxx	xxx
Total shareholder's equity		xxx	xxx
Total liabilities and shareholder's equity		xxx	xxx
Restricted investment accounts		xxx	xxx
Total Islamic banking asset		xxx	xxx
Commitment & contingencies		xxx	xxx

Diagram 1: Illustrative statements of financial position of an Islamic bank
Source: Bank Negara Malaysia (BNM) policy document
on Financial Reporting of Islamic Banking Institutions 2018

The statement of profit or loss and other comprehensive income provides information about the financial performance of the entity where income and expenses are recognised. This is presented as follows:

Statement of Comprehensive Income	Note	20X1 RM'000	20X0 RM'000
Income derived from investment of depositors' funds		xxx	xxx
Income derived from investment of investment account funds		xxx	xxx
Income derived from investment of shareholders' funds		xxx	xxx
Impairment loss on investments		(xxx)	(xxx)
Total distributable income		xxx	xxx
Profit share/*wakalah* fees income from investment accounts[33]		xxx	xxx
Profit/hibah distributed to depositors		(xxx)	(xxx)
Profit distributed to investment account holders		(xxx)	(xxx)
Total net income		xxx	xxx
Personnel expenses		xxx	xxx
Other overhead expenses		xxx	xxx
Profit before zakat and taxation		xxx	xxx
Zakat		xxx	xxx
Taxation		xxx	xxx
Profit for the year		xxx	xxx
Earnings per share (sen)		xxx	xxx

Diagram 2: Illustrative statements of comprehensive income of an Islamic bank
Source: BNM policy document on Financial Reporting of Islamic Banking Institutions 2018

2.0 GENERAL DIFFERENCES BETWEEN BANKS AND OTHER BUSINESSES

Conventional and Islamic banks are principally engaged in the banking business and the provision of related services. Accordingly, there are differences between the financial statements of these banks and other businesses which are as follows:

2.1 Sources and uses of funds

The sources of funds of banks are mainly deposits from customers, investment accounts and capital reserves while their uses of funds mainly comprise loans/financing and advances as well as investments in securities such as sukuks and the Malaysian Government Securities. Typically, in other businesses, such as a trading entity, the sources of funds are from sale of goods and/or services whereas their uses of funds are for purchase of goods and/or services.

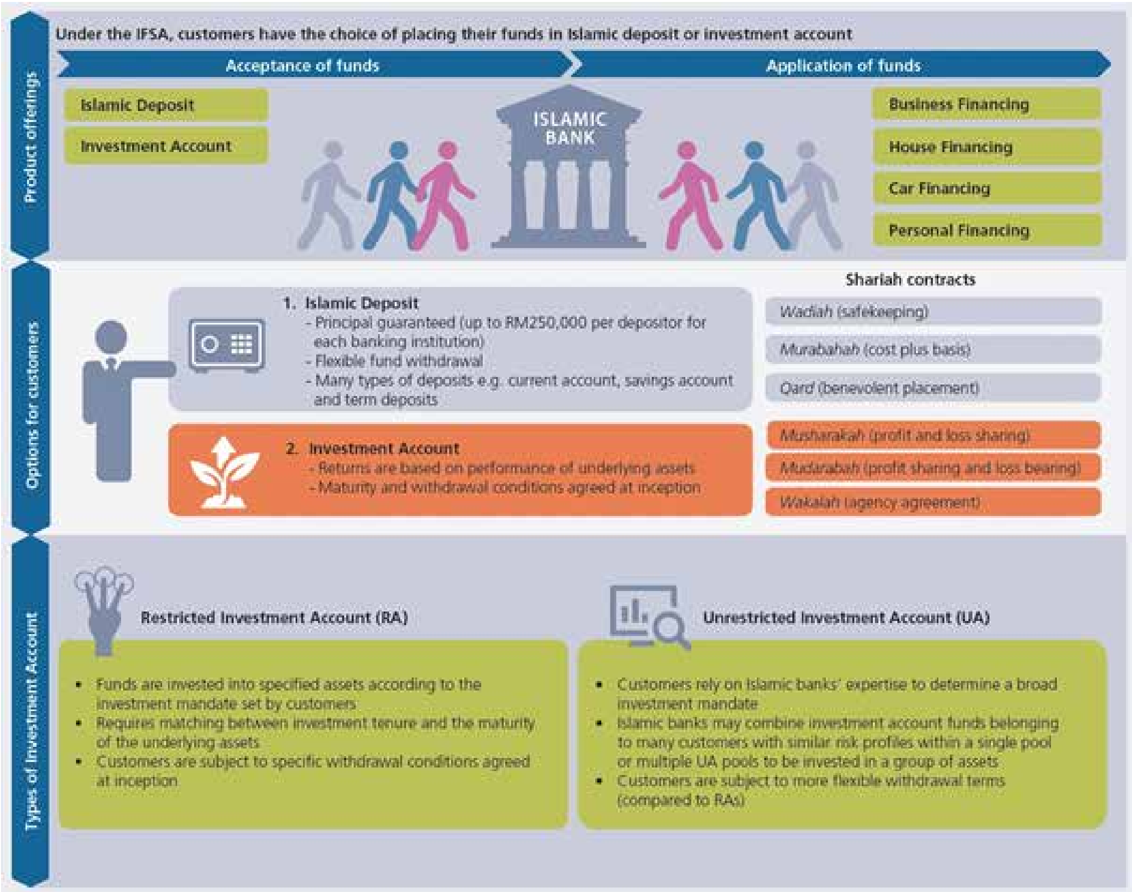

Diagram 3: Sources and uses of funds of Islamic banks

Source: The Financial Stability and Payment Systems Report 2014, BNM

2.2 Types of assets and liabilities

Following the sources and uses of funds of banks as explained above, the assets of banks comprise a significant portion of loans, advances and financing while deposits from customers substantially represent their liabilities. As an illustration, financing and advances represent 73% of Bank Islam's total assets, while deposits from customers represent 88% of its total liabilities as of 31 December 2017.

2.3 Additional guidance in the preparation of financial statements

The preparation of financial statements of banks are governed by the policy documents issued by Bank Negara Malaysia (BNM) which are:

- Financial Reporting which is applicable to conventional banks, insurers and financial holding companies; and
- Financial Reporting for Islamic Banking Institutions which is applicable to Islamic banks, conventional banks that carry on Islamic banking business and financial holding companies.

In general, these policy documents require the financial statements of banks to be prepared in accordance with the Malaysian Financial Reporting Standards (MFRS) with additional disclosures to be included such as detailed breakdown on deposits from customers, loans/financing and advances, capital as well as liquidity risk information.

2.4 Current and non-current distinction

MFRS requires an entity to present current and non-current assets, and current and non-current liabilities, as separate classifications in its statement of financial position. However, it allows entities to present all assets and liabilities in order of liquidity when such presentation provides information that is reliable and more relevant. As the principal activities of banks are the banking and related services, presentation by liquidity is more appropriate. Liquidity is a measure of the ability and ease with which assets can be converted to cash. Liquid assets are those that can be converted to cash quickly if needed to meet financial obligations[2] such as cash and short-term funds. Liquidity management is critical to both conventional and Islamic banks as they need to create a right balance between having adequate liquidity such as to meet near-term obligations such as withdrawals by depositors and managing asset and liability to maximise profitability.

[2] *www.federalreserve.gov*

3.0 GENERAL DIFFERENCES BETWEEN CONVENTIONAL AND ISLAMIC BANKS

Islamic Financial Services Act 2013 (IFSA 2013) defines Islamic banking business as the business of:

a. accepting Islamic deposits on current account, deposit account, savings account or other similar accounts, with or without the business of paying or collecting cheques drawn by or paid in by customers;
b. accepting money under an investment account; and
c. provision of finance; and
d. such other business as prescribed by the Minister of Finance[3].

An essential role of banks in general is to match surplus fund units and deficit fund units via financial intermediation that they provide by collecting funds from depositors and making financing to customers. In the case of conventional banks, deposits are acquired at lower interest rates while loans are given out at higher interest rates. The difference between interest charged on loans and interest paid to depositors is known as interest spread which represents income or revenue to conventional banks.

Islamic banks perform similar functions to conventional banks but operate within the realms of Shariah teachings. Accordingly, there are a number of differences between Islamic and conventional banking as discussed below.

1. Islamic banks use trade contracts instead of loans. Charging interest on a loan principal is not allowed in Islam. However, it is perfectly acceptable to make gains on trading. For example, Islamic banks do not give out housing loans. The bank either buys the house then sells to the customer at a profit (known as *Murabahah*), or the bank leases the house to the customer over the period of financing, with either gradual sales over the lease or a sale at the end of the lease (known as *Ijarah*)[4].

[3]IFSA 2013
[4]MASB, 2012, A Word About Islamic Finance: Part I. Available at www.masb.org.my

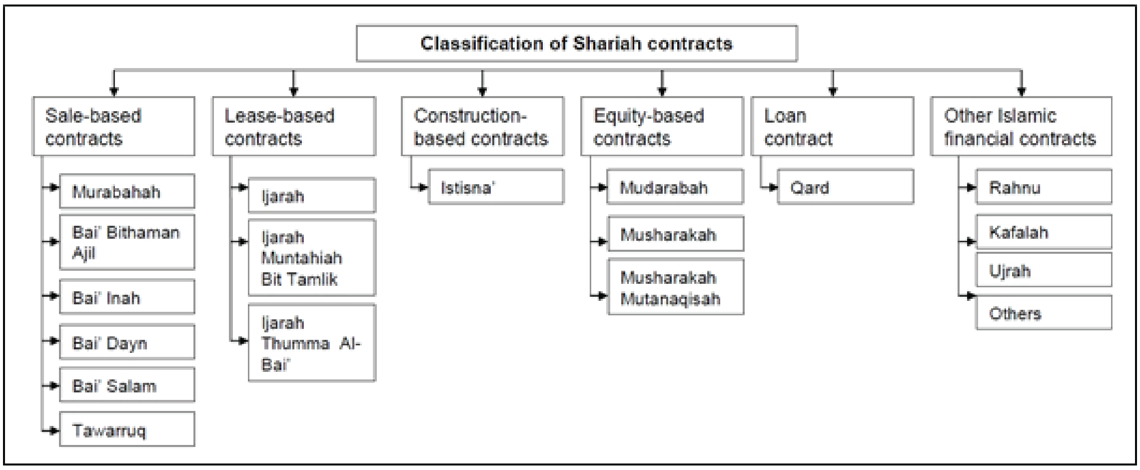

Diagram 4: Classification of Shariah contracts

Source: BNM policy document on Financial Reporting for Islamic Banking Institutions 2018

2. The subject of trade must usually be a tangible item such as land and buildings or a permitted intangible such as the usufruct, or the right-of-use, in a lease. Trade related to a prohibited item (e.g. alcohol, tobacco, gaming) would not be permitted[5].

The above distinctions have led to several differences on the presentation and disclosure of financial statements of Islamic banks in comparison to conventional banks. This is discussed below by looking at certain line-by-line items in the statement of financial position and statement of profit or loss and other comprehensive income as illustrated in Diagrams 1 and 2 set out earlier in this Chapter. Detailed discussions on every single line-by-line item can be found in Chapters 5 to 8.

4.0 PRESENTATION AND DISCLOSURES OF THE ISLAMIC BANK'S FINANCIAL STATEMENTS

This section focuses on typical items presented and/or disclosed in the Islamic bank's financial statements as set out below.

4.1 Investment accounts placement (asset) and investment accounts of customers (liability)

The IFSA 2013 distinguishes investment account from Islamic deposit, where an investment account is defined by the application of Shariah contracts with non-principal guarantee feature for investment[6]. In contrast to Islamic deposit, an investment account allows customers, depending on their risk appetite, to make placement in investment accounts that potentially offer higher rates of return but are not principal-guaranteed. It also expands financing opportunities for entrepreneurs with viable projects to reach a wider investor base, while improving cost and operational efficiencies for participating banks by enabling them to leverage on a shared platform and services[7].

[5]*Ibid*
[6]*BNM, 2014, BNM policy document on Investment Account*
[7]*BNM, 2015, The Financial Stability and Payment Systems Report 2015*

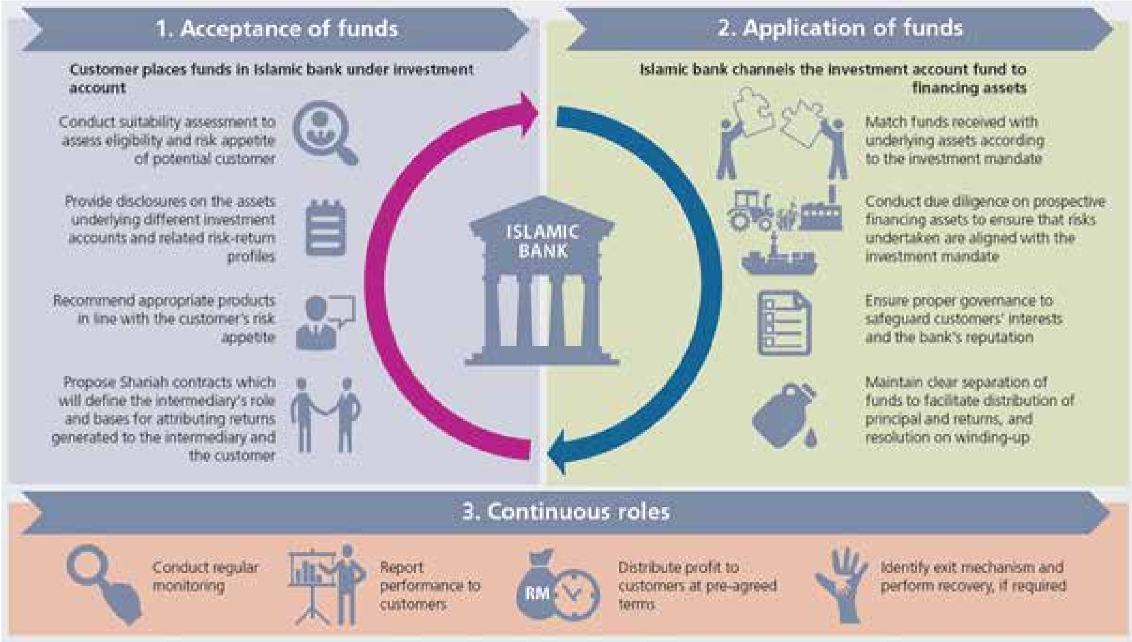

Diagram 5: Intermediation functions of Islamic banks in operationalising an investment account
Source: The Financial Stability and Payment Systems Report 2014, BNM

Accordingly, following such distinction, 'investment accounts of customers' and 'investments accounts due to designated financial institutions' are presented as separate line items in the financial statements of Islamic banks with additional disclosures. In addition, Islamic banks are required to disclose the nature of the underlying assets for the investment which is included in 'financing and advances'.

The investment account may be in the form of either a restricted investment account or an unrestricted investment account. A restricted investment account (RIA) provides for the account holder to specify investment mandates that must be complied with by the Islamic banks, such as the purpose of the investment, the underlying assets that the funds can invest in and the period of investment. An unrestricted investment account (URIA), on the other hand, provides the Islamic banks the flexibility to make investment decisions on behalf of the account holder without restrictions or conditions. The inherent complexities and risks associated with investment accounts vary according to the underlying investment assets[8].

In relation to RIA, where Islamic banks do not recognise such an investment account, the carrying amount of the off-balance amount should be presented separately from its commitments and contingencies. In addition, Islamic banks should disclose a total carrying amount of the Islamic banking assets in the statement of financial position of its separate financial statements. The total Islamic banking assets shall be calculated as the sum of total assets and financial assets which are funded by the investment account which are recognised off-balance sheet. These are illustrated in Diagram 1.

[8] *BNM, 2015, The Financial Stability and Payment Systems Report 2015*

4.2 Financing and advances (asset)

As lending money with charging interest is prohibited in Islam and Islamic banks use trade contracts, the item 'loans' has been presented as 'financing' in the statement of financial position. As various Islamic banks' financing products are based on a variety of Shariah contracts, Islamic banks are required to disclose the types of financing by providing further breakdown by main Shariah contracts. Islamic banks must also disclose certain information on *qard* loans. *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[9].

Type	Bai'	Ijarah	Istisna'	Musharakah	Qard	Others	Total financing, advances and other receivables
Cash Line	XX	XX	XX	XX	XX	XX	XX
Term Financing	XX	XX	XX	XX	XX	XX	XX
House Financing	XX	XX	XX	XX	XX	XX	XX
Syndicated Financing	XX	XX	XX	XX	XX	XX	XX
Hire purchase receivables	XX	XX	XX	XX	XX	XX	XX
Lease Receivables	XX	XX	XX	XX	XX	XX	XX
Other term financing	XX	XX	XX	XX	XX	XX	XX
Bills receivable	XX	XX	XX	XX	XX	XX	XX
Trust receipts	XX	XX	XX	XX	XX	XX	XX
Claims on customers under acceptace credits	XX	XX	XX	XX	XX	XX	XX
Staff financing of which RMXXX (20XX: RMXXX) are to Directors	XX	XX	XX	XX	XX	XX	XX
Credit/Charge cards	XX	XX	XX	XX	XX	XX	XX
Revolving credit	XX	XX	XX	XX	XX	XX	XX
Others	XX	XX	XX	XX	XX	XX	XX
Total financing, advances and other receivables	XX	XX	XX	XX	XX	XX	XX

Diagram 6: Illustration of disclosure requirements by Shariah contracts
Source: BNM Policy Document on Financial Reporting for Islamic Banking Institutions, 2018

[9]*BNM, 2016, BNM policy document on Qard*

4.3 Specific disclosure for financing based on *Ijarah* in Malaysia

Ijarah financing such as *Ijarah Muntahia Bittamleek* (IMB) and *Al Ijarah Thumma Al Bai* (AITAB) are structured to transfer the ownership of the asset to the customer at the end of the lease period. Due to the way the *ijarah* contracts are arranged, in substance, *ijarah* financing is a financing rather than a lease. Accordingly, the leased asset is not recognised in the financial statements and in order to enhance the clarity on the structure of ijarah, Islamic banks should disclose the following information:

- carrying amount of assets held for the purpose of *ijarah*, and
- the extent of the transfer of usufruct from the *ijarah* asset to the lessee over the *ijarah* period under the terms of the *ijarah* contract[10] as illustrated below.

Investment Properties	*Land RM'000*	*Building RM'000*	*Total RM'000*
Fair value:			
As at 1 January 20XX	xxx	xxx	xxx
Addition	xxx	xxx	xxx
Disposal	(xxx)	(xxx)	(xxx)
Impairment loss	(xxx)	(xxx)	(xxx)
As at 31 December 20XX	xxx	xxx	xxx

Included in the fair value above are assets held for ijarah:

	RM'000	*Extent of transfer of usufruct (%)*
Land	xxx	xxx
Building	xxx	xxx

Diagram 7: Illustration of disclosure requirements for Ijarah financing
Source: BNM Policy Document on Financial Reporting for Islamic Banking Institutions, 2018

4.4 Profit (income), not interest

Riba' is prohibited in Islam and the majority of contemporary Shariah scholars have taken *riba'* includes any interest above a loan principal. However, Islam permits and encourages profiting from financial transactions, but such profits must arise from permissible contracts. The use of contracts such as trade, leasing or partnership may yield returns in the form of sale proceeds, rental, or dividends. Accordingly, Islamic banks use the term 'profit' for income generated on financing.

[10] *BNM, 2018, BNM policy document on Financial Reporting for Islamic Banking Institutions*

4.5 Islamic deposits from customers (liability)

Similar to financing and advances, Islamic banks are also required to provide a further breakdown of Islamic deposits by Shariah contracts.

Typically, there are 3 types of Islamic deposits as described in the table below.

Types (common structures)	Nature	How it works
Demand deposits *(Wadiah yad dhamanah)*	Customers can withdraw deposits at any time	In a *wadiah yad dhamanah* arrangement, the customers will deposit cash for safekeeping and the bank will guarantee the safety of the cash. Islamic banks are allowed to utilise the cash by investing in Shariah-compliant investments. When Islamic banks receive a return from the investments, *hibah* is given to the depositors at the banks' discretion.
Saving deposits *(Wadiah yad dhamanah)*	Similar to demand deposits but customers also receive returns on deposits	Refer to the above.
Term deposits *(Tawarruq)*	Deposits are held for a fixed term until maturity.	A *Tawarruq* consists of two sale and purchase contracts. The first involves the sale of an asset by a seller to a purchaser on a deferred basis. Subsequently, the purchaser of the first sale will sell the same asset to a third party on a cash and spot basis[11]. Deposits under the *Tawarruq* arrangement are where customers place a term deposit with Islamic banks and the Islamic banks execute the *Tawarruq* arrangement. Customers appoint Islamic banks as its agent to purchase the asset from Supplier 1 and Islamic banks use the deposits placed by customers to pay for the purchase. Customers then appoint Islamic banks as its agent to sell the asset at an agreed selling price. Islamic banks pay a deferred lump sum amount to customers upon maturity of the term deposit. Subsequently, Islamic banks sell the asset to Asset Supplier 2 and obtain cash at a similar amount as per the deposit placement.

[11]*BNM, 2015, Tawarruq Policy Document*

The disclosure of Islamic deposits are as follows:

Islamic deposits from customers	20X1	*20X0*
	RM'000	RM'000
Savings deposits		
Wadiah	xxx	xxx
Qard	xxx	xxx
Demand deposits		
Wadiah	xxx	xxx
Qard	xxx	xxx
Term deposits		
Tawarruq	xxx	xxx
Other Islamic negotiable instruments	xxx	xxx
Structured products	xxx	xxx
	xxx	xxx

Diagram 8: Illustration of disclosure requirements of Islamic deposits by Shariah Contracts
Source: BNM Policy Document on Financial Reporting for Islamic Banking Institutions

4.6 Zakat payable (liability) and zakat expense

Zakat payable represents business zakat that is paid on an Islamic bank's portion. It is an obligatory amount payable to comply with the rules and principles of Shariah. In 1992, the National Fatwa Council (*Majlis Fatwa Kebangsaan*) agreed for companies to pay business zakat of 2.5% on their net income. Please refer to Chapter 6 for a detailed discussion on business zakat and zakat payable.

4.7 Profit equalisation reserve

In modern Islamic finance, a customer may place amounts in an investment account based on the *Mudarabah* contract that is managed by the Islamic bank. Profits made through the arrangement would be shared between the account holder and the Islamic bank. Any losses should, theoretically, be borne solely by the account holder. However, whether because of regulatory controls or to safeguard their reputation, many Islamic banks endeavour to provide consistent returns to account holders 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)[12]. According to the International Financial Services Board, one of the methods for Islamic banks to manage DCR is by establishing a reserve which is called a profit equalisation reserve (PER) which sets aside amounts from the investment profits before allocation between the shareholders and the accountholders, and therefore is seen to be a type of profit smoothing technique. The accounting treatment of PER has been debated by the accounting practitioners in Malaysia for many years.

The introduction of investment accounts in 2014 has led to the disappearance of PER. A policy document issued by BNM on Investment Account prohibits the application of profit smoothing mechanism.

4.8 Presentation of income and expenses by the source of funds

As IFSA 2013 makes a distinction between depositors and investment account holders, Islamic banks are required to present separately the income and expenses by source of funds i.e. depositors, investment accountholders and/or shareholders. This is because these stakeholders have specific rights and obligations over specific resources of Islamic banks. In contrast, depositors of a conventional bank may have recourse to the assets of the entire bank[13].

5.0 MAJOR ACCOUNTING STANDARDS IMPACTING THE ISLAMIC BANK'S FINANCIAL STATEMENTS

Due to the nature of business of the Islamic banks, their assets and liabilities are concentrated with financing and advances and deposits from customers respectively. Both items are financial instruments. A financial instrument is defined as any contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity[14]. Accordingly, they are under the scope of MFRS 9 *Financial Instruments,* MFRS 132 *Financial Instruments: Presentation* and MFRS 7 *Financial Instruments: Disclosures*.

Other accounting standards applicable to other items in the financial statements will be discussed in the respective banking chapters.

[12]AOSSG Islamic Finance Working Group, 2018, Financial Reporting Issues relating to Islamic Finance: An Update to the 2010 Research Paper
[13]Collaboration between Staff of the Malaysian Accounting Standards Board (MASB) and the Malaysian Institute of Accountants (MIA), 2016, Financial Reporting by Islamic Banking Institutions: A study of Presentation and Disclosure in the Financial Statements of Islamic Banks in Malaysia
[14]MFRS 9 Financial Instruments

SUMMARY

- In this Chapter, we have discussed the differences in the presentation and disclosures of financial statements for Islamic banks in comparison to conventional banks and other businesses.
- Other than the differences highlighted above, recognition, measurement, as well as presentation and disclosure of items that can be typically found in these entities, would be similar as they are required to comply with the MFRS Framework.

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MFRS 9 *Financial Instruments*

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CHAPTER 5

ASSETS

ASSETS

LEARNING OBJECTIVES

The chapter aims to:

i. define, classify and explain different types of assets of Islamic banks;
ii. understand the recognition and measurement issues of assets;
iii. clarify the presentation and disclosure issues of assets; and
iv. discuss specific and particular issues pertaining to assets.

1.0 INTRODUCTION

This chapter discusses the accounting treatment of assets in the financial statements of Islamic banks. However, to give a better perspective on the issues and challenges faced by Islamic banks in accounting for assets and the need to consistently comply with Shariah standards, an overview of the nature and definition of assets, its recognition and measurement issues as well as the presentation and disclosure aspects of assets are first discussed.

The International Financial Reporting Standards (IFRS) - compliant Malaysian Financial Reporting Standards (MFRS) came into effect on 1 January 2012. Accordingly, all financial institutions must adopt MFRS in their reporting practices and Islamic financial institutions are not exempted[1].

Given that Shariah forms the basis of all Islamic transactions, this pronouncement may not have taken into consideration the uniqueness of Islamic banking financial products and practices.

Therefore, Bank Negara Malaysia (BNM) issued a further reporting guideline, *Financial Reporting for Islamic Banking Institutions* in 2012. The guideline went through a few revisions of which was the latest in 2018. In 2009, the MASB also issued the Technical Release i-3 (TRi-3) on the Presentation of Financial Statements of Islamic Financial Institutions to address the unique characteristics of financial products in Islamic banks. However, Tri-3 was archived in 2018. The primary reason for this is that Tri-3 is no longer relevant in the current context with the "newer" MFRS standards. Most importantly, Islamic banks currently adopt relevant MFRSs and the guideline issued by BNM in its reporting.

In addition, the reporting practices of Islamic banks in Malaysia are also guided by the provisions in the Companies Act of 2016. Specifically, such financial statements are to be prepared under MFRS 101 *Presentation of Financial Statements* and that the Islamic bank is to disclose a statement to that effect in the financial statements. Islamic banks will also have to adhere to MFRS 132 Financial Instrument: Presentation, MFRS 7 Financial Instruments: Disclosure and MFRS 9 *Financial Instruments.*

[1] Before the introduction of MFRS and MASB's technical release, Islamic banking financial reporting practices were monitored by the BNM and Companies Act 1965 (now Companies Act 2016) and applicable Financial Reporting Standards. In the absence of specific accounting guidance, Islamic banks and other IFIs, as well as conventional banks that provide Islamic banking services, were heavily dependent on the prevailing guidelines issued by the regulator and on Shariah rulings issued by Shariah advisers appointed by the respective banks, but it lacked uniformity and comparability.

Emphasis on the importance of MFRSs in Islamic banks is highlighted in Section 74 of the Islamic Financial Services Act 2013 (IFSA, 2013). The Act stipulates that Islamic Banking Institutions are to prepare financial statements in accord with MFRSs. This provision in the Act stems from the resolutions passed by the Shariah Advisory Council of BNM (SAC) on the applicability of the following four accounting principles adopted in the MFRSs that are deemed consistent with the broader view of the Shariah.

The SAC states that accounts prepared based on accruals concept and the issue of substance over form, probability and the time value of money do not go against any Shariah precept. However, on the time value of money, the SAC rules that this is permissible only for exchange contracts involving deferred payments and is strictly prohibited in loan transactions (*Qard*).

The following section provides an overview of the accounting for assets whilst Section 3 focuses on accounting for each specific asset in Islamic banks. There are two parts to Section 3. Part I deals with all other assets except Financing and Advances while Part II discusses the various Shariah contracts used for Financing and Advances in Islamic banks. Section 4 provides a summary of the chapter.

2.0 ACCOUNTING FOR ASSETS

2.1 Nature and Definition

An asset is a resource controlled by an entity because of past events and from which future benefits are expected to flow to the entity (Conceptual Framework, IASB). An entity is said to have control of an asset if it has control over the benefits which are expected to flow from the asset (control of how and when the asset is used) and bears the risks related to the use of the asset (responsible for the maintenance of the asset) even though it does not own the asset.

Similarly, AAOIFI'S Statement of Financial Accounting on Concepts of Financial Accounting for Islamic Banks and Financial Institutions defines an asset as anything that can generate positive cash flows or other economic benefits in the future either by itself or in combination with other assets to which the Islamic bank has acquired the right as a result of past transactions or events.

2.2 Recognition and Measurement

The Conceptual Framework of the IASB states that an item will be recognised as an asset if there is a probable inflow or outflow of resources and that it can be measured reliably. Further, according to MFRS 9, an entity shall recognise a financial asset or liability in its statement of financial position when and only if it becomes a party to the contractual provisions of the instrument (paragraph 3.1.1 of MFRS 9). For instance, trade receivables and payables are recognised as assets and liabilities when the entity becomes a party to the sales or purchase contract (with immediate delivery of goods) and therefore, has a legal right to receive, or a legal obligation to pay.

An asset is derecognised if the contractual rights to the cash flows from the financial asset expire, or if the entity transfers the contractual rights to receive the cash flows of that financial asset.

MFRS 9 classifies financial assets into three categories, namely:

i. amortised cost,
ii. fair value through other comprehensive income (FVOCI) and
iii. fair value through profit or loss (FVTPL).

Further, in classifying each financial asset, an entity needs to assess if the financial asset satisfies both the business model and the sole payments of principal and interest (SPPI) tests. The details of these tests will be discussed when the discussion of specific assets is undertaken in Section 3.

The new classification for financial assets under MFRS 9 is summarised in Diagram 1 below.

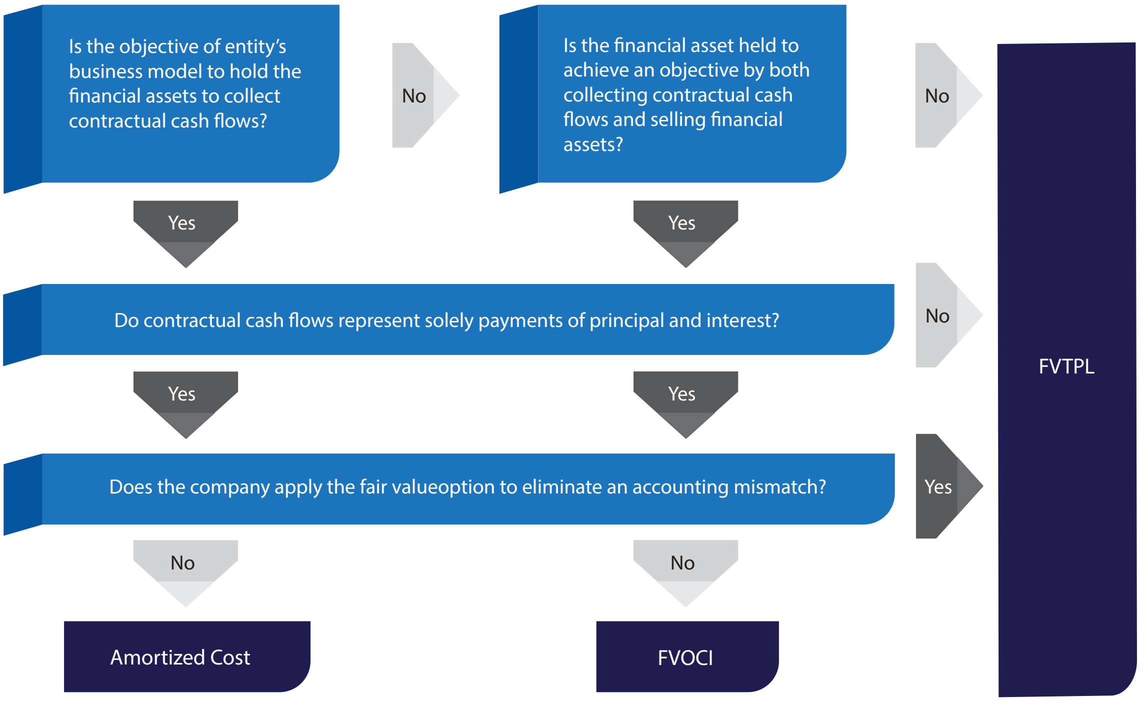

Diagram 1: Classification of Financial Assets[2]

2.3 Presentation and Disclosure

Generally, assets are presented in the statement of financial position of a commercial enterprise as non-current or current. However, in the case of conventional and Islamic banks, the assets are listed in accordance to its liquidity with the most liquid being presented first. This is allowed as paragraph 60 of MFRS 101 specifically states that an entity may present its assets according to its liquidity if such a presentation is reliable and more relevant. Specific to Islamic banks, the relevant standards would be MFRS 132, MFRS 7 and the Guidelines on Financial Reporting for Islamic Banking Institutions issued by BNM in February 2018. A detailed discussion will be provided when each asset of the Islamic bank is covered.

3.0 ASSETS OF ISLAMIC BANKS

Typically, the assets of an Islamic bank comprise the following:

1. Cash and short-term funds
2. Deposits and placements with banks and other financial institutions
3. Financial assets at FVTPL or FVOCI and other financial assets at amortised cost
4. Financing, advances and others
5. Derivative financial assets
6. Statutory deposits with BNM
7. Current tax assets and deferred tax assets
8. Investment in subsidiaries
9. Property, plant and equipment
10. Intangible assets
11. Goodwill

[2] *Adapted from PwC's publication entitled; IFRS 9, Financial Instruments: Understanding the basics, page 12.*

Figure 1 shows the assets in the Statement of Financial Position of Bank Islam Malaysia Berhad (BIMB) as at 31 December 2018. Cash and cash equivalents are the most liquid assets for an entity, and they are presented first while property, plant and equipment are presented last.

Bank Islam Malaysia Berhad (98127-X)
(Incorporated in Malaysia)

Statement of Financial Position as at 31 December 2018

		Group		Bank	
		31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
	Note	RM'000	RM'000	RM'000	RM'000
Assets					
Cash and short-term funds	3	**2,092,654**	4,185,697	**2,086,703**	4,185,561
Deposits and placements with banks and other financial institutions	4	**2,432,000**	–	**2,432,000**	–
Financial assets held-for-trading	5	**–**	380,925	**–**	375,664
Financial assets at fair value through profit or loss	6	**364,959**	–	**359,533**	–
Derivative financial assets	7	**34,148**	68,319	**34,148**	68,319
Financial assets available-for-sale	8	**–**	9,252,683	**–**	9,253,140
Financial assets at fair value through other comprehensive income	9	**11,354,299**	–	**11,355,089**	–
Financial assets held-to-maturity	10	**–**	–	**–**	–
Financing, advances and others	11	**45,680,680**	42,113,420	**45,680,680**	42,113,420
Other financial assets at amortised cost	12	**129,042**	123,503	**126,533**	121,062
Statutory deposits with Bank Negara Malaysia	13	**1,602,284**	1,407,284	**1,602,284**	1,407,284
Current tax assets		**8,466**	1,792	**8,403**	1,737
Deferred tax assets	14	**51,385**	37,288	**49,842**	37,288
Investments in subsidiaries	15	**–**	–	**15,525**	15,525
Property and equipment	16	**188,816**	172,003	**188,153**	171,240
Total assets		**63,938,733**	57,742,914	**63,938,893**	57,750,240

Figure 1: Assets of an Islamic bank

As indicated earlier, the accounting for assets of Islamic banks will be discussed in two parts:

PART I

Focuses on cash and short-term funds, deposits and placements with banks and other financial institutions, financial assets including financial investments and derivative financial assets, intangible assets, investment in subsidiaries, property, plant and equipment, goodwill, statutory deposits with BNM, amounts due from holding and/or other related companies and current and deferred tax assets.

PART II

Discusses *Mudarabah, Musyarakah, Ijarah, Murabahah, Istisna' Ar Rahnu and Qard* contracts in Islamic banks. The discussion will describe the recognition and measurement issues as well as the presentation and disclosure aspects of these assets. Excerpts will also be extracted from the annual report of Islamic banks to help clarify specific issues pertaining to presentation and disclosure. These are reflected under the section "The Practice". "The Practice" focuses on Significant Accounting Policies, Financial Statements and Notes to the Accounts.

PART I

3.1 Cash and Short-Term Funds and Deposits and Placements with Banks and Other Financial Institutions

3.1.1 Nature and Definition

MFRS 107 *Statement of Cash Flows* states that cash comprises cash in hand and demand deposits, whereas cash equivalents are short-term, highly liquid investments that are readily convertible to a known amount of cash and which are subject to an insignificant risk of changes in value (paragraph 6). Cash equivalents are further explained by MFRS 107 as held for the purpose of meeting short-term cash commitments rather than for investment or other purposes (paragraph 7).

For an investment to qualify as short-term funds it must be readily convertible to a known amount of cash and be subject to an insignificant risk of changes in value. Therefore, an investment normally qualifies as short-term funds only if it has a short maturity of, for example, three months or less from the date of acquisition. Deposits and placements with banks and other financial institutions also have the same characteristics as cash and cash equivalents as explained in MFRS 107.

3.1.2 Recognition and Measurement

In general, cash and cash equivalents are recognised when they are under the control of the company because of past events (i.e. cash collections from customers, sales and etc.); and future economic benefits are expected to flow into the entity from the use of the cash and cash equivalents. In addition, since cash and cash equivalents are part of financial assets, MFRS 9 states that an entity shall recognise a financial asset in its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the instrument. For example, the deposits and placements with banks and other financial institutions are recognised once an entity makes the deposits or places an amount of cash with banks or other financial institutions.

The measurement of cash is based on the actual cash in hand which can be verified by a cash count if necessary. Bank balance and other short-term funds are based on the accounting records and reconciliations of bank statements and bank confirmations. Similarly, the measurement of deposits and placements with a bank are based on the accounting records and reconciliations of bank statements and bank confirmations.

MFRS 9 explains that an entity shall measure its financial assets, initially, at transaction price (i.e. the fair value of the consideration given or received). This measurement is relevant for cash equivalent items such as highly liquid investments that are readily convertible to a known amount of cash and subject to an insignificant risk of changes in value. Subsequent measurement of these types of financial assets is at fair value through profit or loss.

3.1.3 Presentation and Disclosure

MFRS 132 *Financial Instruments: Presentation* includes cash and cash equivalents as part of financial assets (paragraph 11). The Application Guideline (AG) 3 of MFRS 132 states that currency (cash) is a financial asset as it represents a medium of exchange and is therefore, the basis on which all transactions are measured and recognised in the financial statements.

Short-term investments in quoted equity shares and quoted bonds (which are classified as financial assets in accordance with MFRS 9) are not deemed as cash equivalents since these are subject to a significant risk of change in value. In addition, equity investments are excluded from cash equivalents unless these are, in substance, cash equivalents. A good example is a preferred share acquired within a short period of its maturity and with a specified redemption date (paragraph 7 of MFRS 107).

3.1.4 The Practice

Under its significant accounting policies for the financial year ended 31 December 2018, BIMB Berhad states that cash and cash equivalents include cash and short term funds and deposits and placements with other banks and financial institutions. In the notes, further clarification is provided as to the amount of cash and short term funds as well as the deposits and placements with other banks and financial institutions. Specifically, as at 31 December 2018, there was RM2,092,654,000 of cash and short term funds for the Group and RM2,086,703,000 for the Bank. Deposits and placements with banks and financial institutions totalled RM2,432,000,000 for the Group as well as for the Bank. In Note 3, further clarification is provided as to the components of the Cash and short term funds (ie. Cash and balances with banks and other financial institutions and Money at call and interbank placements with remaining maturity not exceeding one month). Deposits and placements with banks are those that BIMB has with BNM.

Significant Accounting Policies

Cash and cash equivalents

Cash and cash equivalents include cash and short-term funds, and deposits and placements with banks and other financial institutions.

Financial Statements
Statement of Financial Position as at 31 December 2018

		Group		Bank	
		31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
	Note	RM'000	RM'000	RM'000	RM'000
Assets					
Cash and short-term funds	3	**2,092,654**	4,185,697	**2,086,703**	4,185,561
Deposits and placements with banks and other financial institutions	4	**2,432,000**	—	**2,432,000**	—
Financial assets held-for-trading	5	**—**	380,925	**—**	375,664
Financial assets at fair value through profit or loss	6	**364,959**	—	**359,533**	—
Derivative financial assets	7	**34,148**	68,319	**34,148**	68,319
Financial assets available-for-sale	8	**—**	9,252,683	**—**	9,253,140
Financial assets at fair value through other comprehensive income	9	**11,354,299**	—	**11,355,089**	—
Financial assets held-to-maturity	10	**—**	—	**—**	—
Financing, advances and others	11	**45,680,680**	42,113,420	**45,680,680**	42,113,420
Other financial assets at amortised cost	12	**129,042**	123,503	**126,533**	121,062
Statutory deposits with Bank Negara Malaysia	13	**1,602,284**	1,407,284	**1,602,284**	1,407,284
Current tax assets		**8,466**	1,792	**8,403**	1,737
Deferred tax assets	14	**51,385**	37,288	**49,842**	37,288
Investments in subsidiaries	15	**—**	—	**15,525**	15,525
Property and equipment	16	**188,816**	172,003	**188,153**	171,240
Total assets		**63,938,733**	57,742,914	**63,938,893**	57,750,240

Notes to the Financial Statements

3. Cash and short-term funds

	Group		Bank	
	31 Dec 2018	**31 Dec 2017**	**31 Dec 2018**	**31 Dec 2017**
	RM'000	**RM'000**	**RM'000**	**RM'000**
Cash and balances with banks and other financial institutions	**891,697**	921,777	**886,074**	921,641
Money at call and interbank placements with remaining maturity not exceeding one month	**1,200,957**	3,263,920	**1,200,629**	3,263,920
	2,092,654	4,185,697	**2,086,703**	4,185,561

4. Deposits and placements with banks and other financial institutions

	Group and Bank	
	31 Dec 2018	**31 Dec 2017**
	RM'000	**RM'000**
Bank Negara Malaysia	**2,432,000**	—

Figure 2: Cash and Short Term Funds and Deposits and Placements

Further, an entity shall disclose the components of cash and cash equivalents and shall present a reconciliation of the amounts in its statement of cash flows with the equivalent items reported in the statement of financial position.

For example, BIMB reported in its statement of cash flows, deposits and placements with banks and other financial institutions together with the cash and short-term funds, making up the total of cash and cash equivalents for the financial institution. The amounts reflect the amounts shown in the notes to the accounts. The movement of cash and cash equivalents is reflected in the last section of the Statement of Cash Flows as in Figure 3.

Cash and cash equivalents comprise:

Cash and short-term funds	**2,092,654**	4,185,697	**2,086,703**	
Deposits and placements with banks and other financial institutions	**2,432,000**	—	**2,432,000**	4,185,561
	4,524,654	4,185,697	**4,518,703**	4,185,561

Figure 3: Excerpt from the statement of cash flows (cash and cash equivalents)

3.2 Financial Assets (Investments)

3.2.1 Nature and Definition

Financial investments are part of financial assets. These refer to assets that arise from contractual agreements on future cash flows or from owning equity instruments of another entity. MFRS 132 defines financial instruments as any contract that gives rise to a financial asset to one entity and a financial liability or equity instrument to another entity (paragraph 11).

MFRS 132 states that a financial asset is an asset that is:

- *Cash (i.e. cash at bank, bank deposits);*
- *An equity instrument of another entity (i.e. shares in other company);*
- *A contractual right:*
    - *i. to receive cash or another financial asset from another entity (i.e. receivables);*
    - *ii. to exchange financial assets or financial liabilities with another entity under conditions that are potentially favourable to the entity (i.e. forward exchange contract); or*
- *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 receive 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 financial asset for a fixed number of the entity's own equity instruments. For this purpose the entity's own equity instruments do not include puttable financial instruments classified as equity instruments in accordance with paragraphs 16A and 16B, instruments that impose on the entity an obligation to deliver to another party a pro rata share of the net assets of the entity only on liquidation and are classified as equity instruments in accordance with paragraphs 16C and 16D, or instruments that are contracts for the future receipt or delivery of the entity's own equity instruments.*

An Islamic bank's financial investments include financial assets at FVTPL and FVOCI, while Other financial assets at Amortised cost.

3.2.2 Recognition and Measurement

3.2.2.1 Initial Measurement

MFRS 9 requires financial assets to be classified on initial recognition as measured at amortised cost, FVOCI or FVTPL, a point referred earlier. Additionally, MFRS 9 requires financial assets to be classified based on the business model within which they are held and their contractual cash flow characteristics. Please refer to Diagram 1 for the classification of financial assets.

The business model refers to the way in which an entity manages its financial assets to generate cash flows. This model is determined at a level that reflects the way financial assets are managed together to achieve an objective. The three types of business model, based on the contractual cash flow characteristics of the financial assets, are hold-to-collect, collect-and-sell and "others".

i. hold-to-collect business model (Amortised cost)

If the contractual terms of a financial asset give rise to cash flows on specified dates that are SPPI and the financial asset is held within a business model whose objective is to collect those cash, then, the financial asset is measured at amortised cost.

ii. collect-and-sell business model (FVOCI)

If the contractual terms of a financial asset give rise to cash flows on specified dates that are solely payment of principal and interest on the principal amount outstanding (SPPI) and it is held in which the objective is achieved through collecting contractual cash flows and by selling assets, then the financial asset is measured at FVOCI. In this regard, 'interest' in the context of SPPI refers to a defined term in MFRS 9 whereby paragraph 4.1.3 (b) of MFRS 9 defines interest as "… consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as profit margin." The term 'interest' is also mentioned in other parts of the Report, for instance 'accrued interest'. In these instances, the term 'interest' is reproduced as verbatim from the MFRS Standards and it should remain as such to avoid misinterpretation of the MFRS Standards[3].

When this financial asset is derecognised, cumulative gains and losses previously recognised in other comprehensive income are reclassified from equity to profit or loss for the year.

iii. other business models (FVTPL)

All other financial assets are measured at FVTPL.

More importantly, it is to be noted that an entity can have more than one business model for a portfolio of assets. However, an entity needs to consider the significance and frequency of sale activities when making its business model assessment. For example, for a group of financial assets classified as held-to-collect, some sales are possible provided these are infrequent or insignificant in value. More frequent and higher value sales may indicate that the business model is to collect-and-sell.

Therefore, determining financial assets classification under MFRS 9 can involve significant judgment. Consequently, an entity needs to assess the contractual provisions of each instrument to determine if cash flows are solely payments of principal and interest on the principal amount outstanding (SPPI). In doing this, utmost care is exercised to ensure that financial assets are classified appropriately. An entity may, at initial recognition, designate a financial asset as measured at FVTPL, for certain investments in equity instruments.

3.2.2.2 Subsequent Measurement

After initial recognition, financial assets are recorded at fair values, either as FVTPL or FVOCI. Such gains or losses arising from a change in the fair values will be recognised in the profit or loss and other comprehensive income, respectively.

The subsequent measurement of financing and receivables is at amortised cost using the effective profit rate method. Financial assets which are measured using amortised cost will use the effective profit rate less impairment. Further, an integral part of the effective profit rate method in the calculation of amortised cost is to include any discount or premium on the acquisition. The amortisation, losses arising from an impairment, and gain or loss arising from derecognition of such investments are recognised in the statement of profit or loss.

After initial recognition, financial assets are subsequently measured at amortised cost or FVOCI. This would depend on the business model and whether the asset meets the SPPI test. For the measurement at FVOCI, any gain or loss arising from the change in the fair value is recognised in the fair value reserve through other comprehensive income. Impairment losses and foreign exchange gains and losses arising from monetary items are, however, recognised in profit or loss.

[3]A Review of BNM Shariah Policy Documents from a Financial Reporting Perspective by the Working Group of MASB Standing Committee on Islamic Financial Reporting.

For example, an Islamic bank, purchased a financial asset on 1 January 2016 at a cost of RM5 million with annual profit rate of 5%, payable on 31 December annually. At the reporting date of 31 December 2016 to 2019, profit has been received as expected and the effective profit rate is now 6%. The fair value of the financial asset as at 31 December 2016 was RM5.1 million.

Thus, if the financial asset is measured at FVTPL, at the reporting date of 31 December 2016 the financial asset will be stated at a fair value of RM5.1 million, with the increase in fair value amounting to RM0.1 million taken to profit or loss in the year. Profit received will be taken to profit or loss for the year amounting to RM0.25 million. On the other hand, if the financial assets are measured at FVOCI, the increase in fair value amounting to RM0.1 million would be taken to other comprehensive income in the year.

For the financial asset that is measured at amortised cost, the financial asset will be reported at RM5.05 million as at 31 December 2016, using the effective profit rate of 6%. Table 1 shows the amortised amount for the financial asset as at 31 December 2016 until 31 December 2019.

Year	Profit received	Profit receivable based on effective profit rate of 6%	Balance
31 December 2016	RM5m x 5% = RM0.25m	RM0.30 million	RM5.05 million
31 December 2017	RM0.25m	RM0.303 million	RM5.103 million
31 December 2018	RM0.25m	RM0.306 million	RM5.159 million
31 December 2019	RM0.25m + RM5m	RM0.310 million	RM5.219 million

Table 1: Financial Asset at amortised cost

Under MFRS 9, there are two different treatments depending on whether it is a debt or an equity instrument:

- For debt instruments classified as FVOCI, the cumulative gains or losses previously recognised in other comprehensive income are reclassified from equity into profit or loss on disposal of the financial assets (debt instruments) available-for-sale

- For equity instruments classified as FVOCI, the cumulative gains or losses previously recognised in other comprehensive income are merely transferred from fair value reserve (equity) into retained earnings (equity) on disposal of the financial assets (equity instruments) available-for-sale.

For the amortised cost cl assification, the profit shall be calculated using the effective profit rate method. The effective profit rate is applied to the gross carrying amount of a financial asset except for:

a. purchased or originated credit-impaired assets. For those financial assets, Islamic banks shall apply the credit-adjusted effective profit rate to the amortised cost of the financial asset from initial recognition.

b. financial assets that are not purchased or originated credit-impaired financial assets but subsequently have become credit-impaired financial assets. For these financial assets, Islamic banks shall apply the effective profit rate to the amortised cost of the financial assets in subsequent reporting periods.

This is illustrated in Table 1 above.

Financial asset classification and measurement is an area where many changes have been introduced by MFRS 9. Consistent with MFRS 9, the classification of a financial asset is determined at initial recognition. However, if certain conditions are met, an asset may subsequently need to be reclassified. After initial recognition, all assets within the scope of MFRS 9 are measured at amortised cost, FVOCI or FVTPL. The FVOCI classification is mandatory for certain debt instruments unless the option of FVTPL ('the fair value option') is taken. In the case of equity investments, the FVOCI classification is on an election basis.

A debt instrument that meets the following two conditions must be measured at amortised cost unless the asset is designated at FVTPL (under the fair value option).

a. **Business model test:** The financial asset is held within a business model whose objective is to hold financial assets to collect their contractual cash flows (rather than to sell the assets prior to their contractual maturity to realise changes in fair value).

b. **Cash flow characteristics test:** The contractual terms of the financial asset give rise, on specified dates, to cash flows that are solely payments of principal and interest on the principal amount outstanding.

A debt instrument that meets the cash flow characteristics test and is not designated as FVTPL under the fair value option must be measured at FVOCI if it is held within a business model whose objective is to hold financial assets to collect contractual cash flows and sell financial assets. All other debt instrument assets are measured at FVTPL. It is to be noted that only debt instruments can meet the contractual cash flow characteristics test required by MFRS 9. Derivative assets and investments in equity instruments will not meet the criterion. Contractual cash flows that are solely payments of principal and interest on the principal amount outstanding are consistent with a basic lending arrangement.

In a basic lending arrangement, consideration for the time value of money and credit risks are typically the most significant elements of profit. However, in such an arrangement, profit can also include consideration for other basic lending risks (for example, liquidity risk) and costs (for example, administrative costs) associated with holding the financial asset for a particular period. The assessment whether contractual cash flows are solely payments of principal and interest on the principal amount outstanding is made in the currency in which the financial asset is denominated. Judgement is needed in assessing whether a payment (or non-payment) of a contractual cash flow that only arises from the occurrence or non-occurrence of a contingent event leads to the instrument failing the contractual cash flow characteristics test.

An entity should consider the types of risks that may lead to the occurrence of the contingent event and whether that risk is consistent with risks associated with a basic lending arrangement. The contractual cash flows characteristic assessment should consider all the contractual terms of the instrument, not just those contractual cash flows that are most likely to fall due. When an asset may be prepaid, the contractual cash flow characteristics assessment requires consideration of the contractual cash flows both before and after the timing of the prepayment option, irrespective of the probability that the instrument may be repaid prior to maturity. MFRS 9 contains detailed guidance regarding the assessment of the contractual cash flows of an asset and has specific requirements for non-recourse assets and contractually linked instruments.

An assessment of business models for managing financial assets is fundamental to the classification of financial assets. Under MFRS 9, impairment is based on expected losses and is measured consistently with assets measured at amortised cost. Also, the criteria for measuring at FVOCI are based on the entity's business model.

The requirements for reclassifying gains or losses recognised in other comprehensive income (OCI) are different for debt and equity investments. For debt instruments measured at FVOCI, the profit (calculated using the effective profit rate method), foreign currency gains or losses and impairment gains or losses are recognised directly in profit or loss.

The difference between cumulative fair value gains or losses and the cumulative amounts recognised in profit or loss is recognised in OCI until derecognition. Upon derecognition, the amounts in OCI are transferred to profit or loss.

3.2.2.3 Reclassification

MFRS 9 requires the reclassification to be dealt with in the following manner. If Islamic banks reclassify financial assets, it shall apply the reclassification prospectively from the reclassification date. The entity shall not restate any previously recognised gains, losses (including impairment gains or losses) or profit. If Islamic banks reclassify a financial asset out of the amortised cost measurement category and into fair value through profit or loss (FVTPL) measurement category, its fair value is measured at the reclassification date. Any gain or loss arising from a difference between the previous amortised cost of the financial asset and fair value is recognised in profit or loss.

On the other hand, if Islamic banks reclassify a financial asset out of the fair value through profit or loss measurement category and into the amortised cost measurement category, its fair value at the reclassification date becomes its new gross carrying amount.

Should an Islamic bank reclassify a financial asset out of the amortised cost measurement category and into the fair value through other comprehensive income measurement category or fair value through profit or loss category; its fair value is measured at the reclassification date. Any gain or loss arising from a difference between the previous amortised cost of the financial asset and fair value is recognised in other comprehensive income or profit or loss, respectively.

If Islamic banks reclassify a financial asset out of the fair value through other comprehensive income measurement category and into the amortised cost measurement category, the financial asset is reclassified at its fair value at the reclassification date.

However, the cumulative gain or loss previously recognised in other comprehensive income is removed from equity and adjusted against the fair value of the financial asset at the reclassification date. As a result, the financial asset is measured at the reclassification date as if it had always been measured at amortised cost. This adjustment affects other comprehensive income but does not affect profit or loss and therefore is not a reclassification adjustment. The effective profit rate and the measurement of expected credit losses are not adjusted because of the reclassification.

If Islamic banks reclassify a financial asset out of the fair value through profit or loss measurement category and into the fair value through other comprehensive income measurement category, the financial asset continues to be measured at fair value.

If Islamic banks reclassify a financial asset out of the fair value through other comprehensive income measurement category and into the fair value through profit or loss measurement category, the financial asset continues to be measured at fair value.

The cumulative gain or loss previously recognised in other comprehensive income is reclassified from equity to profit or loss as a reclassification adjustment (see MFRS 101) at the reclassification date. This can be summarised in Table 2.

Reclassification	Adjustments for gain or loss from reclassification
Amortised cost → FVOCI	Other comprehensive income
Amortised cost → FVTPL	Profit or loss
FVOCI → Amortised cost	Other comprehensive income
FVOCI → FVTPL	Profit or loss

Table 2: Reclassification and Adjustments

This reclassification is allowed only when there is a change in a business model which are infrequent, significant to the entity's operations and demonstrable to external parties. However, it is to be noted that a change in intention related to particular financial assets, a temporary disappearance of a particular market for financial assets or a transfer of financial assets between parts of the entity with different business models does not constitute changes in the business model.

3.2.2.4 Impairment

As regards impairment, MFRS 9 introduces a single impairment measurement model known as expected credit loss model for all financial assets subject to credit risk, regardless of the type of instruments held and how such instruments are measured.

Adopting this model, Islamic banks are now required to book all credit losses on "day 1" itself. Thus, the occurrence of loss event is not required before impairment is recognised.

At each reporting date, an entity must assess whether there is any objective evidence that a financial asset is impaired. A financial asset or a portfolio of financial assets is deemed to be impaired if, and only if, there is objective evidence of impairment because of one or more events having an impact on the estimated future cash flows of the assets that can be reliably estimated (paragraph 59).

Objective evidence that a financial asset or a group of assets is impaired includes observable data that comes to the attention of the entity about the following 'trigger loss events':

a. *the significant financial difficulty of the issuer or obligor;*
b. *a breach of contract, such as a default or delinquency in profit or principal payments;*
c. *the fund's provider, for economic or legal reasons relating to the customer's financial difficulty, granting to the customer a concession that the fund's provider would not otherwise consider;*
d. *it is becoming probable that the customer will enter bankruptcy or other financial reorganisation;*
e. *the disappearance of an active market for that financial asset because of financial difficulties; or*
f. *observable data indicating that there is a measurable decrease in the estimated future cash flows from a group of financial assets since the initial recognition of those assets, although the decrease cannot yet be identified with the individual financial assets in the group, including:*

   i. *adverse changes in the payment status of customers in the group (e.g. an increased number of delayed payments or an increased number of credit card customers who have reached their credit limit and are paying the minimum monthly amount); or*

   ii. *national or local economic conditions that correlate with defaults on the assets in the group (e.g. an increase in the unemployment rate in the geographical area of the customers, a decrease in property prices for mortgages in the relevant area, a decrease in oil prices for financial assets to oil producers, or adverse changes in industry conditions that affect the customers in the group).*

In addition to the above events, objective evidence of impairment for an investment in an equity instrument includes information about significant changes with an adverse effect that have taken place in the technological, market, economic or legal environment in which the issuer operates. More importantly, it indicates that the cost of the investment in the equity instrument may not be recovered. A significant or prolonged decline in the fair value of an investment in an equity instrument below its cost is also objective evidence of impairment (paragraph 61).

The application of impairment requirements in MFRS 9 inevitably requires the use of judgment. This includes determining the criterion whether a decline in fair value is "significant or prolonged". The Financial Reporting Standards Implementation Committee (FRSIC) Consensus 14 states that an entity may develop internal guidance to aid consistent application of such judgment.

However, internal guidance should be consistently applied based on objective facts. A "significant or prolonged" decline in the fair value should not merely be regarded as an indicator of possible impairment. If the conclusion is that a decline in fair value of an investment in an equity instrument is "significant or prolonged" after applying the internal guidance, an impairment loss shall be recognised as it is a matter of fact and no longer a matter of judgment.

For financial assets measured at amortised costs; if there is objective evidence that an impairment loss has occurred, the amount of the loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows (excluding future credit losses that have not been incurred) discounted at the financial asset's original effective profit rate (i.e. the effective profit rate computed at initial recognition).

The carrying amount of the asset shall be reduced either directly or through the use of an allowance account. The amount of the loss shall be recognised in the profit or loss (paragraph 63). If subsequently, there is a reversal of an impairment loss, the amount of the reversal shall be recognised in the profit or loss too (paragraph 65).

For financial assets carried at cost (such as an investment in an equity instrument that does not have a quoted price in an active market); if there is objective evidence that an impairment loss has occurred, the amount of the impairment loss is measured as the difference between the carrying amount of the financial asset and the present value of estimated future cash flows discounted at the current market rate of return for a similar financial asset. Such impairment losses shall not be reversed (paragraph 66).

When a decline in the fair value of a financial asset measured at FVOCI has been recognised in other comprehensive income and there is objective evidence that the asset is impaired, the cumulative loss that had been recognised in other comprehensive income shall be reclassified from equity to profit or loss as a reclassification adjustment even though the financial asset has not been derecognised (paragraph 67).

The amount of the cumulative loss that is reclassified from equity to profit or loss shall be the difference between the acquisition cost (net of any principal repayment and amortisation) and current fair value, less any impairment loss on that financial asset previously recognised in profit or loss (paragraph 68). Impairment losses recognised in profit or loss for an investment in an available-for-sale financial asset shall not be reversed through profit or loss (paragraph 69).

Under the impairment approach in MFRS 9, it is no longer necessary for a credit event to have occurred before credit losses are recognised. Instead, Islamic banks must account for expected credit losses and changes in those expected credit losses. The amount of expected credit losses is updated at each reporting date to reflect changes in credit risk since initial recognition and, consequently, more timely information is provided about expected credit losses.

At each reporting date, Islamic banks shall measure the loss allowance for a financial asset at an amount equal to the lifetime expected credit losses if the credit risk on that financial asset has increased significantly since initial recognition (paragraph 5.5.3).

The objective of the impairment requirements is to recognise lifetime expected credit losses for all financial assets for which there have been significant increases in credit risk since initial recognition, whether assessed on an individual or collective basis – considering all reasonable and supportable information, including that which is forward-looking. (paragraph 5.5.4).

If credit risk of a financial asset has not increased significantly since initial recognition, an entity shall measure the loss allowance for that financial asset at an amount equal to 12-month expected credit losses.

If the loss allowance for a financial asset has been measured at an amount equal to lifetime expected credit losses in the previous reporting period, but the Islamic bank determines, at the current reporting date, that the condition is no longer met, the Islamic bank shall measure the loss allowance at an amount equal to 12-month expected credit losses at the current reporting date (paragraph 5.5.7).

The Islamic banks shall then recognise in the profit or loss, as an impairment gain or loss, the number of expected credit losses (or reversal) that is required to adjust the loss allowance at the reporting date to the amount that is required to be recognised in accordance with this Standard (paragraph 5.5.8). This is in accordance with MFRS 9.

Expected credit loss calculations are based on four components which are:

i. Probability of Default ("PD") – This is an estimate of the likelihood of default over a given time horizon.
ii. Exposure at Default ("EAD") – This is an estimate of the exposure at a future default date, taking into account expected changes in the exposure after the reporting date, including repayments of principal and interest, and expected drawdowns on committed facilities.
iii. Loss Given Default ("LGD") – This is an estimate of the loss arising on default. It is based on the difference between the contractual cash flows due and those that the lender would expect to receive, including from any collateral. It is usually expressed as a percentage of the EAD.
iv. Discount Rate – This is used to discount an expected loss to a present value at the reporting date using the effective profit rate at initial recognition.

The three-stage' model (the 'general model') of impairment based on changes in credit quality since initial recognition is described below:

Stage 1 includes financial instruments that have not had a significant increase in credit risk since initial recognition or that have low credit risk at the reporting date. For these assets, the 12-month expected credit losses ('ECL') are recognised and profit is calculated on the gross carrying amount of the asset (that is, without deduction for credit allowance). The 12-month ECL are the expected credit losses that result from default events that are possible within 12 months after the reporting date. It is not the expected cash shortfalls over the 12-month period but the entire credit loss on an asset-weighted by the probability that the loss will occur in the next 12 months.

Stage 2 includes financial instruments that have had a significant increase in credit risk since initial recognition (unless they have a low credit risk at the reporting date) but that do not have objective evidence of impairment. For these assets, lifetime ECL are recognised, but interest revenue is still calculated on the gross carrying amount of the asset. Lifetime ECL are the expected credit losses that result from all possible default events over the expected life of the financial instrument. Expected credit losses are the weighted average credit losses with the PD as the weight.

Stage 3 includes financial assets that have objective evidence of impairment at the reporting date. For these assets, lifetime ECL are recognised and interest revenue is calculated on the net carrying amount (that is, net of credit allowance).

Generally, a financial asset would have a significant increase in credit risk before there is objective evidence of impairment or before a default occurs. MFRS 9 requires both forward-looking and historical information to be used in order to determine whether a significant increase in credit risk has occurred.

3.2.2.5 Derecognition

Derecognition of financial assets can occur when the contractual rights to obtain cash flows from the financial assets have expired or have been transferred. Similarly, derecognition takes place when the Islamic bank still retains the contractual rights to receive cash flows but is obligated to pay the cash flows from the assets and the Islamic bank has transferred all the risks and rewards to the other party, substantially. However, an Islamic bank cannot derecognise the financial assets if the Islamic bank still has control over the assets despite transferring all the risks and rewards to the other party.

On derecognition of a financial asset in its entirety, the difference between

a. The carrying amount; and
b. The sum of (i) the consideration received (including any new assets obtained less any new liability assumed) and (ii) any cumulative gain or loss that had been recognised in other comprehensive income, shall be recognised in profit or loss.

An example of derecognition includes the disposal or sale of the financial assets.

3.2.3 Presentation and Disclosure

According to MFRS 7, for each of the following financial assets category, the carrying amount shall be disclosed either in the statement of financial position or in the notes:

i. financial assets at amortised cost
ii. financial assets at FVOCI
iii. financial assets at FVTPL

MFRS 7 requires additional disclosures for financial assets measured at FVTPL, including maximum exposure to credit risk and changes in fair value due to changes in credit risk.

For financial assets designated at fair value through other comprehensive income, it shall disclose:

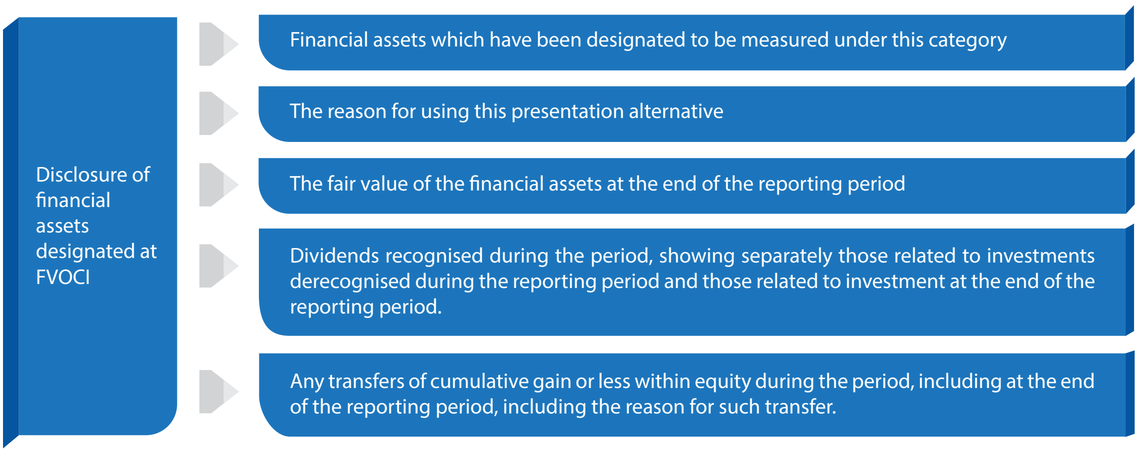

Diagram 2: Disclosure of financial assets designated at FVOCI

If an entity has reclassified a financial asset, it shall disclose the amount reclassified into and out of each category and the reason for that reclassification.

When financial assets are impaired, the entity records the impairment in a separate account (i.e. an allowance account used to record individual impairments or and collective amount of impairments) rather than directly reducing the carrying amount of the asset. Further, it shall disclose a reconciliation of changes in that account during the period for each class of financial assets.

An entity shall disclose information that enables users of its financial statements to evaluate the nature and extent of risks arising from financial instruments to which the entity is exposed at the end of the reporting period. The disclosure requires a focus on the risks that arise from financial instruments and how they have been managed. These risks typically include credit risk, liquidity risk and market risk.

3.2.3.1 The Practice

As discussed earlier, MFRS 7 requires entities to disclose the carrying amounts of each of the financial assets as defined in MFRS 9. The disclosure for each measurement category would assist users in understanding the extent to which accounting policies affect the amounts at which financial assets are recognised.

More importantly, separate disclosure of the carrying amounts of financial assets that are designated upon initial recognition as financial assets at FVTPL and those mandatorily measured at fair value is useful because such designation is at the discretion of the entity. As reflected in the Statement of Financial Position below, as at 31 December 2018, BIMB has Financial Assets available for sale of RM9,252,683 for the Group and RM9,253,140 for the Bank. Financial assets at fair value through other comprehensive income as at 31 December 2018 was RM10,176,619 for the Group and RM10,177,409 as at the same date for the Bank. There were no financial assets held to maturity for BIMB as at 31 December 2017 and 31 December 2018. Further clarification on the items in the assets are given in Notes 14, 15 and 16.

MFRS 7 also requires disclosure of the reason (s) for reclassification of financial assets and of the amount reclassified into and out of each category (Refer Diagram 2). MASB regards such information as useful because the categorisation of financial instruments has a significant effect on their measurement. The decision that requires additional disclosures about the situations in which any such reclassification is made and the effects on the financial statements are useful because the reclassification of a financial asset can have a significant effect on the financial statements.

Movements of allowance for impairment on financial assets at fair value through other comprehensive income is also reflected in the notes to the accounts.

Significant Accounting Policies

i. Classification of financial assets

MFRS 9 largely retains the existing requirements in MFRS 139 for the classification and measurement of financial liabilities. As such, there is no change on the Group's and the Bank's accounting policies related to financial liabilities. However, the standard eliminates the previous MFRS 139 categories for financial assets of held-to-maturity, financing and receivables and available-for-sale.

Under MFRS 9, on initial recognition, a financial asset is classified and measured at: amortised cost; FVOCI – debt investment; FVOCI – equity investment; or FVTPL. The classification of financial assets depends on the Group's and the Bank's business model in which a financial asset is managed and its contractual cash flow characteristics.

ii. Impairment of financial assets

The 'incurred loss' model under MFRS 139 is replaced with the MFRS 9 'expected credit loss' ("ECL") model. The new impairment model applies to financial assets measured at amortised cost, contract assets and debt investments at FVOCI, but not to investments in equity instruments. Under MFRS 9, credit losses are recognised earlier than under MFRS 139.

The financial assets at amortised cost consist of cash and short-term funds, deposits and placements with banks and other financial institutions, financing, advances and others, other assets and statutory deposits with Bank Negara Malaysia.

At each reporting date, the Group and the Bank first assess individually whether objective evidence of impairment exists for significant financial assets and collectively for financial assets that are not individually significant. If it is determined that objective evidence of impairment exists, i.e. credit impaired, for an individually assessed financial assets measured at amortised cost and FVOCI, a lifetime ECL will be recognised for impairment loss which has been incurred.

Under collective assessment, the Group and the Bank apply a three-stage approach to measuring ECL on financial assets measured at amortised cost and FVOCI. Financial assets migrate through the following three stages based on the change in credit quality since initial recognition:

i. **Stage 1: 12-months ECL**
For exposures where there has not been a significant increase in credit risk since initial recognition and that are not credit impaired upon recognition, the portion of lifetime ECL associated with the probability of default events occurring within the next 12 months is recognised.

ii. **Stage 2: Lifetime ECL - not credit impaired**
For exposures where there has been a significant increase in credit risk since initial recognition but that are not credit impaired, a lifetime ECL is recognised.

iii. **Stage 3: Lifetime ECL - credit impaired**
Financial assets are assessed as credit impaired when one or more events that have a negative impact on the estimated future cash flows of that asset have occurred. For financial assets that have become credit impaired, a lifetime ECL is recognised.

When determining whether the credit risk of a financial asset has increased significantly since initial recognition and when estimating ECLs, the Group and the Bank consider reasonable and supportable information that is relevant and available without undue cost or effort. This includes both quantitative and qualitative information and analysis, based on the Group's and the Bank's historical experience, informed credit assessment and including forward-looking information.

The Group and the Bank assume that the credit risk on a financial asset has increased significantly when it is more than 30 days past due. The Group and the Bank also use its internal credit risk grading system and external risk rating to assess deterioration in credit quality of a financial asset.

Measurement of ECL

ECLs are a probability-weighted estimate of credit losses. Credit losses are measured as the present value of all cash shortfalls (i.e. the difference between the cash flows due to the entity in accordance with the contract and the cash flows that the Group and the Bank expect to receive). ECLs are discounted at the effective profit rate of the financial asset.

Credit impaired financial assets

At each reporting date, the Group and the Bank assess whether financial assets carried at amortised cost and debt securities at FVOCI are credit-impaired. A financial asset is 'credit-impaired' when one or more events that have a negative impact on the estimated future cash flows of the financial asset have occurred.

Impact of the new impairment model

For assets in the scope of the MFRS 9 impairment model, impairment losses are generally expected to increase and become more volatile. The Group and the Bank have determined that the application of MFRS 9's impairment requirements at 1 January 2018 resulted in an additional allowance for impairment as follows:

	Financing, advances and others	Debt securities *	Total
	RM'000	RM'000	RM'000
Allowance for impairment at 31 December 2017 under MFRS 139	572,516	—	572,516
Additional allowance - ECL recognised at 1 January 2018	189,099	345	189,444
Allowance for impairment at 1 January 2018 under MFRS 9	761,615	345	761,960

* AFS debt securities reclassified as FVOCI at 1 January 2018.

Financial Statements
Statement of Financial Position as at 31 December 2018

		Group		Bank	
		31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
	Note	RM'000	RM'000	RM'000	RM'000
Assets					
Cash and short-term funds	3	**2,092,654**	4,185,697	**2,086,703**	4,185,561
Deposits and placements with banks and other financial institutions	4	**2,432,000**	—	**2,432,000**	—
Financial assets held-for-trading	5	**—**	380,925	**—**	375,664
Financial assets at fair value through profit or loss	6	**364,959**	—	**359,533**	—
Derivative financial assets	7	**34,148**	68,319	**34,148**	68,319
Financial assets available-for-sale	8	**—**	9,252,683	**—**	9,253,140
Financial assets at fair value through other comprehensive income	9	**11,354,299**	—	**11,355,089**	—
Financial assets held-to-maturity	10	**—**	—	**—**	—
Financing, advances and others	11	**45,680,680**	42,113,420	**45,680,680**	42,113,420
Other financial assets at amortised cost	12	**129,042**	123,503	**126,533**	121,062
Statutory deposits with Bank Negara Malaysia	13	**1,602,284**	1,407,284	**1,602,284**	1,407,284
Current tax assets		**8,466**	1,792	**8,403**	1,737
Deferred tax assets	14	**51,385**	37,288	**49,842**	37,288
Investments in subsidiaries	15	**—**	—	**15,525**	15,525
Property and equipment	16	**188,816**	172,003	**188,153**	171,240
Total assets		**63,938,733**	57,742,914	**63,938,893**	57,750,240

Notes to the Financial Statements 8. Financial assets available-for-sale	Group		Bank	
	31 Dec 2018 RM'000	31 Dec 2017 RM'000	31 Dec 2018 RM'000	31 Dec 2017 RM'000
At fair value				
Malaysian Government Investment Issues	—	1,525,094	—	1,525,094
Negotiable Islamic Debt Certificates	—	—	—	—
Sukuk	—	7,690,740	—	7,691,197
	—	9,215,834	—	9,216,291
At fair value				
Quoted shares - outside Malaysia	—	17,612	—	17,612
Quoted unit trust - in Malaysia	—	13,937	—	13,937
	—	31,549	—	31,549
At cost				
Unquoted shares in Malaysia*	—	23,520	—	23,520
Less: Accumulated impairment loss*	—	(18239)	—	(18239)
	—	5,281	—	5,281
At cost				
Unquoted shares outside Malaysia	—	329	—	329
Less: Impairment loss	—	(310)	—	(310)
	—	19	—	19
	—	9,252,683	—	9,253,140

*Movement in unquoted shares and accumulated impairment loss are due to translation difference

Figure 4: Financial Assets

9. Financial assets at fair value through other comprehensive income				
	Group		Bank	
	31 Dec 2018 RM'000	31 Dec 2017 RM'000	31 Dec 2018 RM'000	31 Dec 2017 RM'000
Financial assets at fair value through other comprehensive income:				
(a) Debt securities	**11,318,781**	—	11,318,781	—
(b) Equity investments	**35,518**	—	36,308	—
	11,354,299	—	11,355,089	—

(a) debt investment securities at fair value through other comprehensive income				
	Group		Bank	
	31 Dec 2018 RM'000	31 Dec 2017 RM'000	31 Dec 2018 RM'000	31 Dec 2017 RM'000
Malaysian Government Investment Issues	**2,129,754**	—	**2,129,754**	—
Sukuk	**8,493,541**	—	**8,493,541**	—
Bank Negara Monetary Notes	**389,231**	—	**389,231**	—
Islamic Commercial Papers	**306,255**	—	**306,255**	—
	11,318,781	—	**11,318,781**	—

Movements of allowance for impairment on financial assets at fair value through other comprehensive income.

	Group and Bank
	31 Dec 2018 RM'000
12 months ECL	
At 1 January 2018	—
- Effects on adoption of MFRS 9	345
At 1 January 2018, as restated	345
Reversal of impairment during the year	(43)
At 31 December 2018	302

(b) equity investments at fair value through other comprehensive income				
	Group		**Bank**	
	31 Dec 2018 RM'000	**31 Dec 2017 RM'000**	**31 Dec 2018 RM'000**	**31 Dec 2017 RM'000**
Quoted shares				
- outside Malaysia	**12,446**	–	**12,446**	–
Unquoted shares				
- in Malaysia	**23,056**	–	**23,846**	–
- outside Malaysia	**16**	–	**16**	–
	23,072	–	**23,862**	–
	35,518	–	**36,308**	

10. Financial assets held-to-maturity		
	Group and Bank	
	31 Dec 2018 RM'000	**31 Dec 2017 RM'000**
At amortised cost		
Unquoted securities in Malaysia: Sukuk	–	6,887
Less: Accumulated impairment loss	–	(6,887)
	–	–

3.3 Derivative Financial Assets

3.3.1 Nature and Definition

Derivative contracts include forwards, futures, swaps and options, all of which are bilateral contracts or payment exchange agreements, whose values are derived from the value of an underlying asset, reference rate or index. Derivatives are flexible and cost-effective tools for assisting in the management of profit rate, exchange rate, commodity, credit and equity exposures. For Islamic banks, derivative financial assets include forward and profit rate swaps.

A forward contract obliges one party to buy and the other to sell, a specific underlying product or instrument at a specific price, amount, and date in the future. A forward rate agreement (FRA) is an agreement between two parties establishing a contract profit rate on a notional principal over a specified period commencing at a specific future date.

A swap transaction obliges the two parties to the contract to exchange a series of cash flows at specified intervals known as payment or settlement dates.

Derivative financial assets shall be accounted for in accordance with MFRS 9 *Financial Instruments: Recognition and Measurement, MFRS 132 Financial Instruments: Presentation and MFRS 7 Financial Instruments: Disclosure.*

3.3.2 Recognition and Measurement

MFRS 9 uses 'rights and obligations' approach to the recognition of financial assets in its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the instruments similar to financial investments.

3.3.2.1 Initial Measurement of Derivative Financial Assets

MFRS 9 requires derivative financial assets to be classified on initial recognition as measured at amortised cost, FVOCI or FVTPL based on the business model within which they are held and their contractual cash flow characteristics. Details of the business model are discussed in Section II under Financial Investments.

3.3.2.2 Subsequent Measurement of Derivative Financial Assets

MFRS 9 requires that after initial recognition, an Islamic bank shall measure derivative financial assets at their fair values. Trading derivative financial instruments are revalued on a gross position and the unrealised gains or losses are reflected as derivative financial assets and liabilities respectively.

Derivative financial assets are subjected to impairment as discussed under financial investments in Section II.

3.3.2.3 Derecognition of Derivative Financial Assets

Derecognition involves the removal of a financial asset from an Islamic bank's statement of financial position. It is thus concerned with 'when' a financial asset shall cease to be recognised in an Islamic bank's statement of financial position.

3.3.3 Presentation and Disclosure

Derivative financial assets are presented in the Statement of Financial Position as assets of the Islamic bank. MFRS 7 specifies the disclosure requirements for financial instruments, including disclosures of financial risks and risk management objectives, policies and processes.

3.3.3.1 The Practice

As reflected in the Statement of Financial Position below, as at 31 December 2018, BIMB has Derivative Financial Assets of RM 34,148,000 for the Group and the Bank. Further clarification on the items in the assets are given in Note 7 as illustrated in Figure 5.

Significant Accounting Policies

The significant accounting policies to be applied to derivative financial assets are similar to those of financial assets discussed earlier.

Financial Statements

The derivative financial assets are presented in the statement of financial position of an Islamic bank as follows:

Statement of Financial Position as at 31 December 2018					
		Group		Bank	
		31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
	Note	RM'000	RM'000	RM'000	RM'000
Assets					
Cash and short-term funds	3	**2,092,654**	4,185,697	**2,086,703**	4,185,561
Deposits and placements with banks and other financial institutions	4	**2,432,000**	—	**2,432,000**	—
Financial assets held-for-trading	5	**—**	380,925	**—**	375,664
Financial assets at fair value through profit or loss	6	**364,959**	—	**359,533**	—
Derivative financial assets	7	**34,148**	68,319	**34,148**	68,319
Financial assets available-for-sale	8	**—**	9,252,683	**—**	9,253,140
Financial assets at fair value through other comprehensive income	9	**11,354,299**	—	**11,355,089**	—
Financial assets held-to-maturity	10	**—**	—	**—**	—
Financing, advances and others	11	**45,680,680**	42,113,420	**45,680,680**	42,113,420
Other financial assets at amortised cost	12	**129,042**	123,503	**126,533**	121,062
Statutory deposits with Bank Negara Malaysia	13	**1,602,284**	1,407,284	**1,602,284**	1,407,284
Current tax assets		**8,466**	1,792	**8,403**	1,737
Deferred tax assets	14	**51,385**	37,288	**49,842**	37,288
Investments in subsidiaries	15	**—**	—	**15,525**	15,525
Property and equipment	16	**188,816**	172,003	**188,153**	171,240
Total assets		**63,938,733**	57,742,914	**63,938,893**	57,750,240

Notes to the Financial Statements

7. Derivative financial assets

The following tables summarise the contractual or underlying principal amounts of derivative financial instruments held at fair value through profit or loss and hedging purposes. The principal or contractual amount of these instruments reflects the volume of transactions outstanding at financial position date, and do not represent amounts at risk.

Trading derivative financial instruments are revalued on a gross position and the unrealised gains or losses are reflected as derivative financial assets and liabilities respectively.

Group and Bank	31 Dec 2018		
	Notional amount	Fair value	
		Assets	Liabilities
	RM'000	RM'000	RM'000
Forward contracts	**2,869,455**	**30,653**	**(17,752)**
Profit rate swaps	**578,379**	**3,495**	**(1,768)**
	3,447,834	**34,148**	**(19,520)**

Group and Bank	31 Dec 2017		
	Notional amount	Fair value	
		Assets	Liabilities
	RM'000	RM'000	RM'000
Forward contracts	3,218,824	63,827	(72,767)
Profit rate swaps	607,992	4,492	(1,901)
	3,826,816	68,319	(74,668)

Figure 5: Derivative Financial Asset

3.4 Financing and Advances

Under financing and advances, an Islamic bank uses various Shariah contracts including *Mudarabah, Musyarakah, Murabaha, Tawarruq, Istisna', Ijarah and Qard* to develop its financing products. BNM in its framework on Financial Reporting for Islamic Banks suggests similar contracts suggesting that Islamic banks may use *Bai', Ijarah, Istisna', Musyarakah, Qard* and others. Given the significance of these products to Islamic Banks, a detailed discussion of these will be provided in Part II of this chapter.

3.5 Intangible Assets

3.5.1 Nature and Definition

An intangible asset is an identifiable non-monetary asset without physical existence (paragraph 8 of MFRS 138 *Intangible Assets*). Additionally, for an item to be classified as an asset, it must be a resource that is controlled by the entity because of past events and from which future economic benefits are expected. More importantly, paragraph 11 of MFRS 138 indicates that an intangible asset must be identifiable to distinguish it from goodwill. The standard goes on to explain that in the case of goodwill, it arises only through a business combination where assets acquired are not individually identified and separately recognised. Goodwill will be discussed in greater detail in a later section.

An asset is identifiable only if it is capable of being separated or divided from the entity and sold, transferred, licensed, rented or exchanged, either individually or together with a related contract, regardless of whether the entity intends to do so. Further, an intangible asset is also identifiable if it arises through contractual or other legal rights, regardless of whether those rights are transferable or separable from the entity or from other rights and obligations (paragraph 12 of MFRS 138).

On the issue of control, paragraph 13 states that an entity has control over an asset only if it has the power to obtain the future economic benefits flowing from the underlying resource and it is able to restrict others from accessing those benefits.

Typical examples of intangible assets include, amongst others, patented technology, computer software, trademarks, customer lists, customer loyalty, mortgage servicing rights, licensing, royalty, franchise agreements, customer and supplier relationships, market share and marketing rights. As alluded to earlier, the standard also distinguishes between goodwill and other intangible assets. As may be recalled, intangible assets acquired as part of a business combination is referred to as goodwill.

3.5.2 Recognition and Measurement

Under paragraph 21 of MFRS 138, intangible assets (whether purchased or self-created) are recognised if, and only if:

a. *it is probable that the expected future economic benefits that are attributable to the asset will flow to the entity; and*
b. *the cost of the asset can be measured reliably.*

The probability of expected future economic benefits will be assessed based on reasonable and supportable assumptions reflecting on management's best estimate of the set of economic conditions that will exist over the useful life of the asset (paragraph 22 of MFRS 138).

The recognition of an intangible asset refers to the initial acquisition cost or if it is internally generated, to the cost incurred to generate it. Such recognition will also include the cost to add to, replace part of, or service it (paragraph 18).

Paragraph 10 of MFRS 138 indicates that for expenditure incurred to acquire intangible assets or for any internally generated intangible assets that do not meet the control feature, its future economic benefits and identifiability criteria would be recognised as an expense.

3.5.2.1 Initial Measurement

Generally, all intangible assets are measured, initially, at cost (paragraph 24).

Separate acquisition

For intangible assets that are acquired, the cost an entity pays to acquire an intangible asset includes the purchase price (including import duties and non-refundable purchase taxes after deducting trade discounts and rebates) and any cost that is directly attributable in preparing the asset for its intended use. Some examples of directly attributable cost include the cost of employee benefits, professional fees and cost of testing (paragraphs 27-28).

Internally generated intangible assets

For internally generated intangible assets recognition problems may arise in identifying whether and when there is an identifiable asset that will generate future economic benefits as well as determining, reliably, the cost of the asset (paragraph 51 of MFRS 138). Accordingly, the standard clearly states that the criteria for recognition of internally generated intangible asset are divided into two phases; one on research and the other on development (paragraph 52).

i. *Research phase*

   Intangible asset arising from research should not be recognised. Thus, the expense incurred in this phase is to be written off. Some examples of activities in this phase include activities which are aimed at obtaining new knowledge, the search for, evaluation and final selection of, applications of research findings or other knowledge and the formulation, design, evaluation and final selection of possible alternatives for new or improved materials. Once written off, such expenditure cannot be reinstated at a future date (paragraph 71 of MFRS 138).

ii. *Development phase*

   Given that the development phase is further advanced than the research phase, an entity can sometimes identify an intangible asset arising from this phase if it fulfils certain criteria. Development costs are capitalised only after technical and commercial feasibility of the asset for sale or use have been established. Essentially what this means is that such an entity has every intention and the ability to complete the intangible asset as well as demonstrating how the asset will generate future economic benefits either through the entity's own use or through the sale of the asset (paragraph 57 of MFRS 138).

   For internally generated intangible asset, the cost includes all directly attributable costs that are necessary to create, produce, and prepare the asset to be capable of operating in the manner intended by management (paragraph 65 of MFRS 138).

3.5.2.2 Subsequent Measurement

Intangible assets, as discussed earlier, are initially measured at cost. Subsequently, the entity can either adopt the cost or revaluation models.

Cost versus revaluation models

Under the cost model an intangible asset is carried at cost less accumulated amortisation and impairment losses (paragraph 74 of MFRS 138). Under the revaluation model an intangible asset may be carried at a revalued amount that is based on a fair value and deduct any subsequent amortisation and impairment losses. It is important that the fair value is determined by reference to an active market.

However, such active markets are expected to be uncommon for intangible assets, particularly in the case of brands, patents, trademarks, music and publishing rights, etc.

Finite versus infinite useful lives

Classification of intangible assets is based on its useful life. Intangible assets with an indefinite life refer to those intangible assets with no foreseeable limit to the period over which the asset is expected to generate net cash inflows for the entity. Those with a finite life are intangible assets that have a limited period of benefits accruing to the entity. For intangible assets with finite lives, its measurement after the acquisition would be the cost less residual value and this should be amortised on a systematic basis over that limited period. The amortisation method should accord with the pattern of benefits accruing to the entity.

Should such a pattern be indeterminable, then the straight-line method should be adopted. The amortisation charge is recognised in the income statement and the amortisation period is reviewed at least annually (paragraph 97). The residual value of an intangible asset with a finite useful life should be taken as zero unless there is a commitment by a third party to purchase the asset at the end of its useful life or there is an active market for the asset (paragraph 100).

An intangible asset with an indefinite useful life should not be amortised. It is pertinent for the useful life to be reviewed every reporting period to ensure that events and circumstances continue to support an indefinite useful life assessment for that asset.

Should there be a change in its useful life (from indefinite to finite), then this should be accounted for as a change in accounting estimate and this follows MFRS 108 (paragraph 109 of MFRS 138).

Impairment losses

To determine if there is any impairment to the intangible asset, an entity should apply MFRS 136 *Impairment of Assets*. Specifically, MFRS 136 discusses when and how an entity reviews the carrying amount of its assets, the manner it determines the recoverable amount of an asset as well as to recognise or reverse an impairment loss (paragraph 111).

Derecognition

An intangible asset shall be derecognised on disposal or when there are no future economic benefits expected from its use or disposal (paragraph 112 of MFRS 138). Further, paragraph 113 states that:

> *"the gain or loss arising from the derecognition of an intangible asset shall be determined as the difference between the net disposal proceeds, if any, and the carrying amount of the asset. It shall be recognised in profit or loss when the asset is derecognised (unless IAS 17 requires otherwise on a sale and leaseback.) Gains shall not be classified as revenue."*

3.5.3 Presentation and Disclosure

Internally generated intangible assets and other intangible assets are to be disclosed separately. Additionally, for each class of intangible asset, the following should be included:

i. *whether the useful lives are indefinite or finite and, if finite, the useful lives or the amortisation rates used;*
ii. *the amortisation methods used for intangible assets with finite useful lives;*
iii. *the gross carrying amount and any accumulated amortisation (aggregated with accumulated impairment losses) at the beginning and end of the period;*
iv. *the line item(s) of the statement of comprehensive income in which any amortisation of intangible assets is included;*
v. *a reconciliation of the carrying amount at the beginning and end of the period showing:*

1. *additions, indicating separately those from internal development, those acquired separately, and those acquired through business combinations;*
2. *assets classified as held for sale or included in a disposal group classified as held for sale in accordance with MFRS 5 Non-current Assets Held for Sale and Discontinued Operations and other disposals;*
3. *increases or decreases during the period resulting from revaluations under paragraphs 75, 85 and 86 and from impairment losses recognised or reversed in other comprehensive income in accordance with MFRS 136 (if any);*
4. *impairment losses recognised in profit or loss during the period in accordance with MFRS 136 (if any);*
5. *impairment losses reversed in profit or loss during the period in accordance with MFRS 36 (if any);*
6. *any amortisation recognised during the period;*
7. *net exchange differences arising on the translation of the financial statements into the presentation currency, and on the translation of a foreign operation into the presentation currency of the entity; and*
8. *other changes in the carrying amount during the period.*
   (paragraph 118 of MFRS 138)

3.5.3.1 The Practice

Intangible Assets as at 31 December 208 was RM71,536,000 for the Group and the Bank. These intangible assets are further clarified in Note 19 of the financial statements as illustrated in Figure 6.

Significant Accounting Policies

b) Other intangible assets are measured at fair value. Other intangible assets include computer software. Acquired computer software licences are capitalised on the basis of the costs incurred to acquire and bring to use the specific software.

Computer software are stated at cost less accumulated amortisation and accumulated impairment losses, and are amortised over their estimated useful lives as follows:

Computer software 3 –15 years

Financial Statement

Company No: 671380-H
CIMB Islamic Bank Berhad
(Incorporated in Malaysia)

Statement of Financial Position as at 31 December 2018

		Group		Bank	
		31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
	Note	RM'000	RM'000	RM'000	RM'000
Assets					
Cash and short-term funds	2	**10,441,142**	14,282,896	**10,441,096**	14,282,850
Deposits and placements with banks and other financial institutions	3	**483,685**	530,017	**483,685**	530,017
Financial assets at fair value through profit or loss	4	**2,925,344**	—	**2,925,344**	—
Debt instruments at fair value through other comprehensive income	5	**2,756,547**	—	**2,756,547**	—
Equity instruments at fair value through other comprehensive income	6	**575**	—	**575**	—
Debt instruments at amortised cost	7	**6,544,723**	—	**6,544,723**	—
Financial assets held-for-trading	8	**—**	3,225,138	**—**	3,225,138
Financial assets available-for-sale	9	**—**	1,923,597	**—**	1,923,597
Financial assets held-to-maturity	10	**—**	4,732,389	**—**	4,732,389
Islamic derivative financial instruments	26(a)	**564,384**	634,306	**564,384**	634,306
Financing, advances and others financing/loans	11	**70,618,727**	57,551,408	**70,618,727**	57,551,408
Other assets	12	**723,563**	604,089	**723,563**	604,089
Deferred taxation	13	**77,248**	17,795	**77,248**	17,795
Amount due from holding company	14	**90,731**	—	**90,731**	—
Amount due from related companies	15	**620**	414	**620**	414
Statutory deposits with Bank Negara Malaysia	16	**2,076,422**	1,554,286	**2,076,422**	1,554,286
Investments in subsidiaries	17	**—**	—	**11**	11
Property and equipment	18	**2,756**	6,031	**2,756**	6,031
Intangible assets	19	**71,536**	79,092	**71,536**	79,092
Goodwill	20	**136,000**	136,000	**136,000**	136,000
		97,514,003	85,277,458	**97,513,968**	85,277,458

Notes to the Financial Statements

19. Intangible assets

		The Group and the Bank	
	Note	31 Dec 2018 RM'000	31 Dec 2017 RM'000
Computer software			
Cost			
At 1 January		**133,973**	132,518
Additions		**2,201**	6,119
Written off		**–**	(3332)
Reclassified to property, plant and equipment	18	**–**	(1332)
At 31 December		**136,174**	133,973
Accumulated amortisation			
At 1 January		**54,881**	51,477
Amortisation for the financial year		**9,757**	8,068
Written off		**–**	(3332)
Reclassified to property, plant and equipment	18	**–**	(1332)
At 31 December		**64,638**	54,881
Net book value at 31 December		**71,536**	79,092

The remaining amortisation period of the intangible assets are as follows:

Computer Software 1-15 years

The above intangible assets include computer software under construction at cost of the Group and the Bank of RM659,650 (2017:RM4,405,484).

Figure 6: Intangible Assets

3.6 Investment in Subsidiaries

3.6.1 Nature and Definition

The parent-subsidiary relationship exists when a company holds a controlling interest in another company. A parent company can create new subsidiaries internally or take over the control of existing companies through mergers or acquisitions. Most large companies have subsidiaries primarily due to brand recognition, financial considerations as well as for the specific need in raising capital. There are two standards that are relevant for investments in subsidiaries; MFRS 127 *Separate Financial Statements* and MFRS 10 *Consolidated Financial Statements.*

Specifically, the objective of MFRS 10 is to develop principles for the presentation and preparation of consolidated financial statements of an entity that controls other entities. MFRS 10 defines a subsidiary as 'an entity that is controlled by another entity'. Additionally, the standard states that consolidated financial statements are the financial statements of a group in which the assets, liabilities, equity, income, expenses and cash flows of the parent and its subsidiaries are presented as those of a single economic entity.

The same definition of consolidated financial statements is also found in paragraph 4 of MFRS 127. MFRS 127 (paragraph 4) states that separate financial statements are those presented by a parent (i.e. an investor with control of a subsidiary) or an investor with joint control of, or significant influence over, an investee, in which the investments are accounted for at cost or in accordance with MFRS 9.

3.6.2 Recognition and Measurement

The issue of control thus is of importance and this is clarified in MFRS 10. An investor controls an investee when it is exposed, or has rights, to variable returns from its involvement with the investee and can affect those returns through its power over the investee (paragraph 6).

Additionally, an investor has control over the investee if and only if the investor has:

i power over the investee;
ii. exposure, or rights, to variable returns from its involvement with the investee; and
iii. the ability to use its power over the investee to affect the amount of the investor's returns. (paragraph 7).

Investment in subsidiaries is recognised at fair value. The fair value shall be regarded as the fair value on initial recognition of a financial asset in accordance with MFRS 9 or, when appropriate, the cost on initial recognition of an investment in an associate or joint venture.

3.6.2.1 Derecognition

Should a parent lose control of a subsidiary, the parent must:

i derecognise the assets and liabilities of the former subsidiary from the consolidated statement of financial position.
ii. recognise any investment retained in the former subsidiary at its fair value when control is lost and subsequently accounts for it and for any amounts owed by or to the former subsidiary in accordance with relevant MFRSs.
iii. recognises the gain or loss associated with the loss of control attributable to the former controlling interest (paragraph 25).

3.6.3 Presentation and Disclosure

An entity which is a parent shall prepare consolidated financial statements with uniform accounting policies for like transactions and other events in similar circumstances. Consolidation of an investee is on the date the investor obtains control and ceases when the investor loses control of the investee (paragraphs 19 and 20 of MFRS 10).

Should a parent have a non-controlling interest in an entity, such information should be presented in the consolidated statement of financial position within equity and this should be separate from the equity of the owners of the parent (paragraph 22 of MFRS 10).

For investments in subsidiaries, the Islamic bank shall present the carrying amount in separate line items in its separate financial statements, while for consolidated financial statements each element in the financial statements of the parent and its subsidiaries are consolidated and presented as a single economic entity.

Islamic banks are also required to disclose a list of significant information pertaining to investments in subsidiaries such as the investees' name, principal place of business and the parent proportion of the ownership interest held in the subsidiaries.

3.6.3.1 The Practice

Investments in subsidiaries totalled RM 15,525,000 as at 31 December 2018. Note 15 of the financial statements indicates that all these investments consist of unquoted shares (Figure 7).

Significant Accounting Policies

Basis of consolidation

a. Subsidiaries

Subsidiaries are entities, including structured entities, controlled by the Bank. The financial statements of the subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases.

The Group controls an entity when it is exposed, or has rights, to variable returns from its involvement with the entity and has the ability to affect those returns through its power over the entity. Potential voting rights are considered when assessing control only when such rights are substantive. The Group also considers it has de facto power over an investee when, despite not having the majority of voting rights, it has the current ability to direct the activities of the investee that significantly affect the investee's return.

Investments in subsidiaries are measured in the Bank's statement of financial position at cost less impairment losses, if any. Where there is indication of impairment, the carrying amount of the investment is assessed. A write down is made if the carrying amount exceeds its recoverable amount.

Financial Statements
Statement of Financial Position as at 31 December 2018

		Group		Bank	
		31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
	Note	RM'000	RM'000	RM'000	RM'000
Assets					
Cash and short-term funds	3	**2,092,654**	4,185,697	**2,086,703**	4,185,561
Deposits and placements with banks and other financial institutions	4	**2,432,000**	–	**2,432,000**	–
Financial assets held-for-trading	5	**–**	380,925	**–**	375,664
Financial assets at fair value through profit or loss	6	**364,959**	–	**359,533**	–
Derivative financial assets	7	**34,148**	68,319	**34,148**	68,319
Financial assets available-for-sale	8	**–**	9,252,683	**–**	9,253,140
Financial assets at fair value through other comprehensive income	9	**11,354,299**	–	**11,355,089**	–
Financial assets held-to-maturity	10	**–**	–	**–**	–
Financing, advances and others	11	**45,680,680**	42,113,420	**45,680,680**	42,113,420
Other financial assets at amortised cost	12	**129,042**	123,503	**126,533**	121,062
Statutory deposits with Bank Negara Malaysia	13	**1,602,284**	1,407,284	**1,602,284**	1,407,284
Current tax assets		**8,466**	1,792	**8,403**	1,737
Deferred tax assets	14	**51,385**	37,288	**49,842**	37,288
Investments in subsidiaries	15	**–**	–	**15,525**	15,525
Property and equipment	16	**188,816**	172,003	**188,153**	171,240
Total assets		**63,938,733**	57,742,914	**63,938,893**	57,750,240

Notes to the Financial Statements

Investments in subsidiaries

	Group and Bank	
	31 Dec 2018 RM'000	**31 Dec 2017 RM'000**
At cost		
Unquoted shares in Malaysia	16,447	16,447
Less: Accumulated impairment loss	(922)	(922)
	15,525	15,525

Details of subsidiaries are as follows:

		Effective ownership interest	
		31 Dec 2018 RM'000	**31 Dec 2017 RM'000**
Name of Company	**Principal activities**	**%**	**%**
Al-Wakalah Nominees (Tempatan) Sdn. Bhd.	Provides nominee services	**100**	100
BIMB Investment Management Berhad	Manages Islamic Unit Trust Funds	**100**	100
Bank Islam Trust Company (Labuan) Ltd.	Provides services as a Labuan registered trust company	**100**	100
and its subsidiary:			
BIMB Offshore Company Management Services Sdn. Bhd.	Acts as Resident Corporate Secretary and Director for Offshore Companies	**100**	100
Farihan Corporation Sdn. Bhd.	Provides manpower services to the Bank	**100**	100

Figure 7: Investments on Subsidiaries

3.7 Property, Plant and Equipment (PPE)

3.7.1 Nature and Definition

The standard applicable for PPE is MFRS 116 *Property, Plant and Equipment.* The objective of this standard is to establish the accounting treatment for property, plant and equipment to provide insight to users of financial statements on information about an entity's investment in its PPE and the changes in such investment.

Specifically, the standard deals with issues pertaining to the recognition of the assets, the determination of their carrying amounts and the depreciation charges and impairment losses to be recognised in relation to PPE.

MFRS 116 defines PPE as tangible items that are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes and such assets are expected to be used for more than one period (paragraph 6 of MFRS 116).

However, the standard clearly indicates that the following do not fall under the purview of MFRS 116 except for certain exceptions discussed later:

i. property, plant and equipment classified as held for sale in accordance with MFRS 5 *Non-current Assets Held for Sale and Discontinued Operations;*
ii. biological assets related to agricultural activity (see MFRS 141 *Agriculture*);
iii. the recognition and measurement of exploration and evaluation assets (see MFRS *6 Exploration for and Evaluation of Mineral Resources*); or
iv. mineral rights and mineral reserves such as oil, natural gas and similar non-regenerative resources.

Although the standard does not cover the four classes of items described above, MFRS 116 does apply in *developing and maintaining the property*, plant and equipment classified as held for sale, biological assets related to agricultural activity and on mineral rights and mineral reserves (i, ii and iv above).

3.7.2 Recognition and Measurement

Similar to the definition of an asset discussed elsewhere in the chapter, the cost of an item of property, plant and equipment shall be recognised as an asset if, and only if:

i. it is probable that future economic benefits associated with the item will flow to the entity, and
ii. the cost of the item can be measured reliably.

While most assets are controlled and legally owned by the entity, legal ownership is not a criterion for the recognition of an asset. Recognition of an asset relies on control. A good example is a finance lease. MFRS 117 *Leases* regards a lessee with a finance lease as consistent with the conceptual framework's definition of an asset. Thus, where all the risks and rewards of ownership are substantial with the lessee and that the lease is a finance lease, the lessee should recognise it as an asset in its statement of financial position.

The acquisition of PPE that may be necessary for an entity to obtain future economic benefits from its other assets would also be recognised as PPE. This is because such items enable an entity to derive future economic benefits from *related assets* more than what could be derived had those items not been acquired. However, the resulting carrying amount of such an asset and its related assets will have to be reviewed for any impairment in accordance with MFRS 136 *Impairment of Assets.*

3.7.2.1 Derecognition

The carrying amount of an item of property, plant and equipment shall be derecognised upon disposal or when no future economic benefits are expected from its use or disposal (paragraph 67 of MFRS 116). Such gains or losses arising from the derecognition of an item of PPE shall be included in the profit or loss when the item is derecognised. Gains shall not be classified as revenue (paragraph 68 of MFRS 116).

These issues will be discussed in Chapter 8.

3.7.2.2 Initial Measurement

The cost of PPE will be the costs that are incurred initially to acquire or construct an item of property, plant and equipment. This will also include the subsequent costs that are incurred that add to the PPE, to replace parts of the PPE as well as in servicing it.

The carrying amount of the asset is the amount which is recognised after deducting any accumulated depreciation and accumulated impairment losses.

Note that the cost of an item of PPE is the cash price equivalent at the recognition date. If payment is deferred beyond normal credit terms, the difference between the cash price equivalent and the total payment is recognised as profit over the period of credit unless such profit is capitalised in accordance with MFRS 123 *Borrowing Costs.*

3.7.2.3 Subsequent Measurement

After initial recognition, the entity may choose the cost or the revaluation model as its accounting policy and shall apply that policy to the entire class of property, plant and equipment.

Cost versus revaluation model

Based on the cost model, an item of PPE shall be carried at its cost less any accumulated depreciation and any accumulated impairment losses (paragraph 30). Under the revaluation model, the fair value of the PPE (if it can be measured reliably) shall be carried at the revalued amount. This is the fair value at the date of the revaluation less any subsequent accumulated depreciation and subsequent accumulated impairment losses. In order to ensure that the carrying amount does not differ materially from that which would be determined using fair value at the end of the reporting period, such revaluations should be made regularly (paragraph 31 of MFRS 116). It is important to note that if an item of PPE is revalued, the entire class of property, plant and equipment to which that asset belongs shall be revalued (paragraph 36 of MFRS 116).

3.7.3 Presentation .and Disclosure

For each class of PPE, the following should be disclosed:

i. the basis for measuring the carrying amount
ii. the depreciation method (s) used
iii. useful lives or depreciation rates
iv. the gross carrying amount and accumulated depreciation and impairment losses and
v. reconciliation of the carrying amount at the beginning and the end of the period.

For the reconciliation statement, the additions, disposals, acquisitions through business combinations, revaluation increases or decreases, impairment losses, reversals of impairment losses, depreciation, net foreign exchange differences on translation and other movements should be disclosed.

In addition, the restrictions on title and items pledged as security for liabilities, expenditures to construct PPE during the period, contractual commitments to acquire PPE, compensation from third parties for items of PPE that were impaired, lost or given up that is included in profit or loss are also to be included as part of the disclosure.

For PPE that is revalued, the effective date of the revaluation, whether an independent valuer was involved for each revalued class of property, the carrying amount that would have been recognised had the assets been carried under the cost model, the revaluation surplus, including changes during the period and any restrictions on the distribution of the balance to shareholders, are important details to be included by the entity.

3.7.3.1 The Practice

The significant accounting policies of PPE generally focus on recognition and measurement issues. For example, it is normally stated that PPE are measured at cost less accumulated depreciation and any accumulated impairment losses.

The statement of financial position of BIMB as at 31 December 2018 is given below. Notice that PPE is presented last. Thus, in banks, the most liquid asset is listed first and most non-liquid asset displayed last. Typically, an entity should present separately the current and non-current assets in its statement of financial position. However, an entity is allowed to present its assets on the basis of liquidity if such a presentation provides information that is reliable (paragraph 60 of IAS 1). If this is the case, then a disclosure in the notes must indicate the combined amounts of the assets that will be received beyond 12 months with assets that will be received within 12 months. (paragraph 61 of IAS 1).

Significant Accounting Policies

Property and equipment

a. Recognition and measurement

Items of property and equipment are measured at cost less accumulated depreciation and any accumulated impairment losses.

Cost includes expenditures that are directly attributable to the acquisition of the asset and any other costs directly attributable to bringing the asset to working condition for its intended use, and the costs of dismantling and removing the items and restoring the site on which they are located. The cost of self-constructed assets also includes the cost of materials and direct labour. For qualifying assets, borrowing costs are capitalised in accordance with the accounting policy on borrowing costs. Cost also may include transfers from equity of any gain or loss on qualifying cash flow hedges of foreign currency purchases of property and equipment.

Purchased software that is integral to the functionality of the related equipment is capitalised as part of that equipment.

The cost of property and equipment recognised as a result of a business combination is based on fair value at acquisition date. The fair value of property is the estimated amount for which a property could be exchanged between knowledgeable willing parties in an arm's length transaction after proper marketing wherein the parties had each acted knowledgeably, prudently and without compulsion. The fair value of equipment is based on the quoted market prices for similar items when available and replacement cost when appropriate.

When significant parts of an item of property and equipment have different useful lives, they are accounted for as separate items (major components) of property and equipment.

The gain or loss on disposal of an item of property and equipment is determined by comparing the proceeds from disposal with the carrying amount of property and equipment and is recognised net within "other income" and "other expenses" respectively in profit or loss.

b. Subsequent costs

The cost of replacing a component of an item of property and equipment is recognised in the carrying amount of the item if it is probable that the future economic benefits embodied within the component will flow to the Group or the Bank, and its cost can be measured reliably. The carrying amount of the replaced component is derecognised to profit or loss. The costs of the day-to-day servicing of property and equipment are recognised in profit or loss as incurred.

c. Depreciation

Depreciation is based on the cost of an asset less its residual value. Significant components of individual assets are assessed, and if a component has a useful life that is different from the remainder of that asset, then that component is depreciated separately.

Depreciation is recognised in profit or loss on a straight-line basis over the estimated useful lives of each component of an item of property and equipment. Leased assets are depreciated over the shorter of the lease term and their useful lives unless it is reasonably certain that the Group and the Bank will obtain ownership by the end of the lease term. Property and equipment under construction are not depreciated until the assets are ready for their intended use.

The estimated useful lives for the current and comparative periods are as follows

- Long term leasehold land 50 years
- Building improvement and renovations 10 years
- Furniture, fixtures and fittings 2 - 10 years
- Office equipment 6 years
- Motor vehicles 5 years
- Computer equipment
  - Core Banking System 7 years
  - Other hardware/software 5 years

Depreciation methods, useful lives and residual values are reassessed at end of the reporting period, and adjusted as appropriate.

Financial Statements
Statement of Financial Position as at 31 December 2018

		Group		Bank	
		31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
	Note	RM'000	RM'000	RM'000	RM'000
Assets					
Cash and short-term funds	3	**2,092,654**	4,185,697	**2,086,703**	4,185,561
Deposits and placements with banks and other financial institutions	4	**2,432,000**	–	**2,432,000**	–
Financial assets held-for-trading	5	**–**	380,925	**–**	375,664
Financial assets at fair value through profit or loss	6	**364,959**	–	**359,533**	–
Derivative financial assets	7	**34,148**	68,319	**34,148**	68,319
Financial assets available-for-sale	8	**–**	9,252,683	**–**	9,253,140
Financial assets at fair value through other comprehensive income	9	**11,354,299**	–	**11,355,089**	–
Financial assets held-to-maturity	10	**–**	–	**–**	–
Financing, advances and others	11	**45,680,680**	42,113,420	**45,680,680**	42,113,420
Other financial assets at amortised cost	12	**129,042**	123,503	**126,533**	121,062
Statutory deposits with Bank Negara Malaysia	13	**1,602,284**	1,407,284	**1,602,284**	1,407,284
Current tax assets		**8,466**	1,792	**8,403**	1,737
Deferred tax assets	14	**51,385**	37,288	**49,842**	37,288
Investments in subsidiaries	15	**–**	–	**15,525**	15,525
Property and equipment	16	**188,816**	172,003	**188,153**	171,240
Total assets		**63,938,733**	57,742,914	**63,938,893**	57,750,240

Notes to the Financial Statements

16.Property and equipment

Group	Long term leasehold land RM'000	Building improvements and fittings RM'000	Furniture, fixtures and fittings RM'000	Office equipment RM'000	Computer equipment RM'000	Motor vehicles RM'000	Renovation work-in-progress RM'000	Management information system under development RM'000	Total RM'000
Cost									
At 1 January 2017	14,784	33,172	122,865	90,091	346,970	1,157	62	5,726	614,827
Additions	–	545	1,807	4,983	11,552	466	4,733	17,274	41,360
Reclassifications	–	256	1,362	686	3,159	–	(2,304)	(3,159)	–
Disposals	–	–	(3)	(209)	(1,339)	(680)	–	–	(2,231)
Written off	–	(113)	(921)	(420)	–	–	–	–	(1,454)
Exchange difference	–	(2)	(32)	(45)	(32)	–	–	–	(111)
At 31 December 2017	**14,784**	**33,858**	**125,078**	**95,086**	**360,310**	**943**	**2,491**	**19,841**	**652,391**
Additions	**–**	**789**	**4,807**	**4,253**	**25,972**	**–**	**4,459**	**24,887**	**65,167**
Reclassifications	**–**	**89**	**1,694**	**321**	**7,854**	**–**	**(2,104)**	**(7,854)**	**–**
Disposals	**–**	**–**	**(13)**	**(333)**	**(5,479)**	**–**	**–**	**–**	**(5,825)**
Written off	**–**	**(113)**	**(688)**	**(563)**	**(285)**	**–**	**–**	**–**	**(1,669)**
Exchange difference	**–**	**1**	**6**	**9**	**7**	**–**	**–**	**–**	**23**
At 31 December 2018	**14,784**	**34,604**	**130,884**	**98,773**	**388,379**	**943**	**4,846**	**36,874**	**710,087**
Accumulated depreciation									
At 1 January 2017	1,652	22,333	75,559	71,826	257,181	714	–	–	429,265
Depreciation for the year	174	2,004	9,128	7,065	35,991	118	–	–	54,480
Disposals	–	–	(3)	(203)	(1,332)	(317)	–	–	(1,855)
Written off	–	(104)	(898)	(396)	–	–	–	–	(1,398)
Exchange difference	–	(2)	(31)	(41)	(30)	–	–	–	(104)
At 31 December 2017	**1,826**	**24,231**	**83,755**	**78,251**	**291,810**	**515**	**–**	**–**	**480,388**
Depreciation for the year	**174**	**1,965**	**9,451**	**7,012**	**29,275**	**93**	**–**	**–**	**47,970**
Disposals	**–**	**–**	**(13)**	**(328)**	**(5,431)**	**–**	**–**	**–**	**(5,772)**
Written off	**–**	**(72)**	**(476)**	**(506)**	**(283)**	**–**	**–**	**–**	**(1,337)**
Exchange difference	**–**	**–**	**6**	**9**	**7**	**–**	**–**	**–**	**22**
At 31 December 2018	**2,000**	**26,124**	**92,723**	**84,438**	**315,378**	**608**	**–**	**–**	**521,271**
Carrying amounts									
At 1 January 2017	13,132	10,839	47,306	18,265	89,789	443	62	5,726	185,562
At 31 December 2017	12,958	9,627	41,323	16,835	68,500	428	2,491	19,841	172,003
At 31 December 2018	**12,784**	**8,480**	**38,161**	**14,335**	**73,001**	**335**	**4,846**	**36,874**	**188,816**

Figure 8: Property, Plant and Equipment

16. Property and equipment (cont'd)									
Bank	**Long term leasehold land RM'000**	**Building improvements and renovations RM'000**	**Furniture, fixtures and fittings RM'000**	**Office equipment RM'000**	**Computer equipment RM'000**	**Motor vehicles RM'000**	**Renovation work-in-progress RM'000**	**Management information system under development RM'000**	**Total RM'000**
Cost									
At 1 January 2017	14,784	32,983	122,789	89,729	344,950	1,157	62	5,726	612,180
Additions	–	545	1,807	4,980	11,544	466	4,733	17,274	41,349
Reclassifications	–	256	1,362	686	3,159	–	(2,304)	(3,159)	–
Disposals	–	–	(3)	(209)	(1,339)	(680)	–	–	(2,231)
Written off	–	(113)	(921)	(417)	–	–	–	–	(1,451)
Exchange difference	–	(2)	(32)	(31)	(6)	–	–	–	(71)
At 31 December 2017	**14,784**	**33,669**	**125,002**	**94,738**	**358,308**	**943**	**2,491**	**19,841**	**649,776**
Additions	**–**	**743**	**4,800**	**4,250**	**25,881**	**–**	**4,459**	**24,887**	**65,020**
Reclassifications	**–**	**89**	**1,694**	**321**	**7,854**	**–**	**(2,104)**	**(7,854)**	**–**
Disposals	**–**	**–**	**(13)**	**(333)**	**(5,479)**	**–**	**–**	**–**	**(5,825)**
Written off	**–**	**(113)**	**(688)**	**(549)**	**(237)**	**–**	**–**	**–**	**(1,607)**
Exchange difference	**–**	**1**	**6**	**6**	**1**	**–**	**–**	**–**	**14**
At 31 December 2018	**14,784**	**34,369**	**130,801**	**98,433**	**386,328**	**943**	**4,846**	**36,874**	**707,378**
Accumulated depreciation									
At 1 January 2017	1,652	22,208	75,521	71,484	256,054	714	–	–	427,633
Depreciation for the year	174	1,971	9,118	7,059	35,780	118	–	–	54,220
Disposals	–	–	(3)	(203)	(1,332)	(317)	–	–	(1,855)
Written off	–	(104)	(898)	(393)	–	–	–	–	(1,395)
Exchange difference	–	(2)	(31)	(28)	(6)	–	–	–	(67)
At 31 December 2017	**1,826**	**24,073**	**83,707**	**77,919**	**290,496**	**515**	**–**	**–**	**478,536**
Depreciation for the year	**174**	**1,935**	**9,442**	**7,010**	**29,069**	**93**	**–**	**–**	**47,723**
Disposals	**–**	**–**	**(13)**	**(328)**	**(5,431)**	**–**	**–**	**–**	**(5,772)**
Written off	**–**	**(72)**	**(476)**	**(492)**	**(235)**	**–**	**–**	**–**	**(1,275)**
Exchange difference	**–**	**–**	**6**	**6**	**1**	**–**	**–**	**–**	**13**
At 31 December 2018	**2,000**	**25,936**	**92,666**	**84,115**	**313,900**	**608**	**–**	**–**	**519,225**
Carrying amounts									
At 1 January 2017	13,132	10,775	47,268	18,245	88,896	443	62	5,726	184,547
At 31 December 2017	12,958	9,596	41,295	16,819	67,812	428	2,491	19,841	171,240
At 31 December 2018	**12,784**	**8,433**	**38,135**	**14,318**	**72,428**	**335**	**4,846**	**36,874**	**188,153**

3.8 Goodwill

3.8.1 Nature and Definition

MFRS 3 *Business Combinations* defines goodwill as an asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised.

Generally, there are two types of goodwill: internally generated goodwill and purchased goodwill. Internally generated goodwill relates to expenditure incurred to generate future economic benefits but does not result in the condition of an intangible asset (paragraph 49 of MFRS 138). It may exist through its brand value or image, customer relationships and creditors trust of the entity. This was discussed in Section V of the chapter.

Purchased goodwill is externally generated and arises when there is a business combination. This happens when the business is sold to another entity. Purchased goodwill is the excess amount that is paid by the acquirer after deducting the fair value of net identifiable assets in the seller's business.

3.8.2 Recognition and Measurement

As may be recalled, MFRS 138 requires an entity to recognise an intangible asset, whether acquired externally or generated internally at cost if:

i. it is probable that the future economic benefits that are attributable to the asset will flow to the entity; and
ii. the cost of the asset can be measured reliably (paragraph 21 of MFRS 138).

Paragraph 48 of MFRS 138 states that internally generated goodwill should not be recognised as an asset in the financial statements. Purchased goodwill, on the other hand, can be capitalised and recognised as an intangible asset in the Consolidated Statement of Financial Position of the acquirer (holding company).

Paragraph 32 of MFRS 3 states that the acquirer shall recognise goodwill as at the date of acquisition. Further, such goodwill should be measured as the excess of (a) over (b) where:

(a) is the aggregate of:

i the consideration transferred measured in accordance with this MFRS, which generally requires acquisition-date fair value;
ii. the amount of any non-controlling interest in the acquire, measured in accordance with this MFRS; and
iii. in a business combination achieved in stages, the acquisition-date fair value of the acquirer's previously held an equity interest in the acquire and

(b) is the net of the acquisition-date amounts of identifiable assets acquired and the liabilities assumed measured in accordance with this MFRS.

The equation below clarifies the above:

Goodwill = Consideration transferred + Amount of non-controlling interests + Fair value of previous equity interests – Fair value of net assets at the acquisition date.

If the difference in the above is negative, this would indicate a bargain purchase and account for in the income statement. Such a situation may arise when it is a forced sale (paragraphs 34-35 of MFRS 3). It is important to note that goodwill would, initially, be measured at cost. For subsequent measurement, goodwill is not to be amortised.

However, under MFRS 136, goodwill will be tested for impairment at least annually. At the financial year end, it will be recorded at cost less any impairment loss.

3.8.3 Presentation and Disclosure

The presentation and disclosure issues pertaining to goodwill align with the provisions in MFRS 138 on intangible assets. For a detailed discussion on the presentation and disclosure of goodwill, please refer to Section V above.

3.8.3.1 The Practice

Goodwill in CIMB, as at 31 December 2018 amounted to RM136,000,000 for the Bank. Note 20 to the financial statement for the year ended 31 December 2018 provides further explanation on the goodwill and its impairment test. There was no impairment charge for 2018.

Significant Accounting Policies

a. Goodwill

Goodwill arises from a business combination and represents the excess of the aggregate of fair value of consideration transferred, the amount of any non-controlling interest in the acquiree and the fair value of any previous equity interest in the acquiree over the fair value of the net identifiable assets acquired and liabilities assumed on the acquisition date. If the fair value of consideration transferred, the amount of non-controlling interest and the fair value of previously held interest in the acquiree are less than the fair value of the net identifiable assets of the acquiree, the resulting gain is recognised in profit or loss.

Goodwill is not amortised, but it is tested for impairment annually or more frequently if events or changes in circumstances indicate that might be impaired, and carried at cost less accumulated impairment losses. For the purpose of impairment testing, goodwill acquired in a business combination is allocated to cash-generating units ("CGU"), or groups of CGUs, that is expected to benefit from the business combination in which goodwill arose, identified according to operating segment.

The carrying value of goodwill is compared to the recoverable amount, which is the higher of value in use and the fair value less costs of disposal. Any impairment is recognised immediately as an expense and is not subsequently reversed.

Financial Statement
Company No: 671380-H
CIMB Islamic Bank Berhad
(Incorporated in Malaysia)
Statement of Financial Position as at 31 December 2018

		Group		Bank	
		31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
	Note	RM'000	RM'000	RM'000	RM'000
Assets					
Cash and short-term funds	2	**10,441,142**	14,282,896	**10,441,096**	14,282,850
Deposits and placements with banks and other financial institutions	3	**483,685**	530,017	**483,685**	530,017
Financial assets at fair value through profit or loss	4	**2,925,344**	–	**2,925,344**	–
Debt instruments at fair value through other comprehensive income	5	**2,756,547**	–	**2,756,547**	–
Equity instruments at fair value through other comprehensive income	6	**575**	–	**575**	–
Debt instruments at amortised cost	7	**6,544,723**	–	**6,544,723**	–
Financial assets held-for-trading	8	**–**	3,225,138	**–**	3,225,138
Financial investments available-for-sale	9	**–**	1,923,597	**–**	1,923,597
Financial investments held-to-maturity	10	**–**	4,732,389	**–**	4,732,389
Islamic derivative financial instruments	26(a)	**564,384**	634,306	**564,384**	634,306
Financing, advances and others financing/loans	11	**70,618,727**	57,551,408	**70,618,727**	57,551,408
Other assets	12	**723,563**	604,089	**723,563**	604,089
Deferred taxation	13	**77,248**	17,795	**77,248**	17,795
Amount due from holding company	14	**90,731**	–	**90,731**	–
Amount due from related companies	15	**620**	414	**620**	414
Statutory deposits with Bank Negara Malaysia	16	**2,076,422**	1,554,286	**2,076,422**	1,554,286
Investments in subsidiaries	17	**–**	–	**11**	11
Property, plant and equipment	18	**2,756**	6,031	**2,756**	6,031
Intangible assets	19	**71,536**	79,092	**71,536**	79,092
Goodwill	20	**136,000**	136,000	**136,000**	136,000
		97,514,003	85,277,458	**97,513,968**	85,277,458

Figure 9: Goodwill

Notes to the Financial Statements

20. Goodwill

	The Group and The Bank	
	31 Dec 2018 RM'000	**31 Dec 2017 RM'000**
Cost		
At 1 January/At 31 December	**136,000**	136,000

Goodwill is wholly allocated to the retail banking cash-generating unit ("CGU"). This CGUs do not carry any intangible assets with indefinite useful life

Impairment test for goodwill

Value-in-use

The recoverable amount of the CGU is determined based on value-in-use calculations. These calculations use pre-tax cash flow projections based on the 2019financialbudgets approved by the Board of Directors, projected for five years based on the average historical Gross Domestic Product ("GDP") growth of the country covering a five year period, revised for current economic conditions. Cash flows beyond the five year period are extrapolated using an estimated growth rate of 4.27% (2017:4.20%). The cash flow projections are derived based on a number of key factors including the past performance and managements expectation of market developments. The discount rate used in determining the recoverable amount of all the CGU is 7.47% (2017: 6.92%). The discount rate is pre-tax and reflects the specific risks relating to the CGU.

Impairment charge

There was no impairment charge for the financial year ended 31 December 2018 and
31 December 2017.

3.9 Statutory Deposits With BNM

3.9.1 Nature and Definition

A bank must have a certain level of reserves in the form of cash to ensure it remains solvent. In Malaysia, BNM requires all financial institutions, whether Islamic or otherwise, to maintain a reserve account with BNM. This is known as a statutory reserve or deposits. More importantly, this reserve/deposit acts as a monetary policy instrument available to BNM to manage the country's liquidity and for credit creation.

3.9.2 Recognition and Measurement

Statutory deposits with BNM are recognised at the point when the amount is being set aside for this reserve. All banks are required to maintain balances in their reserve accounts equivalent to a certain proportion of their eligible liabilities. Effective 1 February 2016, the statutory reserve rate for banking institutions is 3.5% of its eligible liabilities. Detailed calculation of this and what constitute eligible liabilities are laid out in the policy document on Statutory Reserve Requirement issued on 26 January 2016 by BNM. In addition, all investment accounts are excluded from the Eligible Liabilities (EL) base for the purposes of computing statutory reserve requirement (SRR).

3.9.3 Presentation and Disclosure

The statutory reserve with BNM is presented as an asset of the Islamic bank in its statement of financial position. As reflected in BIMB's annual report, the item is presented after "other assets." Further disclosure is made in the notes. Specifically, it indicates that the reserve is non-interest bearing and that such reserves are to comply with the Central Bank Act of 2009.

3.9.3.1 The Practice

There were no significant accounting policies indicated for Statutory Deposits with Bank Negara Malaysia. The total amount as at 31 December 2018 stood at RM1,602,284,000 for the Group and the Bank. Note 13 provides further explanation on Statutory Deposits with Bank Negara Malaysia.

Figure 10: Statutory Deposits

Financial Statements
Statement of Financial Position as at 31 December 2018

		Group		Bank	
		31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
	Note	RM'000	RM'000	RM'000	RM'000
Assets					
Cash and short-term funds	3	**2,092,654**	4,185,697	**2,086,703**	4,185,561
Deposits and placements with banks and other financial institutions	4	**2,432,000**	–	**2,432,000**	–
Financial assets held-for-trading	5	**–**	380,925	**–**	375,664
Financial assets at fair value through profit or loss	6	**364,959**	–	**359,533**	–
Derivative financial assets	7	**34,148**	68,319	**34,148**	68,319
Financial assets available-for-sale	8	**–**	9,252,683	**–**	9,253,140
Financial assets at fair value through other comprehensive income	9	**11,354,299**	–	**11,355,089**	–
Financial assets held-to-maturity	10	**–**	–	**–**	–
Financing, advances and others	11	**45,680,680**	42,113,420	**45,680,680**	42,113,420
Other financial assets at amortised cost	12	**129,042**	123,503	**126,533**	121,062
Statutory deposits with Bank Negara Malaysia	13	**1,602,284**	1,407,284	**1,602,284**	1,407,284
Current tax assets		**8,466**	1,792	**8,403**	1,737
Deferred tax assets	14	**51,385**	37,288	**49,842**	37,288
Investments in subsidiaries	15	**–**	–	**15,525**	15,525
Property and equipment	16	**188,816**	172,003	**188,153**	171,240
Total assets		**63,938,733**	57,742,914	**63,938,893**	57,750,240

Notes to the Financial Statements

The non-interest bearing statutory deposits are maintained with Bank Negara Malaysia in compliance with Section 26(2)(c) of the Central Bank of Malaysia Act, 2009, the amount of which are determined as set percentages of total eligible liabilities.

3.10 Amounts Due from Holding and/or Other Related Companies

3.10.1 Nature and Definition

Amounts due from holding and/or other related companies arise when inter-company transactions occur amongst companies within a group of companies. These transactions can occur for a variety of reasons and they often occur because of the normal business relationships that exist between members within a group. These intra-group trading and other transactions may result in members of the group owing to each other sums of money.

These balances may be in the form of:

i. Financing
ii. Receivables/payables
iii. Current accounts
iv. Bills receivable/payable
v. Income receivable/payable
iv. Dividend receivable/payable

3.10.2 Recognition and Measurement

In situations where there are many inter-company transactions, it is more appropriate to maintain a current account to record the amounts due to and due from each other. The current account is debited for amounts due and credited for amounts owing. Similarly, bills receivable and payable are negotiable financial instruments that can generally be used for such purposes.

For example, if a subsidiary owes its parent RM10,000, the parent may have a bill drawn on which it is stated that the subsidiary owes the parent RM10,000. These legal documents can be used by the parent to pay for another party. At times, these bills are discounted at discount houses or financial institutions.

Amounts due from holding and/or other related companies are classified as non-derivative financial assets under the category of financing and receivables. These amounts are measured at amortised cost using the effective profit rate method under with MFRS 9.

The remaining balance of amounts due from holding and/or other related companies, after some collections are made, will continue to be measured at amortised cost as no reclassification to other categories applies to financial assets under financing and receivables category.

3.10.2.1 Impairment

For some entities, the amounts due from holding and/or other related companies are unsecured and are not subject to compensation charges for late payment. Additionally, repayment terms are neither fixed nor expected. As such, the amounts due from holding and/ or related entities are reviewed at the end of each reporting period to determine whether there is any indication of impairment. If any such indication exists, then the recoverable amount of the asset is estimated. An impairment loss is recognised if the carrying amount exceeds its recoverable amount.

The recoverable amount of an asset is the greater of its value in use and its fair value less costs to sell. In assessing the value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects the current market assessment of the time value of money and the risks specific to the assets.

3.10.3 Presentation and Disclosure

Amounts due from holding and/or other related entities are presented in the statement of financial position under current assets as part of the financial assets of an entity less any impairment loss recognised during the year.

3.10.3.1 The Practice

In the financial statements of BIMB for the year ended 31 December 2018, the amounts due from holding and/or other related companies are presented under other assets. As at 31 December 2018, BIMB has other financial assets at amortised cost of RM129,042,000 for the Group and RM126,533,000 for the Bank. Note 12 provides further explanation Amounts due from holding and/or other related companies, which is included under other financial assets at amortised cost as in Figure 11.

There were no Significant Accounting Policies indicated for Amounts Due From Holding and/or Other Related Companies

Financial Statements
Statement of Financial Position as at 31 December 2018

		Group		Bank	
		31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
	Note	RM'000	RM'000	RM'000	RM'000
Assets					
Cash and short-term funds	3	**2,092,654**	4,185,697	**2,086,703**	4,185,561
Deposits and placements with banks and other financial institutions	4	**2,432,000**	–	**2,432,000**	–
Financial assets held-for-trading	5	**–**	380,925	**–**	375,664
Financial assets at fair value through profit or loss	6	**364,959**	–	**359,533**	–
Derivative financial assets	7	**34,148**	68,319	**34,148**	68,319
Financial assets available-for-sale	8	**–**	9,252,683	**–**	9,253,140
Financial assets at fair value through other comprehensive income	9	**11,354,299**	–	**11,355,089**	–
Financial assets held-to-maturity	10	**–**	–	**–**	–
Financing, advances and others	11	**45,680,680**	42,113,420	**45,680,680**	42,113,420
Other financial assets at amortised cost	12	**129,042**	123,503	**126,533**	121,062
Statutory deposits with Bank Negara Malaysia	13	**1,602,284**	1,407,284	**1,602,284**	1,407,284
Current tax assets		**8,466**	1,792	**8,403**	1,737
Deferred tax assets	14	**51,385**	37,288	**49,842**	37,288
Investments in subsidiaries	15	**–**	–	**15,525**	15,525
Property and equipment	16	**188,816**	172,003	**188,153**	171,240
Total assets		**63,938,733**	57,742,914	**63,938,893**	57,750,240

Figure 11: Amounts Due from Holding and/or Other Related Companies Significant Accounting Policies

Notes to the Financial Statements
Other financial assets at amortised cost

	Group		Bank	
	31 Dec 2018 RM'000	31 Dec 2017 RM'000	31 Dec 2018 RM'000	31 Dec 2017 RM'000
Sukuk^	**6,887**	—	**6,887**	—
Other receivables	**97,473**	90,137	**95,680**	87,964
Deposit and prepayments	**31,458**	33,086	**30,434**	31,968
Related companies*	**586**	755	**894**	1,605
	136,404	123,978	**133,895**	121,537
Less : Accumulated impairment loss				
Individual assessment				
Sukuk^	**(6887)**	—	**(6887)**	—
Other receivables	**(475)**	(475)	**(475)**	(475)
	129,042	123,503	**126,533**	121,062

3.11 Current Tax and Deferred Tax

3.11.1 Nature and Definition

Current tax under asset refers to the expected tax receivable on the taxable income or loss for the year, using tax rates enacted by the end of the reporting period, and any adjustment to the tax in respect of previous financial years. Current tax is one of the components of income tax expense (in addition to deferred tax expense) in the determination of profit or loss of an entity for the period.

Deferred tax refers to the tax effect of temporary differences between accounting income that is calculated by taking into consideration the requirements in accounting standards and taxable income that is calculated by taking into consideration the provisions of the tax authority. Based on paragraph 5 of MFRS 112 *Income Taxes*, Deferred tax assets are the amounts of income taxes recoverable in future periods in respect of:

a. deductible temporary differences;
b. the carry forward of unused tax losses; and
c. the carry forward of unused tax credits.

3.11.2 Recognition and Measurement

MFRS 112 states that the current tax receivable for current and prior periods shall be recognised as an asset. This asset arises due to the amount already paid in respect of current and prior periods exceeding the amount due for those periods. The benefit relating to a tax loss that can be carried back to recover the current tax of a previous period shall be recognised as an asset. When a tax loss is used to recover the current tax of a previous period, an entity recognises the benefit as an asset in the period in which the tax loss occurs because it is probable that the benefit will flow to the entity and that the benefit can be reliably measured.

Current tax assets for the current and prior periods shall be measured at the amount expected to be recovered from the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

Current tax is usually measured using the tax rates (and tax laws) that have been enacted. However, in some jurisdictions, announcements of tax rates (and tax laws) by the government have the substantive effect of actual enactment, which may follow the announcement by a period of several months. In these circumstances, tax assets and liabilities are measured using the announced tax rate (and tax laws).

According to MFRS112, deferred tax asset can be recognised on deductible temporary differences such as when the carrying amount of the asset is less than its tax base or when the carrying amount of the liability is more than its tax base. For example, if the Islamic bank has not received the profit from the financing amounted to RM100,000 and for tax purposes, receivable amount is not included but this amount has been included in the calculation of tax expense. So, this RM100,000 will give differences in the amount of tax expenses and tax payable which lead to tax being deferred.

3.11.3 Presentation and Disclosure

The current tax is presented under assets if the amount already paid in respect of the current and prior periods exceeds the amount due for those periods.

3.11.3.1 The Practice

For BIMB, as at 31 December 2018, the current tax assets totalled RM8,466,000 for the Group and RM8,463,000 for the Bank. Deferred tax assets amounted to RM51,385,000 for the Group and RM49,842,000 for the Bank.

Significant Accounting Policies

Income Tax

Income tax expense comprises current and deferred tax. Current tax and deferred tax are recognised in profit or loss except to the extent that it relates to a business combination or items recognised directly in equity or other comprehensive income.

Current tax is the expected tax payable or receivable on the taxable income or loss for the year, using tax rates enacted or substantively enacted by the end of the reporting period, and any adjustment to tax payable in respect of previous financial years.

Deferred tax is recognised using the liability method, providing for temporary differences between the carrying amounts of assets and liabilities in the statement of financial position and their tax bases. Deferred tax is not recognised for the following temporary differences: the initial recognition of assets or liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable profit or loss. Deferred tax is measured at the tax rates that are expected to be applied to the temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the end of the reporting period.

Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realised simultaneously.

A deferred tax asset is recognised to the extent that it is probable that future taxable profits will be available against which the temporary difference can be utilised. Deferred tax assets are reviewed at the end of each reporting period and are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

Financial Statements
Statement of Financial Position as at 31 December 2018

		Group		Bank	
		31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
	Note	RM'000	RM'000	RM'000	RM'000
Assets					
Cash and short-term funds	3	**2,092,654**	4,185,697	**2,086,703**	4,185,561
Deposits and placements with banks and other financial institutions	4	**2,432,000**	—	**2,432,000**	—
Financial assets held-for-trading	5	**—**	380,925	**—**	375,664
Financial assets at fair value through profit or loss	6	**364,959**	—	**359,533**	—
Derivative financial assets	7	**34,148**	68,319	**34,148**	68,319
Financial assets available-for-sale	8	**—**	9,252,683	**—**	9,253,140
Financial assets at fair value through other comprehensive income	9	**11,354,299**	—	**11,355,089**	—
Financial assets held-to-maturity	10	**—**	—	**—**	—
Financing, advances and others	11	**45,680,680**	42,113,420	**45,680,680**	42,113,420
Other financial assets at amortised cost	12	**129,042**	123,503	**126,533**	121,062
Statutory deposits with Bank Negara Malaysia	13	**1,602,284**	1,407,284	**1,602,284**	1,407,284
Current tax assets		**8,466**	1,792	**8,403**	1,737
Deferred tax assets	14	**51,385**	37,288	**49,842**	37,288
Investments in subsidiaries	15	**—**	—	**15,525**	15,525
Property and equipment	16	**188,816**	172,003	**188,153**	171,240
Total assets		**63,938,733**	57,742,914	**63,938,893**	57,750,240

Notes to the Financial Statements

Deferred tax assets
Recognised deferred tax assets
Deferred tax assets are attributable to the following

Group	Assets		Liabilities		Net	
	31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
	RM'000	RM'000	RM'000	RM'000	RM'000	RM'000
Property and equipment	–	–	(6568)	(8986)	(6568)	(8986)
Provisions	29,787	26,478	–	–	29,787	26,478
Impairment allowances	26,860	–	–	–	26,860	–
Unabsorbed capital allowances	829	12,829	–	–	829	12,829
Change in fair value reserve	–	6,967	(831)	–	(831)	6,967
Set off of tax	(7379)	(8,986)	7379	8986	–	–
Tax losses	1,308	–	–	–	1,308	–
Net tax assets	51,405	37,288	(20)	–	51,385	37,288

Bank	Assets		Liabilities		Net	
	31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
	RM'000	RM'000	RM'000	RM'000	RM'000	RM'000
Property and equipment	–	–	(6548)	(8986)	(6548)	(8986)
Provisions	29,532	26,478	–	–	29,532	26,478
Impairment allowances	26,860	–	–	–	26,860	–
Unabsorbed capital allowances	829	12,829	–	–	829	12,829
Change in fair value reserve	–	6,967	(831)	–	(831)	6,967
Set off of tax	(7379)	(8,986)	7379	8986	–	–
Net tax assets	49,842	37,288	–	–	49,842	37,288

Figure 12: Current Tax and Deferred Tax

Unrecognised deferred tax assets
Deferred tax assets have not been recognised in respect of the following items:

	Group		Bank	
	31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
	RM'000	RM'000	RM'000	RM'000
Unabsorbed capital allowance	**128,475**	78,475	**128,440**	78,440
Unutilised tax losses	**1,251**	6,701	**–**	–
Deductible temporary differences	**329**	329	**–**	–
	130,055	85,505	**128,440**	78,440

The Bank's unabsorbed capital allowances of RM128,440,000 in respect of its leasing business whereby management considered it uncertain whether the Bank is able to utilise the benefits in the future. As such, deferred tax assets have not been recognised.

PART II: Financing and Advances

The Islamic banks' financing and advances consist of sale-based contracts (namely *Bai' Bithaman Ajil, Bai Al-Inah, Murabahah, Bai Al-Dayn and At-Tawarruq*), lease-based contracts (namely *Ijarah Muntahiah Bit-Tamleek and Ijarah Thumma Al-Bai*), construction-based contracts (*Istisna'*), *Ar-Rahnu* contract and *Qard*. The nature and definition of such contracts, its recognition and measurement aspects, as well as the presentation and disclosure issues of each product, will be discussed next.

4.0 GENERAL CONSIDERATIONS ON ACCOUNTING FOR ISLAMIC FINANCIAL PRODUCTS

Given that there is no specific accounting standard that governs the disclosure for Islamic financial products, IBs are generally guided by MFRS 101 *Presentation of Financial Statements.* Specifically, paragraph 17 of MFRS 101 states that a fair presentation of the financial statements requires an entity to:

a. *present information, including accounting policies, in a manner that provides relevant, reliable, comparable and understandable information.*
b. *provide additional disclosures when compliance with the specific requirements in MFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance.*

Where there is any departure from the provisions of the relevant MFRSs, the Islamic bank, in order to reflect a true and fair view of the state of affairs of the bank, should disclose the following:

i. the relevant MFRS for which the Islamic bank has departed from;
ii. the nature and reason of the departure; and
iii. the financial effect of the departure on each item in the financial statements that would have been reported in complying with the MFRS requirement.

However, the above is extremely rare as any departure may lead to qualified audit reports.

As required by paragraph S 10.7 of the BNM Guidelines on Financial Reporting for Islamic Financial Institutions, the Islamic bank is also to disclose financing, receivables and other *Qard* loans with a breakdown on:

i. measurement basis (e.g. amortised cost, fair value);
ii. types of financing (e.g. overdrafts, term financing, revolving financing, hire purchase, mortgage financing);
iii. geographical distribution;
iv. profit rate sensitivity (e.g. fixed rate, variable rate);
v. economic sector or purpose; and
vi. residual contractual maturity (e.g. up to 1 year, 1-5 years, > 5 years).

On (i), the Islamic bank should ensure that for financial instruments measured at fair value through profit or loss, it should separately disclose those designated as fair value upon initial recognition, and those that have been specified under the Operational Risk Integrated Online Network (ORION) for guidance on treatment of Shariah non-compliant items.

On the types of financing under (ii) above, there should be a further breakdown by main Shariah contracts in tabular format. In addition, the Islamic bank should disclose:

i. the significant subclasses of the main contracts; and
ii. the classification of main Shariah contracts and their subclasses (see Figure 13).

A movement schedule of impairment allowances segregated between individual impairment and collective impairment and showing separately the amount charged and the amount utilised to write-off impaired financing/advances during the year should also be included.

Figure 13: BNM Guidelines on Financial Reporting for Islamic Financial Institutions

Financing by types and Shariah contracts in table format

Type	Bai’	Ijarah	Istisna’	Musharakah	Qard	Others	Total financing, advances and other receivables
Cash Line	XX	XX	XX	XX	XX	XX	XX
Term Financing	XX	XX	XX	XX	XX	XX	XX
House Financing	XX	XX	XX	XX	XX	XX	XX
Syndicated Financing	XX	XX	XX	XX	XX	XX	XX
Hire purchased receivables	XX	XX	XX	XX	XX	XX	XX
Lease receivables	XX	XX	XX	XX	XX	XX	XX
Other term financing	XX	XX	XX	XX	XX	XX	XX
Bills receivable	XX	XX	XX	XX	XX	XX	XX
Trust receipts	XX	XX	XX	XX	XX	XX	XX
Claims on customers under acceptace credits	XX	XX	XX	XX	XX	XX	XX
Staff financing of which RMXXX (20XX: RMXXX) are to Directors	XX	XX	XX	XX	XX	XX	XX
Credit /Charge cards	XX	XX	XX	XX	XX	XX	XX
Revolving credit	XX	XX	XX	XX	XX	XX	XX
Others	XX	XX	XX	XX	XX	XX	XX
Total financing, advances and other receivables	XX	XX	XX	XX	XX	XX	XX

4.1 *Mudarabah*

4.1.1 Nature And Definition

Section 10.1 of BNM's policy document on *Mudarabah* defines a *Mudarabah* as

> *"a contract between a capital provider (rabbul mal) and an entrepreneur (mudarib) under which the rabbul mal provides capital to be managed by the mudarib and any profit generated from the capital is shared between the rabbul mal and the mudarib according to a mutually agreed profit sharing ratio (PSR) whilst financial losses are borne by the rabbul mal provided that such losses are not due to the mudarib's misconduct (ta`addi), negligence (taqsir) or breach of specified terms (mukhalafah al-shurut)."*

Islamic banks may enter into two *Mudarabah* contracts. The first is when depositors or investors deposit money to the Islamic bank. In such a situation, the *Rabbul Mal* would be the depositor and the Islamic bank is the *Mudarib*. The policy document on *Mudarabah* spells out clearly the roles of the *Mudarib*, one of which is to ensure that there is proper management of the *Mudarabah* venture and that the *Mudarib* must always act in the best interest of the *Rabbul mal*. This will be discussed in the Chapter on liabilities (see Chapter 6).

The second situation is the *Mudarabah* financing contract between the Islamic bank and the Entrepreneur. In such a case, the Islamic bank is the *Rabbul mal* and the *Mudarib* is the Entrepreneur. The financing part represents an asset (investment) to the Islamic bank. This is the focus of this section. It must be noted that in both cases, the Islamic bank (whether as a *Mudarib* or a *Rabbul mal*) is expected to perform to the best of its ability so as to ensure that the business is profitable.

4.1.2 Recognition And Measurement

Accounting for *Mudarabah* depends on whether the capital is invested (i) internally or (ii) with external parties. *Mudarabah* capital invested internally (i.e the in Islamic bank's own assets) are generally funds from the parent company. For the capital invested externally, the question to raise is whether it represents an equity interest in another entity or is it an investment with contractual rights to cash flows. Each requires a different accounting treatment.

<u>Mudarabah capital invested internally</u>

If the capital of the *Mudarabah* is invested in Islamic bank's existing assets, then the question arises whether those assets should be derecognised. An asset is derecognised if the contractual rights to the cash flows from the financial asset expire, or if the entity transfers the contractual rights to receive the cash flows of that financial asset.

However, in the case where an entity retains the contractual rights to receive the cash flows of a financial asset (the 'original asset'), but assumes a contractual obligation to pay those cash flows to one or more entities (the 'eventual recipients'), the entity will regard this as a transfer of a financial asset if, and only if, all the following three conditions are met (MFRS 9; paragraph 3.2.5):

a. *The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset. Short-term advances by the entity with the right of full recovery of the amount lent plus accrued interest at market rates do not violate this condition.*
b. *The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.*
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 for investments in cash or cash equivalents (as defined in MFRS 107 Statement of Cash Flows) during the short settlement period from the collection date to the date of required remittance to the eventual recipients, and interest earned on such investments is passed to the eventual recipients.*

If all the above conditions are met, then the Islamic bank needs to assess whether the risks and rewards of ownership of the financial asset have been transferred. If it is, then the asset will be derecognised from the Islamic bank's financial statements. If such assets are derecognised, then the funds received from the *Rabbul mal* will also be an off-balance sheet item.

However, if the risks and rewards of owning the asset have not been substantially transferred, then the assets will not be derecognised. In such a case, the funds from the *Rabbul mal* will then be assessed whether it can be considered a liability.

Accordingly, MFRS 132 *Financial Instruments: Presentation* is applied. MFRS 132 defines a financial liability as any liability that is a contractual obligation to:

a. deliver cash or another financial asset to another entity; or
b. exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.

Mudarabah capital invested externally

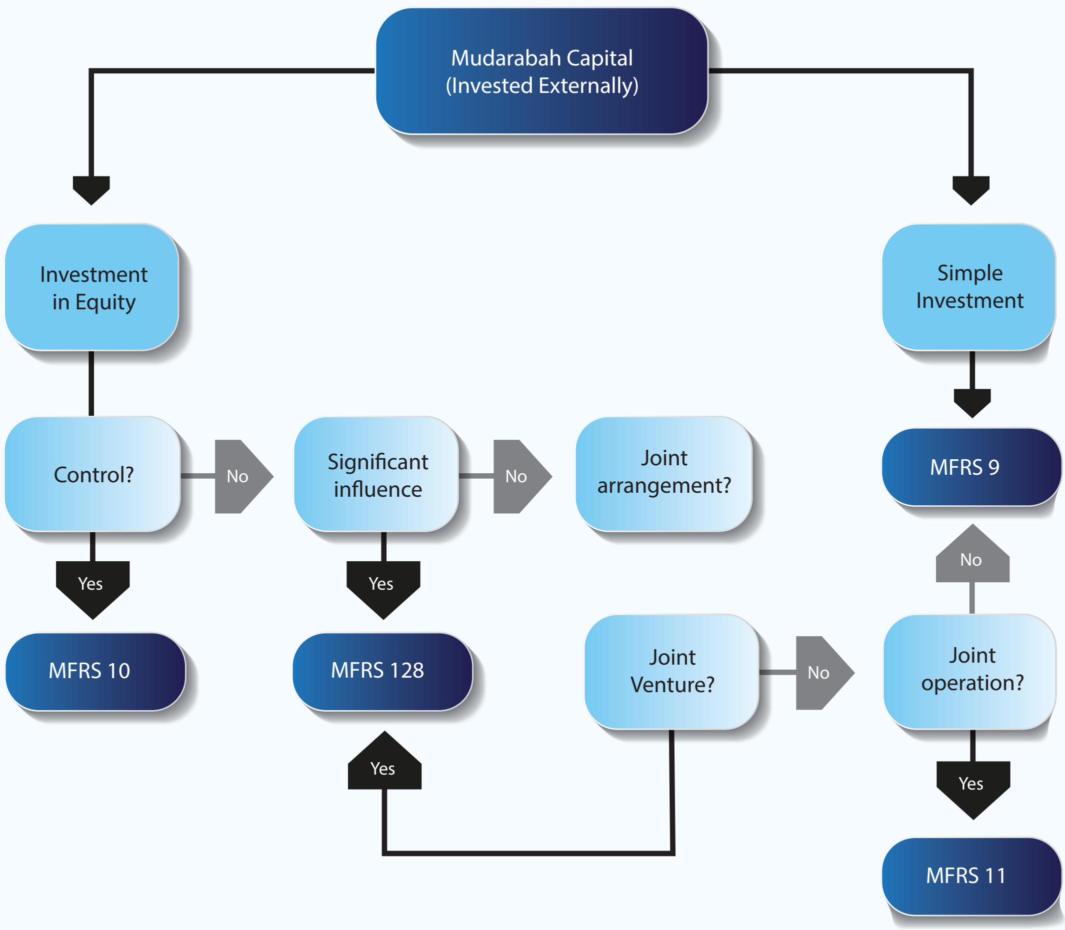

Diagram 3: *Mudarabah* Capital Invested Externally

The Islamic bank may also invest the *Mudarabah* capital externally, either as equity in another entity or simply, as an investment. If it is the former (i.e. equity in another entity), then the Islamic bank needs to consider to account for such investments either under MFRS 10 *Consolidated Financial Statements*, MFRS 128 *Investment in Associates and Joint Ventures* or MFRS 11 *Joint Arrangements.* If none of these standards is applicable, then MFRS 9 is relevant.

MFRS 10

For the investment to be under MFRS 10, the issue of control is pertinent. Control exists when the entity meets all the following:

a. power over the investee;
b. exposure, or rights, to variable returns from its involvement with the investee; and
c. the ability to use its power over the investee to affect the amount of the investor's returns. (paragraph 7 of MFRS 10)

Specifically, on power, the investor must have existing rights to direct the relevant activities of the investee..More importantly, determining control involves judgment based on facts and circumstances and the terms of the *Mudarabah* venture. Thus, if the Islamic bank has control over the investee, the investment will be consolidated in the Islamic bank's financial statements.

However, if control is not established, then the investment could either be an investment in associates and joint venture and would thus come under the purview of MFRS 128 or the investment may be relevant under MFRS 11.

MFRS 128

Paragraph 5 of MFRS 128 defines an associate as "an entity over which the investor has a significant influence". Further, it is presumed that an entity has significant influence when the entity holds, directly or indirectly (e.g. through subsidiaries), 20 per cent or more of the voting power of the investee, unless it can be clearly demonstrated that this is not the case.

Significant influence is defined as the power to participate in the financial and operating policy decisions of the investee but is not control or joint control over those policies. If the Islamic bank has a significant influence over the venture, the investment shall be equity accounted in accordance with MFRS 128 (paragraph 16).

MFRS 11

If the *Mudarabah* investment is not an investment in the associate, then the Islamic bank needs to assess if the *Mudarabah* investment meets the definition of a joint arrangement under MFRS 11. To establish if there exists a joint arrangement, one needs to determine if the parties are bound by a contractual arrangement and whether the arrangement provides two or more parties joint control of the arrangement. A joint arrangement can either be that of a joint operation or a joint venture. In a joint operation, the parties that have joint control of the arrangement have *rights to the assets, and obligations for the liabilities*, relating to the arrangement.

However, in the case of a joint venture, the parties that have joint control of the arrangement have rights to the net assets of the arrangement. A joint venture is accounted for using equity method in accordance with MFRS 128 while a joint operation is accounted for in accordance with MFRS 11.

For separate financial statements, MFRS 127 (paragraph 10) states that an entity shall account for investment in subsidiaries, joint ventures and associates either:

a. at cost, in accordance with MFRS 9 or;
b. using the equity method as prescribed in MFRS 128.

More importantly, if the Islamic bank elects, in accordance with MFRS 128 to measure its investment in associates or joint ventures at FVTPL in accordance with MFRS 9, it shall also account for those investments in the same way in its separate financial statements.

MFRS 9

If the *Mudarabah* investment does not fall within the scope of these three standards, then it may fall within the scope of MFRS 9. Accordingly, the investment is regarded as a financial asset. Specific on recognition of such assets, paragraph 3.1.1 of MFRS 9 states:

An entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the instrument (MFRS 9: 3.1.1)

Thus, it is important to determine if the Islamic bank is a party to the contractual arrangement. In a *Mudarabah* arrangement, the Islamic bank will enter into the financing agreement with its customers/entrepreneurs. The Islamic bank, as a contractual party to the *Mudarabah* agreement, has the right to collect profits and repayments of principal amounts from the customers/entrepreneurs as illustrated in Figure 4. Accordingly, the Islamic bank should recognise such *Mudarabah* assets as its financial assets.

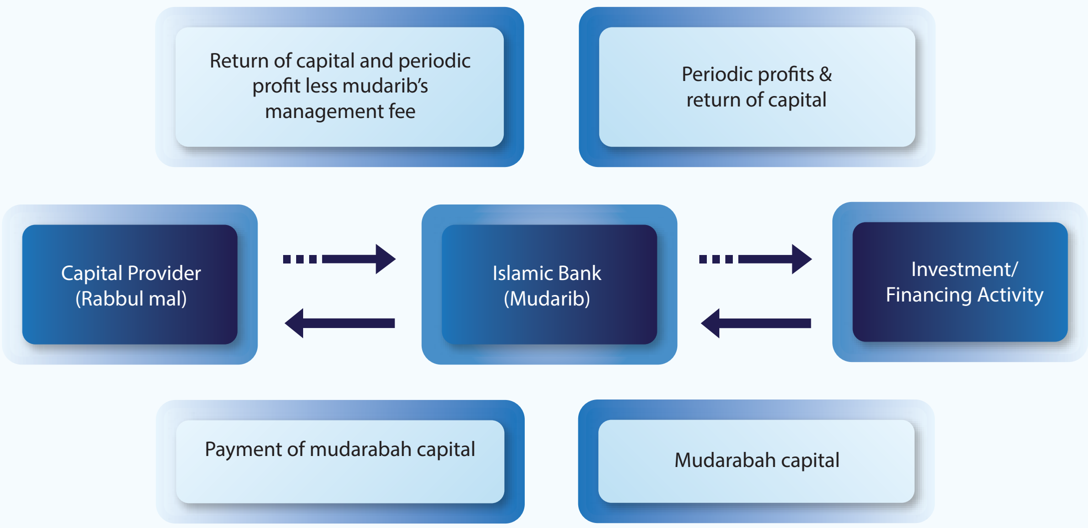

Diagram 4: *Mudarabah* arrangement

Under MFRS 9, a financial asset based on the *Mudarabah* contract would be measured at amortised cost if:

i. the asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows and that
ii. the contractual terms of the financial asset give rise on specified dates to cash flows that are SPPI.

The financial asset that is based on the *Mudarabah* contract generally satisfies the above conditions. Accordingly, such assets are measured at amortised cost. In the rare circumstance that such an asset does not satisfy the two conditions discussed earlier, then the asset is measured at FVTPL.

4.1.3 Presentation and Disclosure

Given that there is no specific MFRS governing the presentation and disclosure of *Mudarabah* investments, the provision in MFRS 101 is relevant. It specifically states that for an entity to provide a fair presentation of the financial statements, the entity must:

> *provide additional disclosures when compliance with the specific requirements in MFRSs is insufficient to enable users to understand the impact of particular transactions, other events and conditions on the entity's financial position and financial performance (paragraph 17(c) of MFRS 101).*

4.1.3.1 The Practice

As at 31 December 2018, the Bank and the Group has a total of RM45,680,680,000 under Financing, Advances and Others for the Group and the Bank. Note 11 further clarifies the components of the assets into *Bai Bithamin Ajil, Murabahah, Bai Al-Dayn, Bai Al-Inah, At-Tawarruq, Ijarah Muntahia Bit-Tamleek, Ijarah Rhumma Al-Bai, Istisna'* and *Ar-Rahnu*. Of these, *At-Tawarruq*, at more than RM 34 billion, represents the contract that is most used by BIMB.

Significant Accounting Policies

MFRS 9, *Financial Instruments*

The Group and the Bank have adopted the MFRS 9 *Financial Instruments* issued by the MASB which became effective on 1 January 2018, which resulted in changes in accounting policies and adjustments to the amounts previously recognised in the financial statements. MFRS 9 sets out requirements for recognising and measuring financial assets, financial liabilities and some contracts to buy or sell non-financial items. This standard replaces MFRS 139 *Financial Instruments: Recognition and Measurement*.

On initial recognition, a financial asset is classified and measured at: amortised cost; FVOCI - debt investment; FVOCI - equity investment; or FVTPL.

The 'incurred loss' model under MFRS 139 is replaced with the MFRS 9 'expected credit loss' ("ECL") model. The new impairment model applies to financial assets measured at amortised cost, contract assets and debt investments at FVOCI, but not to investments in equity instruments. Under MFRS 9, credit losses are recognised earlier than under MFRS 139.

*Refer to next page

Financial Statements
Statement of Financial Position as at 31 December 2018

		Group		Bank	
		31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
	Note	RM'000	RM'000	RM'000	RM'000
Assets					
Cash and short-term funds	3	**2,092,654**	4,185,697	**2,086,703**	4,185,561
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Total assets		**63,938,733**	57,742,914	**63,938,893**	57,750,240

Figure 14: Islamic Financial Contracts and the breakdown as per BNM Guidelines

Notes to the Financial Statements
(a) By type and Shariah contract

Group and Bank 31.12.2018	Bai' Bithaman Ajil RM'000	Murabahah RM'000	Bai' Al-Dayn RM'000	Bai' Al-Inah RM'000	At-Tawarruq RM'000	Ijarah Muntahiah Bit-Tamleek^ RM'000	Ijarah Thumma Al-Bai^ RM'000	Istisna' RM'000	Ar-Rahnu RM'000	Total RM'000
At amortised cost										
Cash Line	–	–	–	1,875	1,521,991	–	–	–	–	1,523,866
Term financing										
House financing	3,764,219	–	–	–	14,285,203	–	–	51,490	–	18,100,912
Syndicated financing	–	–	–	41,327	665,745	–	89,540	–	–	796,612
Leasing financing	–	–	–	–	–	106,520	35	–	–	106,555
Bridging financing	–	–	–	–	–	–	–	65,268	–	65,268
Personal financing	–	–	–	10,178	13,755,492	–	–	–	–	13,765,670
Other term financing	1,099,152	1,239,988	–	6,650	7,992,899	–	–	1,194	–	10,339,883
Staff financing	60,777	9,322	–	–	155,590	–	–	9,846	–	235,535
Credit cards	–	–	–	–	477,602	–	–	–	–	477,602
Trade bills discounted	–	820,833	144,827	–	–	–	–	–	–	965,660
Trust receipts	–	10,113	–	–	–	–	–	–	–	10,113
Pawn broking	–	–	–	–	–	–	–	–	73,110	73,110
Investment Account Platform*	–	–	–	–	9,599	–	–	–	–	9,599
	4,924,148	2,080,256	144,827	60,030	38,864,121	106,520	89,575	127,798	73,110	46,470,385
Allowance for impairment on financing, advances and others										
- collective assessment allowance - 12 months ECL										(416,450)
- collective assessment allowance - lifetime ECL										(216,564)
- individual assessment allowance - lifetime ECL										(156,691)
Net financing, advances and others										45,680,680

(b) By type of customer

	Group and Bank	
	31.12.2018 RM'000	31.12.2017 RM'000
Domestic non-bank financial institutions	1,637,318	1,353,524
Domestic business enterprise	6,924,836	6,426,088
Small & medium enterprises	2,092,024	1,869,781
Government & statutory bodies	601,285	827,671
Individuals	35,069,160	32,014,038
Other domestic entities	18,947	7,642
Foreign entities	126,815	187,192
	46,470,385	42,685,936

(c) By profit rate sensitivity

	Group and Bank	
	31.12.2018 RM'000	31.12.2017 RM'000
Fixed rate		
House financing	1,073,575	1,168,200
Others	3,102,294	3,560,756
Floating rate		
House financing	17,636,273	15,625,095
Others	24,658,243	22,331,885
	46,470,385	42,685,936

(d) By remaining contractual maturity

	Group and Bank	
	31.12.2018 RM'000	31.12.2017 RM'000
Maturity within one year	4,774,098	4,414,217
More than one year to three years	1,299,229	1,087,304
More than three years to five years	2,921,287	2,598,903
More than five years	37,475,771	34,585,512
	46,470,385	42,685,936

(e) By geographical distribution

	Group and Bank	
	31.12.2018 RM'000	31.12.2017 RM'000
Central Region	22,125,064	20,673,380
Eastern Region	7,646,307	6,860,968
Northern Region	6,640,816	6,121,471
Southern Region	6,723,490	5,908,526
East Malaysia Region	3,334,708	3,121,591
	46,470,385	42,685,936

(f) By sector

	Group and Bank	
	31.12.2018 RM'000	31.12.2017 RM'000
Primary agriculture	754,835	486,679
Mining and quarrying	9,060	8,080
Manufacturing (including agro-based)	909,850	835,268
Electricity, gas and water	371,479	337,388
Wholesale & retail trade, and hotels & restaurants	1,098,346	1,228,681
Construction	2,417,262	2,176,453
Real estate	1,712,250	1,582,531
Transportation, storage and communications	824,949	655,633
Finance, insurance and business activities	2,299,319	2,147,118
Education, health and others	1,000,735	1,210,056
Household sectors	35,072,300	32,018,049
	46,470,385	42,685,936

4.2 *Musyarakah*

4.2.1 Nature and Definition

Musyarakah refers to a partnership between two or more parties, where all contracting parties contribute capital to the *Musyarakah* venture and profit and losses from the partnership are shared according to the agreed profit-sharing ratio. Some examples where *Musyarakah* can be used include project financing, working capital financing, import financing as well as export financing.

It is also important to determine the verses from the Qur'an which support such contracts in order to ensure its legitimacy. Scholars have pointed to the following verse to support *Musyarakah* contracts:

> *"If there be more (brothers and sisters of the same mother), they shall (equally) share a third of the estate, after payment of any bequest that may have been bequeathed or debt (incurred); the bequests made should not harm (the rights of the heirs)." (Surah an-Nisaa', verse 12).*

Although the above appears to refer to the rule of inheritance in Islam, jurists have regarded the text as containing general permissibility of any form of partnership, thus providing an indirect support of *Musyarakah* contracts.

The verse from Surah As-Sod (verse 24) points to the ethics of partners:

> *"Truly many partners (in all walks of life) are unjust to one another: but not so those who believe and do good works, and they are few." (Surah As-Sod, verse 24).*

The verse reminds the partners to be ethical when dealing with each other. Accordingly, this may indirectly indicate the support of partnership arrangements in Islam.

Types of Musyarakah

Typically, there are two (2) types of *Musyarakah: Shirkah al-Milk* (Partnership in joint ownership) and *Shirkah al- `Aqd* (Contractual Partnership).

i. Shirkah al-Milk (Partnership in joint ownership)

This type of partnership refers to the possession of an asset by two or more persons with or without prior arrangement to enter into a joint ownership. Under *Shirkah Al-Milk*, each partner's ownership is mutually exclusive. Thus, one partner cannot deal with the other partner's asset without the latter's consent.

ii. Shirkah al- `Aqd (Contractual Partnership)

Shirkah al- `Aqd* is a contract executed between two or more partners to venture into a business with a view to generating profit. In *Shirkah al- `Aqd (Contractual Partnership), a partner is an agent for the other partners. Accordingly, the conduct of any partner in the ordinary course of business is deemed to represent the partnership.

Advantages and disadvantages of Musyarakah

The Islamic bank has two advantages when using this contract. First, it enables the bank to manage the *Musyarakah* business, thus, allowing for control of agency costs and moral hazard problems. Second, the losses are shared according to the capital contribution, whereas in the case of *Mudarabah*, it is borne by the bank as the *Rabbul Mal*. However, one main disadvantage is that the Islamic bank may not want to get involved in the management of the business due to the lack of expertise or regulatory requirements. More importantly, the Islamic bank regards itself as a financial intermediary not as an organisation going into business with another. Accordingly, it does not exist to be a party to any business venture. However, in many jurisdictions, some flexibility is given to Islamic banks to be more commercial as opposed to being strictly a financial institution.

Constant versus the Diminishing Musyarakah (MMQ)

Musyarakah can be further categorised as a constant *Musyarakah* or diminishing *Musyarakah*. The latter is also termed, *Musyarakah Mutanaqisah* (MMQ). A constant *Musyarakah* is when the partners' shares in the capital remain constant throughout the period as specified in the contract. Thus, if the Islamic bank and Ali enter into a *Musyarakah* contract with Ali contributing $40,000 and the Islamic bank contributing $60,000, the capital of both will remain as such if there are no losses incurred by the *Musyarakah*.

MMQ is when the Islamic bank agrees to transfer, gradually, to the other partner its share in the *Musyarakah*, so that the bank's share declines and the other partner's share increases until the latter becomes the sole owner of the venture.

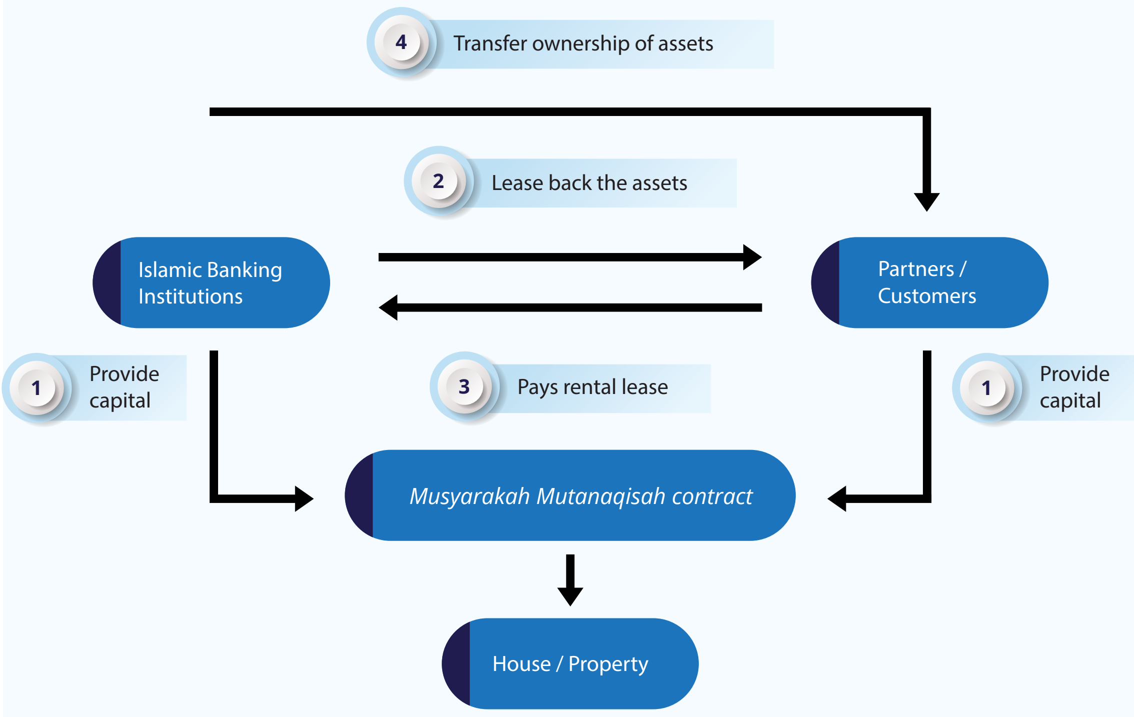


Diagram 5: *Musyarakah Mutanaqisah*

In Diagram 5 above, a *Musyarakah Mutanaqisah* contract is signed between the customer and the Islamic bank. Following that:

1. The bank then leases the asset to the customer.
2. The customer pays rent and also buy a proportion of the Islamic bank's share.
3. Finally, the customer would have purchased all the share of the Islamic bank and the ownership now is transferred to the customer.

4.2.2 Recognition and Measurement

Similar to the issue on *Mudarabah* investments discussed earlier, one issue in accounting for *Musyarakah* that has been often raised is whether the accounting treatment should align with MFRS 10 *Consolidated Financial Statements*, MFRS 11 *Joint Arrangements* or MFRS 128 *Investments in Associate*.

The discussion on *Mudarabah* discussed earlier is relevant. A *Musyarakah* venture can only be consolidated if the Islamic bank has control over the venture. Under MFRS 10, control is when the Islamic bank has:

a. power over the investee;
b. exposure, or rights, to variable returns from its involvement with the investee; and
c. the ability to use its power over the investee to affect the amount of the investor's returns. (paragraph 7 of MFRS10)

Additionally, the standard clarifies that such power relates only to substantive rights of the investee (held by the investor and others). To have substantive rights the Islamic bank must have the practical ability to exercise that right and that it is currently exercisable. For example, if an Islamic bank has executive decisions over the activities of the *Musyarakah* venture as well as on the removal of its manager, then the Islamic bank is deemed to have control over the venture. Thus, the *Musyarakah* should be regarded as a subsidiary regardless of the percentage of profit in the venture. Accordingly, the *Musyarakah* needs to be consolidated in accordance with MFRS 10 and the investment should adopt equity accounting in its separate financial statements in accordance with MFRS 127.

If the Islamic banks do not have control over the *Musyarakah* venture, then one should determine if such a venture should be reported as a joint arrangement under MFRS 11 or as an investment in an associate under MFRS 128.

The *Musyarakah* will be accounted for under MFRS 11 if a joint arrangement can be established. For it to come under a joint arrangement the following two criteria must be satisfied:

a. The parties are bound by a contractual arrangement; and
b. The contractual arrangement gives two or more of those parties joint control of the arrangement.

Decisions that are made would need to be unanimous among the partners of the *Musyarakah* venture. However, this need not necessarily mean equal contributions. Once the joint arrangement has been established, one needs to determine if such a joint arrangement constitutes either as a joint operation or as a joint venture. A joint operation is when the parties have rights to the assets, and obligations for the liabilities, relating to the joint arrangement. The parties will then be termed joint operators. A joint venture is when the parties have rights to the net assets of the arrangement. Such parties are termed joint venturers.

If the *Musyarakah* venture is not consolidated (MFRS 10) because the Islamic bank has no control over the venture or it does not fall under the purview of MFRS 11 because a joint arrangement has not been established, then it is pertinent to determine if the Islamic bank has significant influence over the venture and thus is under the purview of MFRS 128.

Significant influence is defined as the power to participate in the financial and operating policy decisions of the investee. However, the Islamic bank has no control or do not have joint control over those policies of the investee. If it can be established that the Islamic bank has significant influence over the *Musyarakah* venture, then it shall be accounted for as an investment in the associate. Accordingly, the investment in an associate shall be equity accounted in accordance with MFRS 128.
Again, if the *Musyarakah* investment does not fall within the scope of MFRS 10, MFRS 11 or MFRS 128, then it is most likely to be under the purview of MFRS 9. Under MFRS 9, a financial asset can only be measured at amortised cost if it satisfies both the business model and the SPPI tests as discussed earlier. If either or both conditions are not met, then the *Musyarakah* should be measured at fair value (through other comprehensive income or profit and loss).

Typically, the SPPI test is undertaken to determine if the structure and cash flows of the *Musyarakah* financing align with the basic lending arrangement. Essentially, what this means is that the profit element considers the time value of money, the credit risk associated with the instrument, the basic lending risks and costs and the profit margin. A *Musyarakah* financing may not satisfy the SPPI test primarily because the excess profit from the financing or losses is shared with the Islamic bank.

4.2.3 Presentation and Disclosure

The presentation and disclosure of *Musyarakah* investments are guided by BNM's Financial Reporting for Islamic Banking Institutions that was issued in 2012 with the last revision done in February 2018.

Excerpts from the annual report of an Islamic Bank on the Significant Accounting Policies, the Financial Statements and the Notes to the Financial Statements are similar to what has been disclosed under *Mudarabah* Financing above. There is no *Musyarakah* Financing in BIMB (refer to Figure 14).

4.3 *Ijarah*

4.3.1 Nature and Definition

The term *Ijarah* is derived from the noun '*al-ajr*' which means compensation, reward, consideration, return or counter value (*Al-'Iwad*) against the use of an object. According to the Hanafi school, *Ijarah* is a contract pertaining to usufruct with compensation while the Shafii school defines *Ijarah* as a contract over a desirable, known, permissible, and accessible usufruct for a known period in exchange for compensation. Notably, while many *Ijarah* transactions relate to leasing, it can also be used for contracts of employment or hire of services. Typically, there are two parties to an *Ijarah* contract: the lessor (the party who owns the asset) and the lessee (the party who is given the right to use the asset).

When used for other than employment or services, *Ijarah* in its classical form is often said to be 'rental'. However, in modern times, *Ijarah* may be transacted with an arrangement to transfer the ownership of the underlying asset by or at the end of the lease term. Such arrangements are commonly known as *Ijarah Muntahia Bittamleek*, which means '*Ijarah* ending with ownership'; or *Ijarah Thumma Al-Bai*', which means '*Ijarah* followed by a sale'.

Muslim scholars have indicated that the verse from Surah Al-Qasas (verses 26-27) describing the story of Prophet Musa (peace be upon him) being hired for a certain period to undertake a specific venture appears to provide support for *Ijarah*. The compensation for the task undertaken by the Prophet is deemed payment for the outstanding dowry. The verses from al-Qasas are as follows:

> *And said one of them (the two women):" O my father! Hire him! Verily, the best of men for you to hire is strong, the trustworthy. He said: I intend to wed one of these two daughters of mine to you, on condition that you serve me for eight years, but if you complete ten years, it will be (a favour) from you. But I intend not to place you under a difficulty. If Allah wills, you will find me one of the righteous" (Al-Qasas, verses 26-27)*

Ijarah, as defined in BNM's policy document, is a contract that transfers ownership of the usufruct or service for a specified period in exchange for a specified consideration.

Types of Ijarah structures

In the context of Islamic financial transactions, there are two primary structures of the *Ijarah*: operating *Ijarah* and *Ijarah* financing. Under the operating *Ijarah* structure, the customer does not have the intention of owning the asset. The main purpose is to obtain benefits from the leased asset. Accordingly, at the end of the lease period, the ownership of the asset may still remain with the Islamic bank as the lessor. Diagram 6 illustrates the operating *Ijarah*. On the other hand, in *Ijarah* financing, the ownership of the asset is to be transferred to the lessee at the end of the lease period. This is illustrated in Diagram 7.

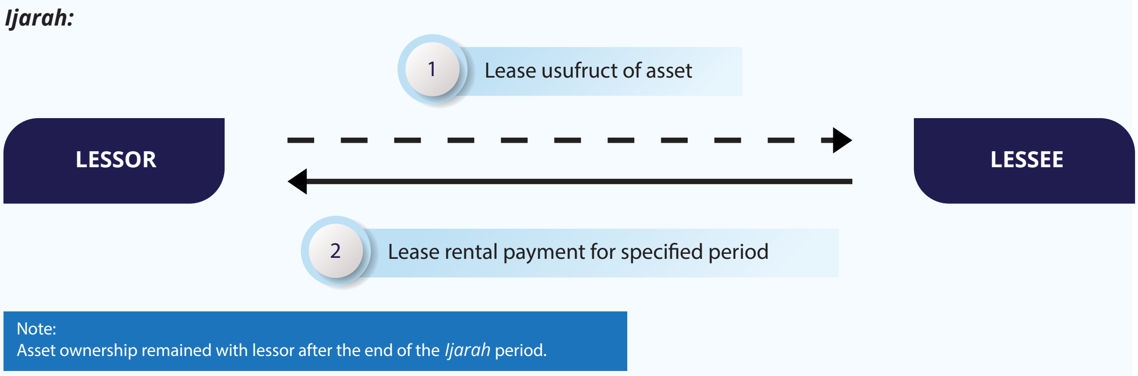


Diagram 6: Operating *Ijarah*

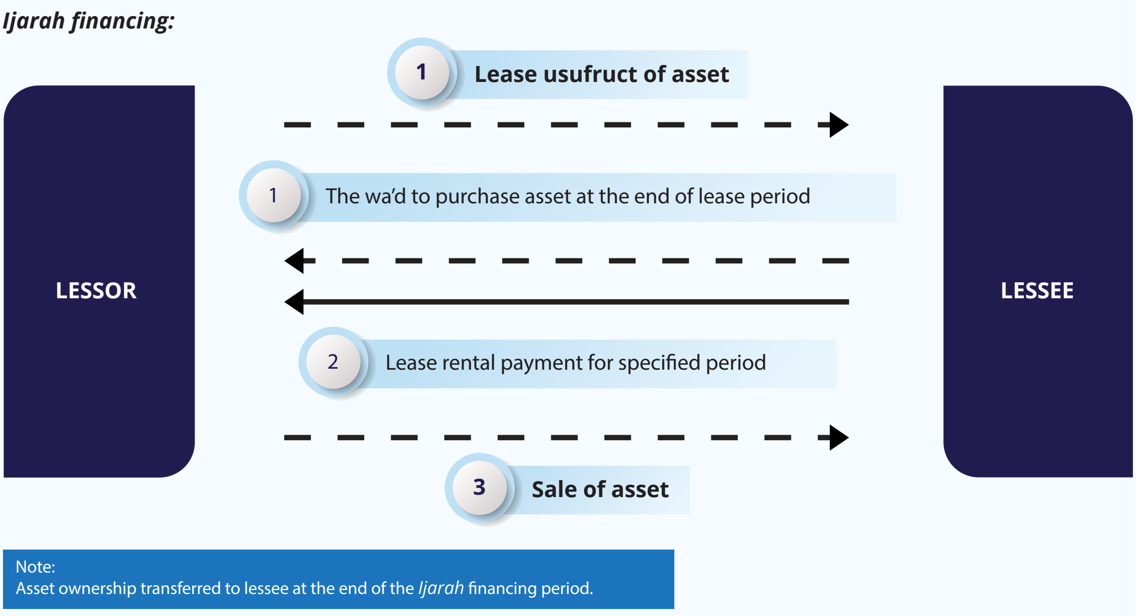


Diagram 7: *Ijarah Muntahia Bittamleek*

The two different *Ijarah* structures just described have different risks and return profiles which correspond to the degree of responsibilities and level of risks borne by the Islamic bank (the lessor) and the customer (the lessee). The inherent risks associated with the primary *Ijarah* structure include the operational risk arising from the ownership of the asset (e.g. maintenance costs relating to the ownership), market risk that relates to the potential loss in value of the asset owned by the Islamic bank, and the credit risk arising from the potential failure of the customer to pay the rental following the transfer of usufruct. With the *Ijarah* financing structure, the Islamic bank is mainly exposed to the credit risk where the customer may potentially fail to pay the rental instalments. Given that there is a commitment from the customer to purchase the asset, the operational and market risks are somewhat mitigated. Such risks would now be transferred to the customer (lessee).

Typically, *Ijarah* financing is that of *Ijarah Muntahia Bittamleek* (IMBT). Corresponding to BNM's policy document, the Islamic bank as a lessor may appoint the lessee to maintain the leased asset as well as getting takaful coverage for it. Such costs could be mutually agreed between the two parties. In Malaysia, the type of *Ijarah* followed by a sale which is called *al-Ijarah Thumma al-Bai'* or AITAB is very common in vehicle financing. The financing based on AITAB involves two types of contracts, namely leasing contract (*Ijarah*), followed by sale contract (al-Bai`). At the initial stage, the Islamic bank will conclude an *Ijarah* agreement with the customer. Under this agreement, the Islamic bank will appoint the customer as an agent to purchase the vehicle identified by the customer. Subsequently, the Islamic bank will lease the vehicle to the customer for a specified period. Upon expiry of the lease period, the customer has the option to purchase the vehicle from the Islamic bank. If the customer opts to purchase the vehicle, the Islamic bank and the customer will conclude a sale contract and the ownership of the vehicle will be transferred from the Islamic bank to the customer.

4.3.2 Recognition And Measurement

One important question to raise is whether *Ijarah* should be accounted for under MFRS 16 Leases or MFRS 9 *Financial Instruments*. IMBT and AITAB are currently accounted for as a financial asset under MFRS 9 instead of a lease under MFRS 16. This is to reflect the substance of the arrangement as opposed to its legal form. If a contractual arrangement is not a lease, then MFRS 9 is applicable. As explained elsewhere in the chapter, the entity would first need to ascertain if the *Ijarah* can be recognised as a financial asset. MFRS 9 (paragraph 3.1.1) alluded to the fact that the IB shall recognise a financial asset in its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the *Ijarah*.

To determine if *Ijarah* financing should be measured at the amortised cost the entity has to determine if the *Ijarah* financing satisfies both the business model and the SPPI tests. It is highly likely that the business model test to hold the asset to collect contractual cash flows is met. As for the SPPI test, paragraph 4.1.3 (b) of MFRS 9 states that:

> *interest (profit) consists of consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period and for other basic lending risks and costs, as well as a profit margin*

Based on the current practice of *Ijarah* financing in Malaysia, the Islamic bank appears to be exposed mainly to credit risk. Given this, such financing is likely to meet the SPPI test. Thus, such assets should be measured at amortised cost.

BNM also states that the provisions pertaining to repossession and several consumer protection elements in the Hire Purchase Act 1967 should also be reflected in *Ijarah* financing contracts.

4.3.3 Presentation And Disclosure

Specific to accounting, Principle 5 in the policy document of BNM on *Ijarah* clearly states that:

The IFI shall provide adequate disclosure to facilitate stakeholders' understanding and assessment of the Ijarah transactions.

Islamic Bank as Lessor

Under MFRS 16 and on the basis of 'substance over form', the Islamic bank is to present assets held under a finance lease as a receivable at an amount equal to the net investment in the lease. Further, Islamic banks must disclose as additional notes, the following information:

a. Assets funded under this mode of financing are owned by the IB throughout the tenure of the *Ijarah* financing; and
b. Ownership of the assets will be transferred to the customer via a suitable mechanism at the end of the *Ijarah* financing.

Such disclosures clarify the Shariah aspect of an *Ijarah*, whereby a lessor must own the *Ijarah* asset throughout the *Ijarah* period. This would enable users to make more informed decisions.

Islamic Bank as Lessee

When an Islamic bank enters into an *Ijarah* contract as a 'lessee', MFRS 16 requires the lessee to recognise the right-of-use (ROU) asset with a corresponding lease liability in its financial statements. This is the major change in MFRS 16. It is to be noted that the ROU asset shall be treated just like any fixed asset of an Islamic bank. Such assets shall be depreciated and tested for impairment, similar to the provisions in MFRS 116 *Property, Plant and Equipment.*

4.3.3.1 The Practice

As reflected in Note 11 of BIMB's financial statements for the year ended 31 December 2018, *Ijarah Muntahia Bit-Tamleek* totalled RM106,520,000 as at 31 December 2018.

4.4 *Murabahah*

4.4.1 Nature and Definition

According to the BNM Policy Document (PD) on *Murabahah* (2013), *Murabahah* refers to a sale and purchase of an asset where the acquisition cost and the mark-up are disclosed to the purchaser. Usually, the sale price is payable by the purchaser on deferred terms. An asset to be traded in a *Murabahah* contract shall be one that is recognised by the Shariah as valuable, identifiable and deliverable and that the asset is already in existence and owned by the seller.

The specific inherent nature of the contract of *Murabahah* is the sale contract which is based on the element of trust in disclosing the cost and mark-up. The common inherent nature of a sale contract is the transfer of ownership of the asset from the seller to the purchaser.

BNM PD describes two types of products: *Murabahah* and *Murabahah* to the Purchase Orderer (MPO).

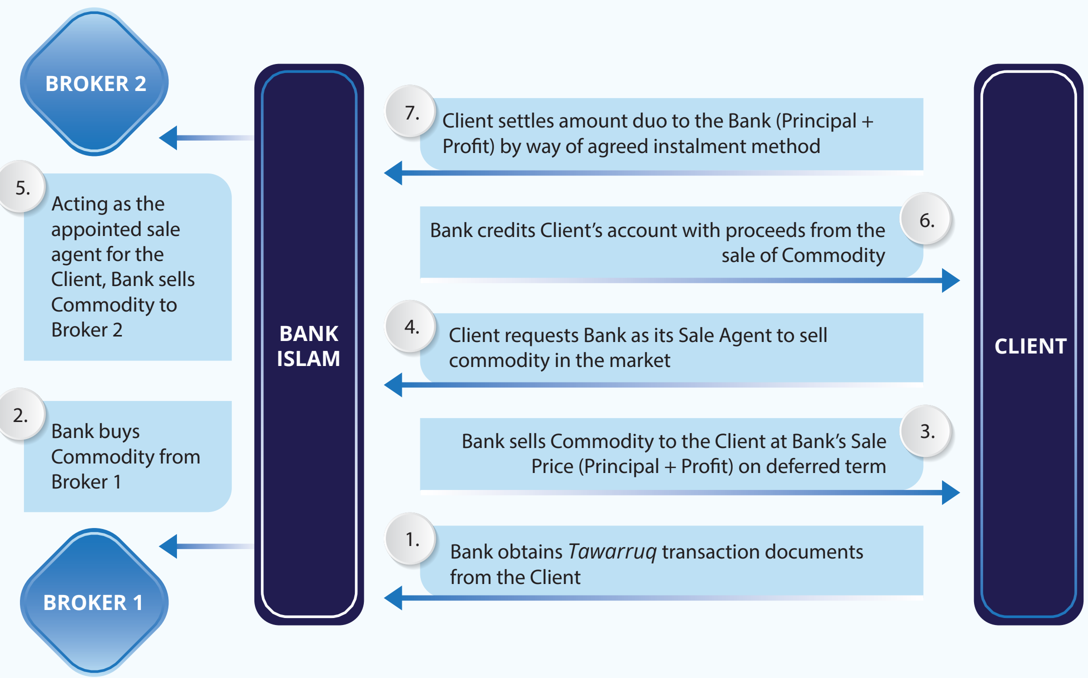
Murabahah to the Purchase Orderer (MPO) refers to an arrangement whereby the purchase orderer (purchaser) promises (*Wa`d*) to purchase an identified and specified asset from a seller on *Murabahah* terms upon the latter's acquisition of the asset. The *Wa`d* to purchase the asset shall be binding on the purchase orderer when the seller has taken an action to acquire the asset. The *Wa`d* shall be executed separately from, and before entering into the *Murabahah* contract.

Products in Islamic banks which adopts the *Murabahah* structure are that of *Bay Bithaman Ajil* (BBA), *Bai Inah* and its variant, the *Tawarruq*. BBA is a sale with deferred payment of the price that is paid gradually during a specified period. BBA is usually used for home or vehicle financing. On the other hand, *Bai Inah* refers to an arrangement which involves the sale of an asset to the purchaser on a deferred payment basis and the subsequent purchase of that asset at a cash price that is lower than the deferred sale price or vice versa. The *Bai Inah* variant, the *Tawarruq* as in BNM's policy document in 2015, is used by Islamic banks to provide cash specific requirements (liquidity) to their customers in need of cash or funds. It basically consists of two sale and purchase contracts. In this case, the customer is purchasing a commodity from an Islamic bank as the underlying asset on a deferred basis. Subsequently, the commodity or asset is sold to a third party for an immediate cash payment (i.e. on a spot basis). In Malaysia, the commodity trading for *Tawarruq* is done through Bursa *Suq Al Sila* in Bursa Malaysia.

Diagram 8 illustrates the *Tawarruq* contract used in personal financing. The bank is performing the role of a dual agent in the model. The *Tawarruq* is used as follows:

1. The bank obtains *Tawarruq* transaction document from a client.
2. The bank, an agent for the client, buys the commodity from Broker 1 through Bursa *Suq Al Sila*.
3. The bank sells the commodity to the client at the bank's selling price (principal plus profit)
4. The client requests bank as its sale agent to sell the commodity in the market.
5. The acting as the appointed sale agent for the client, the bank sells the commodity to Broker 2 through Bursa *Suq Al Sila*.
6. The bank credits the client's account with the proceeds from the same of the commodity at cost.
7. The client settles the amount due to the bank (principal plus profit) by way of the agreed instalment method.

***TAWARRUQ* PERSONAL FINANCING-i**



Source: Bank Islam (2012)

Diagram 8: *Tawarruq* arrangement

4.4.2 Recognition and Measurement

The *Murabahah* contract, including *Murabahah* to the Purchase Orderer, *Tawarruq* and BBA may be regarded as a trading agreement or one of financing. If the *Murabahah* contract is considered as a trading agreement, the relevant standards are MFRS 102 *Inventories* and MFRS 15 *Revenue Recognition*. If it is to be treated as financing, then the relevant standard is MFRS 9 *Financial Instruments*. Accordingly, what is most important is for Islamic banks to establish the substance of the *Murabahah* contract to decide on the relevant standard to adopt.

Essentially, there are two main issues in the accounting for *Murabahah* contracts: substance over form and the time value of money. On this, BNM has clearly indicated that all IBs are to comply with MFRSs when reporting their activities. More importantly, BNM has stated, in no uncertain terms, that it is crucial for an entity to differentiate between Islamic and conventional transactions as the former are guided by Shariah rulings.

For a transaction to be accounted in accordance with MFRS 102 and MFRS 15, the *Murabahah* contract must be a contract with a customer. Additionally, in a pure *Murabahah* contract, the Islamic bank must have purchased assets and hold such assets until these are sold to the customers.

MFRS 15 specifically states that the standard is to be applied:

> *only if the counterparty to the contract is a customer. A customer is a party that has contracted with an entity to obtain goods or services that are an output of the entity's ordinary activities in exchange for consideration. A counterparty to the contract would not be a customer if, for example, the counterparty has contracted with the entity to participate in an activity or process in which the parties to the contract share in the risks and benefits that result from the activity or process (such as developing an asset in a collaboration arrangement) rather than to obtain the output of the entity's ordinary activities (paragraph 6).*

If *Murabahah* is considered as part of the financing, then MFRS 9 is relevant. To adopt MFRS 9, the entity must first determine if such financing gives rise to a financial asset. As indicated in paragraph 3.1.1 of MFRS 9, the entity will recognise a financial asset in its accounts when the entity becomes a party to the contractual agreement. The initial measurement of the asset is based on fair value plus or minus transaction costs.

Subsequent measurement for these financial assets should be measured at amortised cost using the effective profit rate method. The effective profit rate is the rate that exactly discounts estimated future cash payments or receipts through the expected life of the financial instrument to the net carrying amount of the financial asset. The effective profit method is a method of calculating the amortised cost of a financial asset or a financial liability and subsequently allocating the income over the relevant period.

The use of effective profit rate is allowed in Islamic banks based on the arguments by Mufti Taqi Usmani. According to him, the use of interest rate is simply as a benchmark in determining the profit of Islamic banks. Thus, this will not render the transaction as invalid because the deal itself does not contain interest.

Financial assets are subject to an impairment test, except for those carried at FVTPL. If expected life cannot be determined reliably, then the contractual life is used.

4.4.3 Presentation and Disclosure

The presentation in the financial statements for such financing should follow MFRS 132. Further, MFRS 7 stipulates that information on the significance of financial instruments should be disclosed as well as information about the nature and extent of risks arising from such financial instruments. Such risks include credit risk, liquidity risk, and market risk. The carrying amounts of each category of financial assets should be disclosed separately in the notes to the financial statements.

Regarding the disclosure requirements, Islamic banks in Malaysia shall comply with the Guidelines on Financial Reporting for Islamic Banking Institutions issued by BNM in February 2018. This Guideline sets out the information to be disclosed in the financial statements of Islamic banks including those arising from the Shariah contracts applied in Islamic banking transactions. Figure 13 illustrates the financing by types and Shariah contracts as per the Guideline.

4.4.3.1 The Practice

As reflected in Note 11 of BIMB's financial statements for the year ended 31 December 2018, *Murabahah* amounted to RM2,080,256,000.

4.5 *Istisna'*

4.5.1 Nature and Definition

According to the Policy Document of BNM (2015), *Istisna'* refers to a contract to sell to a purchaser a non-existent asset that is to be constructed, built or manufactured according to the agreed specifications and delivered on a specified future date at a pre-determined price. This arrangement is illustrated in Diagram 9.

4.5.2 Recognition and Measurement

The applicable MFRS is MFRS 111. The standard deals with the treatment of revenue and costs on construction contracts. The other two related standards are MFRS 15 and MFRS 9. Given that *Istisna'* is treated as part of financing, the applicable standard would be MFRS 9 on financial instruments.

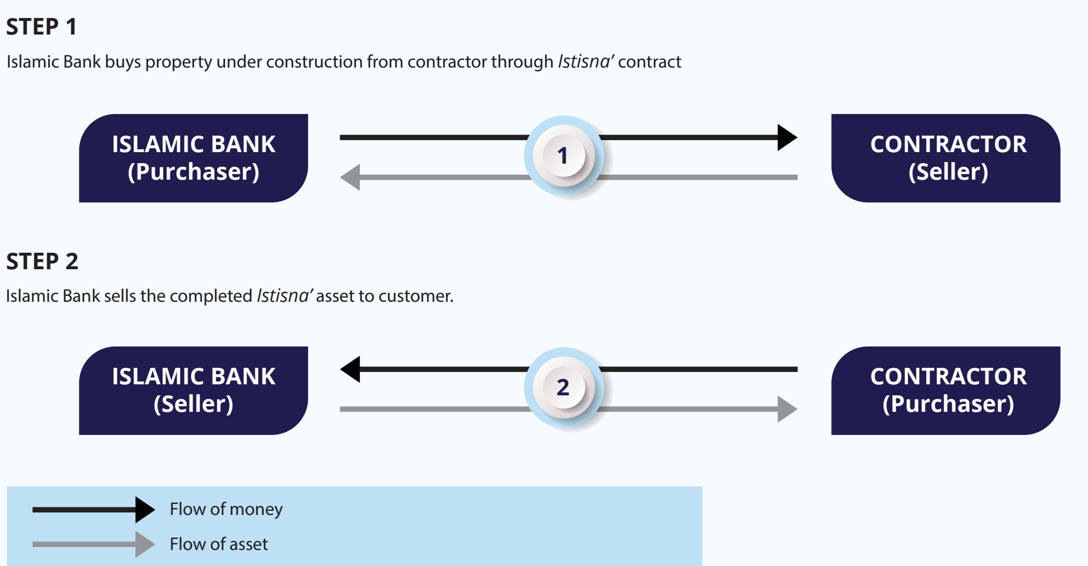


Diagram 9: *Istisna'* arrangement

Similar to *Murabahah* financing, *Istisna'* is also recognised at fair value upon initial recognition and is subsequently measured at amortised costs based on effective profit rate. In Islam, trading is not allowed if the underlying asset is non-existent. However, in the case of *Istisna'*, it is allowed provided that there are the specifications of the *Istisna'* asset and the determination of the price, time and place of delivery and mode of payment (BNM, *Istisna'* Guidelines).

4.5.3 Presentation and Disclosure

The presentation in the financial statements for such financing should be made in accordance with MFRS 132. Additionally, MFRS 7 stipulates that information on the significance of financial instruments should be disclosed as well as information about the nature and extent of risks arising from such financial instruments. Such risks include credit risk, liquidity risk, and market risk. The carrying amounts of each category of financial assets should be disclosed separately in the notes to the financial statements.

Regarding disclosure requirements, Islamic banks in Malaysia shall comply with the Guidelines on Financial Reporting for Islamic Banking Institutions issued by BNM in February 2018 (see Figure 13).

4.5.3.1 The Practice

As reflected in Note 11 of BIMB's financial statements for the year ended 31 December 2018, the amount for *Istisna'* as at 31 December 2018 was RM127,798,000.

4.6 *Rahn (Ar-rahnu)*

4.6.1 Nature and Definition

Rahn refers to a contract where a party (the pledger or *rahin*) pledges an asset as collateral (the *Marhun*) to another party (the pledgee or *murtahin*) to fulfil an obligator's liability or obligation (*marhun bih*) owed to the pledgee in the event of default of such obligor (BNM Policy Document, 2018). The inherent nature of *Rahn* is the assurance that the liability or obligation owed by the obligor to the pledgee will be fulfilled in the event of a default as agreed in the terms and conditions of *Rahn*. *Rahn* is important in Islam in order to help the customer to get short-term funding, for example by pawning gold as collateral and obtain cash from the bank. Consequently, the customer will pay later the full amount of the financing plus the storage costs to claim the gold.

4.6.2 Recognition and Presentation

The initial measurement under MFRS 9 for *Rahn* is based on fair value plus or minus transaction costs. Subsequent measurement for *Rahn* is at amortised cost using the effective profit rate method.

4.6.3 Presentation and Disclosure

The presentation in the financial statement for such financing should follow MFRS 132, MFRS 7 and the BNM Guidelines on Financial Reporting for Islamic Banking Institutions (2018). Presentation and disclosure issues discussed for other financing products earlier are also applicable for *Rahn*. The Islamic bank should disclose the significance of such financial instruments as well as information on the nature and extent of risks arising from financial instruments. As alluded to earlier, such risks include credit risk, liquidity risk, and market risk. The carrying amounts of each category of financial assets should be disclosed separately in the notes to the financial statements.

4.6.3.1 The Practice

As reflected in Note 11 of BIMB's financial statements for the year ended 31 December 2018, there was RM73,110,000 of *Ar-Rahnu*.

4.7 *Qard* (Loan)

4.7.1 Nature and Definition

According to Policy Document on *Qard* (2018), a *Qard* contract is established when ownership of a sum of money belonging to the lender is transferred to the borrower and the borrower is obliged to repay the lender in full. The inherent nature of a *Qard* contract is the obligation of the borrower to repay the money borrowed in full. The subject matter in a *Qard* contract shall be fungible, deliverable and recognised by Shariah. The borrower always has the obligation to repay the subject matter in a *Qard* contract to the lender and in all circumstances.

4.7.2 Recognition and Measurement

The initial measurement for *Qard* under MFRS 9 is based on fair value plus or minus transaction costs and subsequently, *Qard* is measured at amortised cost using the effective *Hibah* rate method.

4.7.3 Presentation and Disclosure

Presentation and disclosure issues pertaining to *Qard* are similar to that of the other financing contracts of the Islamic bank such as *Murabahah, Ijarah, Ar Rahnu* and others. As may be recalled, MFRS 132, MFRS 7 as well as the BNM Guidelines on Financial Reporting (2018) are relevant. Information on the significance of the financial instrument as well as the nature and extent of risks arising from financial instruments such as credit risk, liquidity risk, and market risk. The carrying amount of each category of financial assets should be disclosed separately in the notes to the financial statements.

4.7.3.1 The practice

There was no *Qard* for the year ended 31 December 2018 for BIMB.

SUMMARY

- This chapter discusses the recognition, measurement, presentation and disclosure of assets in an Islamic bank. The chapter consists of two parts:
- Part I focuses on assets such as cash and short-term funds, deposits and placements with banks and other financial institutions, financial investments portfolio, derivative financial assets, the amounts due from holding and/or related companies, statutory deposits with BNM, investments in subsidiaries, PPE, intangible assets and goodwill.
- Part II concentrates on the various products offered by Islamic banks. This is usually categorised under "Financing and Advances". Under Financing and Advances, an IB offers various Shariah-compliant products that are based on specific contr
acts such as *Ijarah, Murabahah, Istisna', Ar Rahnu, Mudarabah* and *Musyarakah*.
- The last two are generally not commonly used by Islamic Banks in Malaysia. The most popular is the *Murabahah* contract and its related *Tawarruq* contract (reverse *Murabahah*). In BIMB's case, the various products offered by the bank include *Bai Bithaman Ajil, Murabahah, Tawarruq, Ijarah, Istisna'* and *Ar Rahnu*.

CHAPTER 6

LIABILITIES

LIABILITIES

LEARNING OBJECTIVES

The chapter aims to:

i. define, classify and explain different types of liabilities;
ii. explain the recognition and measurement issues of liabilities;
iii. clarify the presentation and disclosure issues of liabilities; and
iv. discuss specific issues pertaining to liabilities.

1.0 INTRODUCTION

A liability is the present obligation of an entity that arises from past events. The settlement of this liability would cause an outflow of resources from the entity. Thus, with a loan from the bank, the past event refers to the receipt of the principal amount from the bank. The obligation to pay off the loan would be present from the day the entity receives the loan. However, a liability should not be recognised in anticipation of a loan that a company intends to take in the near future. Generally, liabilities are categorised as current or non-current on the statement of financial position.

2.0 ACCOUNTING FOR LIABILITIES

The conceptual framework of the International Accounting Standards Board (IASB) defines a liability as:

> *a present obligation of the enterprise arising from past events, the settlement of which is expected to result in an outflow from the enterprise of resources embodying economic benefits (IASB Framework).*

For a liability to be recognised, it does not have to be an obligation that is due on demand but just that it is a present obligation. The obligation to transfer economic benefits may not only be a legal one. A liability in respect of a constructive obligation may also be recognised where an entity, based on its past practices, has created a valid expectation in the minds of the concerned persons that it will fulfil such obligations in the future.

For example, if an oil exploration company has a past practice of restoring oil rig sites after they are dismantled despite having no legal obligation to do so and that it advertises itself as an environment friendly organisation, then this gives rise to a constructive obligation and must therefore be recognised in the financial statements of the company. This is because a valid expectation has been created that the company will restore oil rig sites in the future. Thus, where a company constructs an oil rig and that it is responsible to disassemble the structure at the end of the oil rig's life, the future costs to decommission that oil rig is recognised as a non-current liability that is measured at present value.

More importantly, a liability is only recognised if:

i. the outflow of resources embodying economic benefits (such as cash) from the entity is probable; and
ii. the cost/value of the obligation can be measured reliably.

Accordingly, a liability is recognised only if it is likely that the entity will be required to settle it and the second test ensures that only liabilities that can be objectively measured are recognised in the financial statements.

If an obligation meets the definition of liability but fails to meet the recognition criteria, it is classified as a contingent liability. A contingent liability is not presented as a liability in the statement of financial position but is, instead, disclosed in the notes to the financial statements.

3.0 LIABILITIES OF ISLAMIC BANKS

Typically, the liabilities of a bank are made up of deposits from customers, deposits and placements of other banks and financial institutions, bills and acceptance payable, short-term and long-term borrowings, provisions, tax liabilities and liabilities to creditors. Similarly, the liabilities of an Islamic bank will also include the aforementioned items.

However, in addition to the savings, current and fixed deposits, the Islamic bank also has investment deposits. For long-term borrowings, the Islamic bank will have sukuk instead of debentures and bonds. Additionally, while other commercial banks have provision for taxes, the Islamic bank, in addition to this, has a provision for zakat as part of its liabilities.

The liabilities of Islamic banks include the following:

i. Deposits from customers
ii. Investment accounts
iii. Deposits and placements of banks and other financial institutions
iv. Bills and acceptance payable
v. Subordinated sukuk
vi. Derivative liabilities
vii. Provision for tax and zakat

Figure 1 shows the liabilities in the Statement of Financial Position of Bank Islam Malaysia Berhad (BIMB) as at 31 December 2018.

Statement of Financial Position as at 31 December 2018					
		Group		Bank	
		31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
Liabilities and equity	**Note**	**RM'000**	**RM'000**	**RM'000**	**RM'000**
Deposits from customers	17	**49,895,232**	46,192,910	**49,909,199**	46,209,028
Investment accounts of customers	18	**5,176,819**	4,260,185	**5,176,819**	4,260,185
Derivative financial liabilities	7	**19,520**	74,668	**19,520**	74,668
Bills and acceptance payable		**41,114**	420,258	**41,114**	420,258
Resource obligations on financing sold to Cagamas	19	**1,501,187**	-	**1,501,187**	-
Subordinated Sukuk Murabahah	20	**1,308,634**	1,006,486	**1,308,634**	1,006,486
Other liabilities	21	**706,133**	782,299	**695,714**	773,769
Zakat and taxation	22	**13,687**	46,404	**13,539**	46,340
Total liabilities		**58,662,326**	52,783,210	**58,665,726**	52,790,734

Figure 1: Liabilities of an Islamic Bank

3.1 Deposits from Customers

3.1.1 Nature and Definition

Deposits from customers constitute a dominant part of the liabilities of an Islamic bank. Under IFSA 2013, customers have a choice of placing their funds as deposits or as investments. If the customer puts his funds in an Islamic Bank as an Islamic deposit, then up to RM250,000 of the principal amount would be covered under the deposit insurance scheme of Perbadanan Insurans Deposit Malaysia (PIDM).

Such funds have no restrictions on its withdrawals and accordingly, a customer has that flexibility to withdraw his funds as and when he wishes. BNM defines an Islamic deposit as a sum of money accepted or paid in accordance with Shariah,

> *i. on terms under which it will be repaid in full, with or without any gains, return or any other consideration in money or money's worth, either on demand or at a time or in circumstances agreed by or on behalf of the person making the payment and person accepting it; or*
>
> *ii. under an arrangement, on terms whereby the proceeds under the arrangement to be paid to the person paying the sum of money shall not be less than such sum of money.*

Simply put, such deposits are repayable in full (i.e. the principal is guaranteed) and that the returns are subject to the terms of the contract. Additionally, repayment can be affected on demand or at maturity.

Types of deposits

Generally, there are three types of deposits: current account, savings account and term deposits as illustrated in Diagram 1. The Shariah contracts used for savings and current deposits are based on *al qard*[1] while that of term deposits align with *Tawarruq*.

- *Current account*

This type of deposit is contracted under the principle of *Al qard*. *Al qard* refers to a contract of lending money where the borrower is to pay the full amount to the lender. In other words, if Ahmad were to put RM2,000 in a current account in an Islamic bank, the Islamic bank is obliged to pay Ahmad the full amount when he so requires.
Thus, the current account deposits based on the *Qard* contract provides hassle-free safekeeping of one's funds and allows easy access for withdrawals on demand. It is executed between two parties, namely the depositor and the Islamic bank (the custodian). Thus, this arrangement is a liability to the bank as the bank guarantees the return of the principal sum of the depositor. However, the bank can utilise the deposits but cannot promise any returns as *Hibah* (gift). If the bank promises any returns, this would tantamount to *Riba'*.

- *Savings account*

This is similar to the current account except that it does not have a cheque issuing facility. Savings deposits are also based on *Al qard*. Under the strict principle of *Al qard*, banks cannot give any return for such deposits. However, in practice, Islamic banks give some returns as *hibah* (gift) due to *Maslahah* (public interest) and competition from conventional banks.

- *Term deposits*

Term deposits normally use the *Tawarruq* (commodity or reverse *Murabahah*) contract. Under this contract, the Islamic bank will purchase the commodity (normally crude palm oil or metal) from a broker, on behalf of the customer. The customer will, subsequently, sell the commodity to the bank on deferred payment (including profit margin). Once the ownership of the commodity has been transferred, the bank will then sell the commodity on a spot basis for cash through another broker. On maturity of the deferred payment terms, the bank will pay the customer the agreed deferred payment price. Since the commodity is traded in the market, there will be brokerage fees which will be borne by the Islamic bank.

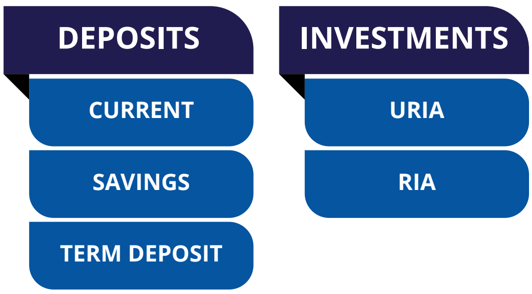


Diagram 1: Deposits and Investments in an Islamic bank

Technically, this product is a fixed profit rate deposit account. The returns are fixed as part of the *Murabahah* structure. The Shariah requirement for *Tawarruq* is that the commodity must be available, and the customer must have physical or constructive possession of the commodity. In addition, the purchase price must be known and with no conditions attached to any future event. Further, the price cannot be changed once fixed. This is somewhat similar to fixed deposits in conventional banks.

[1]Prior to 2018, all savings and current account deposits were based on al-Wadiah (safekeeping or trust). Al Wadiah is a trust contract utilized for the purpose of the safe custody of the savings and current accounts in an Islamic bank.

3.1.2 Recognition and Measurement

Given that deposits are payable "at call" or on demand, such deposits are recognised as financial liabilities. MFRS 9 requires an entity to recognise a financial liability in its statement of financial position upon the entity becoming a party to the contractual obligations of the instrument.

Accordingly, the Islamic bank shall recognise a deposit as a financial liability in its statement of financial position when the entity becomes a party to the contractual provisions of the instrument. *Al qard* deposits are recognised at the point where funds are received from the depositors at cost. Further, an entity shall remove a financial liability (or a part of a financial liability) from its statement of financial position when the obligation specified in the contract is discharged or cancelled or when the obligation expires.

All financial liabilities are measured at amortised cost except for those financial liabilities at FVTPL. These liabilities include derivatives (other than derivatives that are financial guarantee contracts or are designated and effective hedging instruments), other liabilities held for trading, and liabilities that an entity identifies to be measured at FVTPL.

Upon initial recognition, an entity may designate a financial liability to be measured at fair value through profit or loss if this would eliminate or significantly reduce a measurement or recognition inconsistency (sometimes referred to as an 'accounting mismatch') or that this would provide more relevant information. This designation, however, is irrevocable as, after initial recognition, an entity cannot reclassify any financial liability.

3.1.3 Presentation and Disclosure

3.1.3.1 The Practice

For deposits, the Islamic bank shall present the carrying amount related to such deposits in separate line items in its separate financial statements and consolidated financial statements[2] as illustrated in Figure 2. As reflected in the Statement of Financial Position below, as at 31 December 2018, BIMB has deposits from customers for the Group and the Bank amounted to RM49,895,232,000 RM49,909,199,000, respectively.

In the notes to the financial statements (Note 17), the detailed breakdown of deposits from customers should also be disclosed as follows:

i. types of Islamic deposits (e.g. savings, current and term deposits) and further, breakdown by Shariah contracts (e.g. *Wadiah, Qard, Amanah and Tawarruq*) as in Figure 2(a);
ii. types of customers (e.g. government, business enterprises) as in Figure 2(b); and
iii. the maturity structure of term deposits (e.g. < 6 months, 6-12 months, 1-3 years) as in Figure 2.

The significant accounting policies on financial liabilities of BIMB clearly indicate the measurement of such liabilities.

[2]It should be noted that "separate financial statements" and "consolidated financial statements" align with the meaning as set out in MFRS 127 (Separate Financial Statements) and MFRS 10 (Consolidated Financial Statements).

Significant Accounting Policies

Financial liabilities

All financial liabilities are subsequently measured at amortised cost other than those categorised as fair value through profit or loss. The financial liabilities measured at amortised cost are deposit from customers, investment accounts of customers, deposits and placement of banks and other financial institutions, derivative financial liabilities, bills and acceptance payables, Subordinated Sukuk Murabahah and other liabilities. Fair value through profit or loss category comprises financial liabilities that are derivatives or financial liabilities that are specifically designated into this category upon initial recognition.

Derivatives that are linked to and must be settled by delivery of equity instruments that do not have quoted price in an active market for identical instruments whose fair value otherwise cannot be reliably measured are measured at cost. Financial liabilities categorised as fair value through profit or loss are subsequently measured at their fair values with the gain or loss recognised in profit or loss.

Statement of Financial Position as at 31 December 2018

		Group		Bank	
		31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
	Note	RM'000	RM'000	RM'000	RM'000
Liabilities and equity					
Deposits from customers	17	**49,895,232**	46,192,910	**49,909,199**	46,209,028
Investment accounts of customers	18	**5,176,819**	4,260,185	**5,176,819**	4,260,185
Derivative financial liabilities	7	**19,520**	74,668	**19,520**	74,668
Bills and acceptance payable		**41,114**	420,258	**41,114**	420,258
Resource obligations on financing sold to Cagamas	19	**1,501,187**	-	**1,501,187**	-
Subordinated Sukuk Murabahah	20	**1,308,634**	1,006,486	**1,308,634**	1,006,486
Other liabilities	21	**706,133**	782,299	**695,714**	773,769
Zakat and taxation	22	**13,687**	46,404	**13,539**	46,340
Total liabilities		**58,662,326**	52,783,210	**58,665,726**	52,790,734

Notes to the Financial Statements

17. Desposits from customers

a. By type of deposit

	Group		Bank	
	31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
	RM'000	RM'000	RM'000	RM'000
Savings Deposit				
Wadiah	**4,410,537**	4,138,519	**4,410,537**	4,138,519
Demand Deposit				
Wadiah	**10,663,456**	11,333,608	**10,670,826**	11,343,024
Term Deposit	**34,727,635**	30,617,889	**34,734,232**	30,624,591
Special Investment Deposit				
Mudharabah	**6,252**	6,182	**6,252**	6,182
General Investment Deposit				
Mudharabah	**287,013**	322,561	**287,013**	322,561
Term Deposit-i				
Tawarruq	**30,751,990**	26,728,087	**30,758,587**	26,734,789
Negotiable Islamic Debt Certificates (NIDC)	**3,682,380**	3,561,059	**3,682,380**	3,561,059
Others	**93,604**	102,894	**93,604**	102,894
Total Deposits	**49,895,232**	46,192,910	**49,909,199**	46,209,028

Figure 2: Deposits from Customers (to be continued on the next page)

b. Maturity structure of term deposits are as follows

	Group		Bank	
	31 Dec 2018	**31 Dec 2017**	**31 Dec 2018**	**31 Dec 2017**
	RM'000	**RM'000**	**RM'000**	**RM'000**
Due within six months	**16,428,971**	18,565,407	**16,429,087**	18,571,396
More than six months to one year	**9,685,966**	8,742,154	**9,691,736**	8,742,867
More than one year to three years	**6,484,593**	1,618,691	**6,485,304**	1,618,691
More than three years to five years	**2,128,105**	1,691,637	**2,128,105**	1,691,637
	34,727,635	30,617,889	**34,734,232**	30,624,591

By type of customer

	Group		Bank	
	31 Dec 2018	**31 Dec 2017**	**31 Dec 2018**	**31 Dec 2017**
	RM'000	**RM'000**	**RM'000**	**RM'000**
Domestic non-bank financial institutions	**12,385,381**	14,063,475	**12,399,348**	14,079,593
Business enterprises	**16,725,704**	12,406,686	**16,725,704**	12,406,686
Government and statutory bodies	**12,049,184**	8,847,454	**12,049,184**	8,847,454
Individuals	**5,199,550**	4,810,541	**5,199,550**	4,810,541
Domestic banking institutions	**1,634,224**	3,395,740	**1,634,224**	3,395,740
Other	**1,901,189**	2,669,014	**1,901,189**	2,669,014
	49,895,232	46,192,910	**49,909,199**	46,209,028

Figure 2: Deposits from Customers

3.2 Investment Accounts

3.2.1 Nature and Definition

As indicated earlier in the discussion on deposits, a customer of an Islamic bank can put his funds in the Islamic bank as a deposit or as an investment. If the customer puts his funds as an investment, then the returns are based on the performance of the underlying assets.

Essentially, what this means is that the funds are identified to a particular class of assets and the returns on the assets constitute a return to the investor. The maturity and withdrawal conditions of the funds would have to be agreed at its inception.

The Shariah contracts for investment accounts are typically based on *Musyarakah* (profit-and-loss sharing), *Mudarabah* (profit sharing and loss bearing) or *Wakalah* (agency agreement).

An investment account, as defined by the Islamic Financial Services Act 2013 (IFSA) is an account where money is paid and accepted for the purposes of investment, including for the provision of finance, in accordance with Shariah on terms without any express or implied obligation to repay the money in full and;

i. 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
ii. with or without any return.

Further, any investment undertaken by the Islamic bank utilising the funds from the investor should be one that is permissible in Islam and that the repayment is subject to the performance of the underlying assets identified for the investment.

Most importantly, the principal should not be guaranteed. As for profits, this will be shared between the Islamic bank and the investor. If there are losses, these will be borne wholly by the investors if it is based on a *Mudarabah* contract or shared as in the *Musyarakah* contract. If a *Wakalah* contract is used, the Islamic bank is only regarded as an agent. Thus, the Islamic bank is entitled to the *Wakalah* fees irrespective of whether the underlying assets provide positive or negative returns.

The investment account is generally categorised as unrestricted investment accounts (URIA) or restricted investment accounts (RIA). The former is sometimes termed *Mudarabah Moqayyadah* while the latter is termed *Mudarabah Mutlaqah.*

URIA is when the investment account holder authorises the Islamic bank to invest the account holder's funds in a manner which the Islamic bank deems appropriate without laying down any restrictions as to where, how and for what purpose the funds should be invested in. Additionally, the Islamic bank can mix the investment account holder's funds with its own funds or with other funds the Islamic bank has the right to use.

Typically, URIA is structured under *Mudarabah* and *Wakalah* contracts. If URIA is structured according to the *Mudarabah* contract, the returns on the invested funds are shared between the Islamic bank and the investment account holders while losses are wholly borne by the investors.

RIA is when investors provide a specific investment mandate to the bank such as the purpose, the asset class, the economic sector and the period of investment. Thus, the investment account holder imposes certain restrictions on the investment of his funds. The Islamic bank may also be restricted from mixing its own funds with the restricted investment account holders funds.

There may also be other restrictions which the investment account holders may impose. Typically, RIA is structured under the *Wakalah* and *Mudarabah* contract. Thus, the investment account holder appoints the Islamic bank, as the agent, to invest the funds, with a view to earning profits and the Islamic bank will receive fees for the agency service provided.

It is important to note that the Islamic bank has no power over the RIA to affect the amount of the bank's return. The underlying assets and liabilities are not normally recorded as part of the Islamic bank's assets and liabilities.

The additional characteristics of RIA include the following:

i. RIA is not guaranteed by the Islamic bank, PIDM or any third party;
ii. The specific assets are the only source of payment to the RIA holders;
iii. RIA is subject to the credit risk of the underlying assets;
iv. RIA holders are to indemnify the Islamic bank from any legal suits or claims in relation to the Islamic bank;
v. RIA holders have absolute discretion to review the investment portfolios or discontinue the availability of the funds; and
vi. Upon termination, any residual assets and cash balances are returned to RIA holders.

3.2.2 Recognition and Measurement

Given that the Islamic bank does not guarantee the principal and profit of the investment account holders (IAH) and that there is no third-party guarantor, the IAH's recourse, thus, is only on the underlying assets. Accordingly, one question that has often been raised is whether such funds should be treated as an off-balance sheet item or a financial liability of the Islamic bank.

3.2.2.1 RIA

Typically, RIA relates to the placement by a parent company of the Islamic bank where the latter manages and invests the capital in accordance with Shariah[3]. Thus, the former is the capital provider and the Islamic bank, the fund manager. However, RIA can also come from independent external parties. Whether RIA should be presented as an off-balance sheet item rests on how the funds have been used.

If the *Mudarabah* capital is invested in the existing assets of the Islamic bank and the credit, market and liquidity risks of the *Mudarabah* arrangement are all transferred to the *Rabbul mal* (the capital provider), the financial assets of the Islamic bank will be derecognised from the Islamic bank's financial statements.

Accordingly, the *Mudarabah* funds will be treated as an off-balance sheet item. However, if the financial assets on which the *Mudarabah* capital is invested in continues to form part of the Islamic bank's financial asset, then such funds will be treated as a financial liability. MFRS 132 defines a financial liability as a contractual obligation to deliver cash or another financial asset to another entity or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity.

Accordingly, if RIA meets the definition as set out in MFRS 132, then the recognition criteria in paragraph 3 MFRS 9 applies. Specifically, MFRS 9 provides that,

> *an entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the instrument.*

Thus, RIA is regarded as a financial liability (i.e. "on" balance sheet) if it represents a contractual relationship between those relevant parties. Further justification is provided in Paragraph 11 of MFRS 132 where it specifically provides that a financial asset is "a contractual right to receive cash or another financial asset from another entity".

Once the underlying assets of RIA have satisfied the criteria as set out in Paragraph 11 of MFRS 132 and Paragraph 3 of MFRS 9, the next step is to determine if there exists a "pass-through" arrangement between the parent company as the capital provider and the end customer or the eventual recipients. More specifically, whether the Islamic bank has transferred (passed through) the financial assets and hence should derecognise those assets, becomes pertinent. If the Islamic bank has derecognised those assets, then RIA will be an off-balance sheet item. To determine if derecognition has occurred, Paragraph 3.2.5 of MFRS 9 on risks and rewards provides that:

> *when an entity retains the contractual rights to receive the cash flows of a financial asset (the 'original asset'), but assumes a contractual obligation to pay those cash flows to one or more entities (the 'eventual recipients'), the entity treats the transaction as a transfer of a financial asset if, and only if,* **ALL** *the following three conditions are met;*
>
> i. *The entity has no obligation to pay amounts to the eventual recipients unless it collects equivalent amounts from the original asset.*
> ii. *The entity is prohibited by the terms of the transfer contract from selling or pledging the original asset other than as security to the eventual recipients for the obligation to pay them cash flows.*
> iii. *The entity has an obligation to remit any cash flows it collects on behalf of the eventual recipients without material delay.*

[3]*Financial Reporting by Islamic Banking institutions: A study of presentation and disclosure in the financial statements of Islamic banks in Malaysia (MASB and MIA) (2016).*

As alluded to earlier, if the underlying assets of RIA satisfy the derecognition criteria above, RIA will be an off-balance sheet item. Alternatively, if the derecognition criteria are not met, RIA will be an on balance sheet item. If it is, should it be a part of equity or a financial liability?

Paragraph 11 of MFRS 132 defines equity as:

> *any contract that evidences a residual interest in the assets of an entity after deducting all of its liabilities*

Based on the above, it is clear that RIA cannot be recognised as part of equity. Thus, RIA will be treated as a financial liability.

3.2.2.2 URIA

The underlying assets of URIA are typically recognised as the financial assets of the Islamic bank. Accordingly, URIA is recognised as a financial liability in its separate financial statements and consolidated financial statements. As may be recalled, a financial liability is defined as a contractual obligation to deliver cash or another financial asset to another entity or to exchange financial assets or financial liabilities with another entity under conditions that are potentially unfavourable to the entity (Paragraph 11 of MFRS 132).

All financial liabilities are initially valued at fair values and subsequently measured at amortised cost according to the effective profit rate.

3.2.3 Presentation and Disclosure

The investment account in Islamic banks may be recognised as a financial liability if it meets the recognition criteria and the definition of financial liability under MFRS 9 and MFRS 132, respectively. However, if the investment account does not give rise to assets and liabilities of the Islamic bank, such investment account may be reported as an off-balance sheet item, a point alluded to earlier.

3.2.3.1 The Practice

URIA is presented as a financial liability in its separate financial statements and consolidated financial statements. The carrying amount of URIA is presented in separate line items in the financial statements.

RIA is generally not recognised as a financial liability in the Islamic bank's separate financial statements and consolidated financial statements primarily because the Islamic bank has no rights and obligations in respect of the assets related to the RIA or to the residual cash flows from those assets except for the fee income generated by the Islamic bank in managing the RIA.

URIA is presented in the financial statements of the Islamic bank under investment accounts of customers while RIA is presented in the financial statements as an off-balance sheet item (see Figure 3). Specifically, the Islamic bank shall present the carrying amount of RIA separately from its commitments and contingencies. The presentation and disclosure of RIA should follow MFRS 10: Consolidated Financial Statements.

In addition, the following details should also be disclosed, both for URIA and RIA:

1. types of investment account (e.g. unrestricted or restricted investment account) and further breakdown by Shariah contracts (e.g. *Wakalah* and *Mudarabah*)
2. types of customers; and
3. the maturity structure of the investment account together with its date of maturity.

The balances of URIA and RIA for the Group and the Bank as at 31 December 2019 are RM5,176,819,000 and RM78,717,000, respectively (as illustrated in Figure 3). Further clarification on URIA and RIA are given in Note 18. These include types of investment account, types of customers, movements of investment account of customers and the maturity structure, profit sharing ratio and the rate of return for investment accounts.

Significant Accounting Policies

Investment accounts

Investment accounts are either:

i. Unrestricted investment accounts

An unrestricted investment account ("URIA") refers to a type of investment account where the investment account holder ("IAH") provides the Bank with the mandate to make the ultimate decision without specifying any particular restrictions or conditions. The URIA is structured under *Mudharabah* and *Wakalah* contracts.

Impairment allowances required on the assets for investment accounts are charged to and borne by the investors.

ii. Restricted investment accounts

Restricted investment account ("RIA") refers to a type of investment account where the IAH provides a specific investment mandate to the Bank such as purpose, asset class, economic sector and period of investment.

RIA is accounted for as off balance sheet as the Bank has no risk and reward in respect of the assets related to the RIA or to the residual cash flows from those assets except for the fee income generated by the Bank for managing the RIA. The Bank also has no ability to use power over the RIA to affect the amount of the Bank's return. The RIA is structured under *Wakalah* contract. Under *Wakalah* contract, IAH appoints the Bank as the agent to invest the funds provided by IAH to finance customers with a view of earning profits and the Bank receives fees for the agency service provided.

Financial guarantee contracts

A financial guarantee contract is a contract that requires the Group to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument.

Fair value arising from financial guarantee contracts are classified as deferred income and are amortised to profit or loss using a straight-line method over the contractual period or, when there is no specified contractual period, recognised in profit or loss upon discharge of the guarantee. When settlement of a financial guarantee contract becomes probable, an estimate of the obligation is made. If the carrying value of the financial guarantee contract is lower than the obligation, the carrying value is adjusted to the obligation amount and accounted for as a provision.

Derecognition

A financial asset or part of it is derecognised when, and only when the contractual rights to the cash flows from the financial asset expire or the financial asset is transferred to another party without retaining control or substantially all risks and rewards of the asset. On derecognition of a financial asset, the difference between the carrying amount and the sum of the consideration received (including any new asset obtained less any new liability assumed) and any cumulative gain or loss that had been recognised in equity is recognised in profit or loss.

A financial liability or a part of it is derecognised when, and only when, the obligation specified in the contract is discharged or cancelled or expires. On derecognition of a financial liability, the difference between the carrying amount of the financial liability extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, is recognised in profit or loss.

Offsetting

Financial assets and financial liabilities are offset and the net amount presented in the statement of financial position when, and only when, the Group currently has a legally enforceable right to set off the amounts and it intends either to settle them on a net basis or to realise the asset and settle the liability simultaneously.

Financial Statement

Statement of Financial Position as at 31 December 2018

		Group		Bank	
		31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
	Note	RM'000	RM'000	RM'000	RM'000
Liabilities and equity					
Deposits from customers	17	**49,895,232**	46,192,910	**49,909,199**	46,209,028
Investment accounts of customers	18	**5,176,819**	4,260,185	**5,176,819**	4,260,185
Derivative financial liabilities	7	**19,520**	74,668	**19,520**	74,668
Bills and acceptance payable		**41,114**	420,258	**41,114**	420,258
Resource obligations on financing sold to Cagamas	19	**1,501,187**	-	**1,501,187**	-
Subordinated Sukuk Murabahah	20	**1,308,634**	1,006,486	**1,308,634**	1,006,486
Other liabilities	21	**706,133**	782,299	**695,714**	773,769
Zakat and taxation	22	**13,687**	46,404	**13,539**	46,340
Total liabilities		**58,662,326**	52,783,210	**58,665,726**	52,790,734
Restricted investment accounts managed by the Bank	18	**78,717**	124,384	**78,717**	124,384

The restricted investment accounts are presented as off-balance sheet item in the statement of financial position of the Islamic bank.

Restricted investment accounts ("RIA") managed by the bank^

	31 Dec 2018	31 Dec 2017
	RM'000	RM'000
With maturity		
Wakalah	**78,717**	124,384

Notes to the Financial Statements

18. Investment accounts of customers

By type and Shariah contract

	Group and Bank	
	31 Dec 2018	**31 Dec 2017**
	RM'000	**RM'000**
Unrestricted investment accounts		
Without maturity		
Mudharabah	**2,594,846**	1,994,491
- Savings	**2,413,645**	1,986,005
- Demand	**181,201**	8,486
With maturity		
Wakalah	**2,581,973**	2,265,694
	5,176,819	4,260,185
Restricted investment accounts ("RIA") managed by the bank^		
With maturity		
Wakalah	**78,717**	124,384

^ Included in RIA managed by the Bank is an arrangement between the Bank and its ultimate holding entity where the Bank acts as an investment agent to manage and administer the RIA, with underlying assets amounting to RM78,285,000 (2017: RM123,962,000).

By type of customer

	Group and Bank	
	31 Dec 2018	**31 Dec 2017**
	RM'000	**RM'000**
Individuals	**2,674,428**	2,212,239
Government and statutory bodies	**767,996**	400,709
Business enterprises	**507,160**	474,464
Non-bank financial institutions	**1,175,273**	1,077,298
International Islamic Bank	**2,400**	-
Other	**49,562**	95,475
	5,176,819	4,260,185

Figure 3: Investment Accounts of Customers

(c) Movement of investment accounts of cutomers

Group and Bank	Unrestricted investment accounts			Restricted investment accounts
	Mudharabah RM'000	Wakalah RM'000	Total RM'000	Wakalah RM'000
As at 1 January 2017	1,516,844	2,295,417	3,812,261	141,343
Funding inflows/outflows:				
Net movement	475,709	-	475,709	-
New placement	-	6,536,170	6,536,170	19,939
Redemption/Principal repayment	-	(6,669,256)	(6,669,256)	(46,150)
Income from investment	94,386	152,660	247,046	11,847
Bank's share of profit:				
Profit distributed to Mudharib	(92,448)	-	(92,448)	-
Wakalah fees	-	(49,297)	(49,297)	(2,595)
As at 31 December 2017/1 January 2018	**1,994,491**	**2,265,694**	**4,260,185**	**124,384**
Funding inflows/outflows:				
Net movement	**594,825**	**-**	**594,825**	**-**
New placement	**-**	**5,477,624**	**5,477,624**	**6,000**
Redemption/Principal repayment	**-**	**(5,250,374)**	**(5,250,374)**	**(60,080)**
Income from investment	**122,522**	**135,393**	**257,915**	**8,898**
Bank's share of profit:				
Profit distributed to Mudharib	**(116,992)**	**-**	**(116,992)**	**-**
Wakalah fees	**-**	**(46,364)**	**(46,364)**	**(485)**
As at 31 December 2018	**2,594,846**	**2,581,973**	**5,176,819**	**78,717**
Investment portfolio:				
2018				
House financing	**2,594,846**	**1,291,261**	**3,886,107**	**-**
Personal financing	**-**	**1,290,712**	**1,290,712**	**-**
Other term financing	**-**	**-**	**-**	**78,717**
	2,594,846	**2,581,973**	**5,176,819**	**78,717**
2017				
House financing	1,994,491	1,133,112	3,127,603	-
Personal financing	-	1,132,582	1,132,582	-
Other term financing	-	-	-	124,384
	1,994,491	2,265,694	4,260,185	124,384

(d) By maturity structures, profit sharing ratio and rate of return

	Investment accounts holders			
	Total amount RM'000	Average profit sharing ratio (%)	Average rate of return (%)	Bank's wakalah fee (%)
2018				
Unrestricted investment accounts:				
Less than 3 months				
- Mudharabah	2,594,846	2	0.24	-
- Wakalah	1,112,699	-	3.81	1.63
	3,707,545			
Between 3 to 12 months				
- Wakalah	1,469,274	-	3.72	1.72
	5,176,819			
Restricted investment accounts:				
Less than 2 years	87	-	6.30	0.30
Between 2 to 5 years	78,630	-	1.85	0.46
	78,717			
2017				
Unrestricted investment accounts:				
Less than 3 months				
- Mudharabah	1,994,491	2	0.11	-
- Wakalah	1,228,421	-	3.69	1.45
	3,222,912			
Between 3 to 12 months				
- Wakalah	1,037,273	-	3.72	1.42
	4,260,185			
Restricted investment accounts:				
Less than 2 years	429	-	6.30	0.30
Between 2 to 5 years	123,955	-	3.52	1.88
	124,384			

3.3 Bills and Acceptance Payable

3.3.1 Nature and Definition

Bills and acceptance payable represent the Islamic bank's own bills and acceptances rediscounted and outstanding in the market. Bank acceptance is a draft accepted by the bank. This is normally used to finance a customer's purchase or sale of goods for imports and exports. One may also regard this as a money market instrument that can be sold in the secondary market at a discounted price for immediate payment.

Bills payable refer to short-term bank borrowings from other banks. Typically, such borrowings are from the central bank. Banks usually use these borrowings to maintain adequate liquidity levels. The collateral for such borrowings normally consists of the bank's promissory note and a pledge of government securities.

3.3.2 Recognition and Measurement

Bills and acceptance payable are financial liabilities and recognised at the point when funds are received. These liabilities are measured at amortised cost in accordance with MFRS 9. Under MFRS 9, all financial instruments are initially measured at fair value. However, for a financial asset or financial liability that is not measured at FVTPL, the transaction costs will be added or deducted, accordingly. Subsequently, financial liabilities held for trading, (e.g. derivative liabilities), loan commitments and financial guarantee contracts that have been designated as FVTPL will continue to be measured at fair value. Changes in fair value are recognised in the profit or loss statement.

For other financial liabilities classified as FVTPL, the change in the liability's fair value due to changes in credit risk needs to be recognised in other comprehensive income (OCI) whilst the balance arising from a change in fair value is to be recognised in the profit or loss statement. This holds true only if the credit risk component does not give rise to or enhances a measurement mismatch.

3.3.3 Presentation and Disclosure

For bills and acceptance payable, the Islamic bank shall present the carrying amount and income and expenses related to such payable in separate line items in its separate financial statements and consolidated financial statements.

3.3.3.1 The Practice

There are no significant accounting policies and notes to the financial statements of BIMB for bills and acceptance payable as this item is not material in the bank. The amount of bills and acceptance payable for the Group and the Bank as at 31 December 2018 was RM41,114,000 (see Figure 4).

Significant Accounting Policies

None

Financial Statements

Statement of Financial Position as at 31 December 2018

		Group		Bank	
		31 Dec 2018	**31 Dec 2017**	**31 Dec 2018**	**31 Dec 2017**
	Note	**RM'000**	**RM'000**	**RM'000**	**RM'000**
Liabilities and equity					
Deposits from customers	17	**49,895,232**	46,192,910	**49,909,199**	46,209,028
Investment accounts of customers	18	**5,176,819**	4,260,185	**5,176,819**	4,260,185
Derivative financial liabilities	7	**19,520**	74,668	**19,520**	74,668
Bills and acceptance payable		**41,114**	420,258	**41,114**	420,258
Resource obligations on financing sold to Cagamas	19	**1,501,187**	-	**1,501,187**	-
Subordinated Sukuk Murabahah	20	**1,308,634**	1,006,486	**1,308,634**	1,006,486
Other liabilities	21	**706,133**	782,299	**695,714**	773,769
Zakat and taxation	22	**13,687**	46,404	**13,539**	46,340
Total liabilities		**58,662,326**	52,783,210	**58,665,726**	52,790,734

Notes to the Financial Statements

There is no note for this item since the item is not material.

Figure 4: Bills and Acceptance Payable

3.4 Deposits and placements of banks

3.4.1 Nature and Definition

Deposits and placement of banks refer to deposits held by one bank (say Bank A) for another (say Bank B) with the aim of assisting in the transfer of funds. These deposits are typically the bank's non-invested funds. There are also deposits and placement of bank balances that are due from foreign banks which are denominated in foreign currencies. Such accounts are termed 'nostro' accounts. Banks hold 'nostro' accounts to meet international customers' needs and primarily to facilitate transactions in foreign currencies.

3.4.2 Recognition and Measurement

Deposits and placements of banks are recognised at the point where funds are received. Such funds are regarded as financial liabilities and are measured at amortised cost in accordance with MFRS 9 (Financial Instruments: Recognition and Measurement). In the case of CIMB Islamic, if the maturity period for deposits and placements of banks is below six months, their fair values approximate their carrying values.

For deposits and placements that have a maturity period beyond six months, the fair values are estimated using discounted cash flows based on the prevailing money market profit rates for deposits and placements with similar remaining period to maturities.

3.4.3 Presentation and Disclosure

3.4.3.1 The Practice

For deposits and placement of banks, the Islamic bank shall present the carrying amount and income and expenses related to such payables in separate line items in its separate financial statements and consolidated financial statements. As reflected in the Statement of Financial Position below, as at 31 December 2018, CIMB has deposits and placement of banks and other financial institutions of RM2,083,580,000 for the Group and the Bank. Further clarification on the items in the assets are given in Note 23 (see Figure 5).

Significant Accounting Policies
None.

Financial Statements

Company No: 671380-H
CIMB Islamic Bank Berhad
(Incorporated in Malaysia)

Statement of Financial Position as at 31 December 2018

		The Group		The Bank	
		2018	2017	2018	2017
	Note	RM'000	RM'000	RM'000	RM'000
Liabilities and equity					
Deposits from customers	21	**75,931,556**	64,728,979	**76,216,744**	64,910,083
Investment accounts of customers	22	**1,769,270**	907,763	**1,769,270**	907,763
Deposits and placements of banks and other financial institutions	23	**2,083,580**	2,160,415	**2,083,580**	2,160,415
Investment accounts due to designated financial institutions	24	**8,216,809**	8,145,684	**8,216,809**	8,145,684
Financial liabilities designated at fair value through profit or loss	25	**21,918**	2,233	**21,918**	2,233
Islamic derivative financial instruments	26(a)	**598,975**	692,759	**598,975**	692,759
Amount due to holding company	14	**-**	20,588	**-**	20,588
Amount due to related companies	15	**50**	813	**50**	813
Other liabilities	27	**393,125**	616,505	**465,301**	896,914
Provision for tax		**95,443**	56,150	**95,443**	56,150
Recourse obligations on financing sold to Cagamas	28	**1,915,503**	2,072,300	**1,915,503**	2,072,300
Sukuk	29	**358,265**	463,257	**-**	1,000
Subordinated Sukuk	30	**615,033**	615,006	**615,033**	615,006
Total liabilities		**91,999,527**	80,482,452	**91,998,626**	80,481,708

Notes to the Financial Statements

23. Deposits and placements of banks and other financial institutions

	The Group and the Bank	
	31 Dec 2018	**31 Dec 2017**
	RM'000	**RM'000**
Licensed investment banks	**29,433**	340
Licensed banks	**1,037,022**	1,684,313
Other financial institutions	**1,017,125**	475,762
	2,083,580	2,160,415

The maturity structure of deposits and placement of banks and other financial institutions are as follows:

	The Group and the Bank	
	31 Dec 2018	**31 Dec 2017**
	RM'000	**RM'000**
Due within six months	**1,887,840**	2,158,364
Six months to one year	**195,740**	2,051
	2,083,580	2,160,415

Figure 5: Deposits and Placement of banks and other financial institutions

3.5 Subordinated sukuk

3.5.1 Nature and Definition

Sukuk are certificates of equal value representing undivided pro rata ownership of tangible assets, usufruct or services. Although sukuk are, in principle, non-recourse asset-backed instruments, the originator typically undertakes to repurchase the underlying assets at either a fixed or referenced price.

An Islamic bank may issue both normal (senior) and subordinated sukuk. For subordinated sukuk, it gives sukuk holders a residual claim over the assets financed by their funds and, such claims will rank after the claims of other creditors and unrestricted profit sharing investment accounts. Contrary to the conventional sense of subordination, subordinated sukuk does not represent a creditor's claim that rank after those of other creditors as this would be inconsistent with Shariah.

Subordinated sukuk allows Islamic banks to strengthen their Tier 2 capital. For Tier 2 sukuk, the underlying assets would be convertible (as specified in the contract) into shares of common equity at the point of non-viability or insolvency. The terms of conversion, notably the trigger point and the conversion ratio, must be clearly specified in the sukuk contract.

Tier 2 capital is the secondary component of bank capital (in addition to Tier 1 capital), which makes up a bank's required reserves. Such Tier 2 capital is designated as supplementary capital and is composed of items such as revaluation reserves, undisclosed reserves, hybrid instruments and subordinated term debt

Under MFRS 10, the sukuk originator would consolidate a special purpose entity (SPE) if it "controls" the SPE. In a typical sukuk, an originator would transfer an asset to a special purpose entity (SPE).

The SPE would offer to investors a claim on those assets, and the right to its future cash flows for the tenure of the sukuk, in exchange for immediate cash. In many instances, a complex web of additional arrangements is used to effectively guarantee that the return will be at a pre-determined level, subject only to the credit risk of an ultimate obligor.

Thus, apart from compliance with Shariah precepts, sukuk are in practice similar to either a conventional unsecured bond or conventional securitisation. Although there is a transfer of assets to the SPE, usually the transfer is accompanied by an arrangement for the assets to eventually be transferred back to the originator. Thus, in these circumstances, the transfer may not qualify as a sale, and the assets may not be derecognised.

3.5.2 Recognition and Measurement

MFRS 9 requires that subordinated sukuk be recognised at the point when proceeds are received. All financial liabilities (including subordinated sukuk) are subsequently measured at amortised cost. The originator would account for sukuk similar to a secured borrowing and would be classified as a liability.

Sukuk liabilities should be subsequently measured at amortised cost under MFRS 9 unless it is measured at fair value through profit or loss. This is because under MFRS 9, sukuk is classified under financial liabilities which are held to maturity. Accordingly, the amortised cost will be used to measure sukuk.

3.5.3 Presentation and Disclosure

In the statement of financial position, and under MFRS 132, sukuk would most likely be classified as a financial asset by the investor and as a financial liability by the issuer.

3.5.3.1 The Practice

As reflected in the Statement of Financial Position below, as at 31 December 2018, BIMB has Subordinated Sukuk Murabahah of RM1,308,634,000 for the Group and the Bank. Further clarification on the items in the assets are given in Note 20 (see Figure 6).

Significant Accounting Policies

Under significant accounting policies, BIMB states the following general policies on liabilities.

Financial liabilities

All financial liabilities are subsequently measured at amortised cost other than those categorised as fair value through profit or loss.

The financial liabilities measured at amortised cost are deposit from customers, investment accounts of customers, deposits and placement of banks and other financial institutions, derivative financial liabilities, bills and acceptance payables, Subordinated Sukuk Murabahah and other liabilities.

Financial Statement

Statement of Financial Position as at 31 December 2018

		Group		Bank	
		31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
	Note	RM'000	RM'000	RM'000	RM'000
Liabilities and equity					
Deposits from customers	17	**49,895,232**	46,192,910	**49,909,199**	46,209,028
Investment accounts of customers	18	**5,176,819**	4,260,185	**5,176,819**	4,260,185
Derivative financial liabilities	7	**19,520**	74,668	**19,520**	74,668
Bills and acceptance payable		**41,114**	420,258	**41,114**	420,258
Resource obligations on financing sold to Cagamas	19	**1,501,187**	-	**1,501,187**	-
Subordinated Sukuk Murabahah	20	**1,308,634**	1,006,486	**1,308,634**	1,006,486
Other liabilities	21	**706,133**	782,299	**695,714**	773,769
Zakat and taxation	22	**13,687**	46,404	**13,539**	46,340
Total liabilities		**58,662,326**	52,783,210	**58,665,726**	52,790,734

Notes to the Financial Statements
20. Subordinated Sukuk Murabahah

		Group and Bank	
	Note	31 Dec 2018	31 Dec 2017
		RM'000	RM'000
Issued under the RM1.0 billion Subordinated Sukuk Murabahah Programme			
First trance	(a)	**303,450**	303,355
Second tranche	(b)	**400,851**	401,085
Third tranche	(c)	**302,005**	302,046
		1,006,306	1,006,486
Issued under the RM10.0 billion Sukuk Murabahah Programme			
First trance	(d)	**302,328**	-
		1,308,634	1,006,486
Finance cost on Subordinated Sukuk Murabahah		**56,711**	41,296

Figure 6: Subordinated Sukuk Murabahah

The details of the issued subordinated Sukuk are as follows:

Note	Nominal value RM'000	Issue date	First call date*	Maturity date	Profit rate (% p.a.)#
(a)	300,000	22 April 2015	22 April 2020	22 April 2025	5.75
(b)	400,000	15 April 2015	15 April 2020	15 April 2025	5.50
(c)	300,000	13 November 2017	12 November 2022	12 November 2027	5.08
(d)	300,000	7 November 2018	7 November 2023	7 November 2028	5.15

Accrued and payable semi-annually in arrears.

The Subordinated Sukuk Murabahah qualifies as Tier II capital for the computation of the regulatory capital of the Bank in accordance with the Capital Adequacy Framework (Capital Components) for Islamic Banks issued by BNM

Reconciliation of movement of Subordinated Sukuk Murabaha to cash flows arising from financing activities is as follows:

	At 1 Jan 2018	Changes from financing cash flows	Finance cost for the year	At 31 Dec 2018
	RM'000	RM'000	RM'000	RM'000
Group and Bank				
Nominal value	**1,000,000**	300,000	-	**1,300,000**
Finance cost payable	**6,486**	(54,563)	56,711	**8,634**
	1,006,486	245,437	56,711	**1,308,634**

3.6 Derivative Liabilities

3.6.1 Nature and Definition

Derivative contracts (as discussed in Chapter 5 on Assets) can also be used by Islamic banks in the liabilities section. These can include forwards, futures, swaps and options, all of which are bilateral contracts or payment exchange agreements, whose values are derived from the value of an underlying asset, reference rate or index.

Derivative financial liabilities shall be accounted for in accordance with MFRS 9 (Financial Instruments: Recognition and Measurement), MFRS 132 (Financial Instruments: Presentation) and MFRS 7 (Financial Instruments: Disclosure).

3.6.2 Recognition and Measurement

MFRS 9 uses the ‘rights and obligations’ approach to the recognition of financial liabilities in its statement of financial position. A financial liability is recognised when, and only when, the entity becomes a party to the contractual provisions of the instruments. The rights and obligations of the counter-parties are recognised on the contract date regardless of the extent of performance of counter-parties. With this requirement, the Islamic bank recognises all its contractual rights and obligations under derivatives (such as forward contracts and profit rate swap) in its statement of financial position as liabilities on their respective contract dates.

Initial Measurement

MFRS 9 provides that a derivative financial liability is recognised, initially, at its fair value through profit and loss. However, derivatives that do not have a quoted price in an active market for identical instruments and whose fair value cannot be reliably measured are to be measured at cost.

Subsequent Measurement

After initial recognition, an Islamic bank shall measure derivatives at their fair values. As discussed in Chapter 5, all derivatives are carried as assets when fair value is positive and as liabilities when fair value is negative.

3.6.3 Presentation and Disclosure

Derivative financial liabilities are presented in the Statement of Financial Position as Liabilities of the Islamic bank. MFRS 7 (Financial Instruments: Disclosure) specifies the disclosure requirements for financial instruments, including disclosures of financial risks and risk management objectives, policies and processes.

3.6.3.1 The Practice

As at 31 December 2018, BIMB has derivative financial liabilities of RM19,520,000 for the Group and the Bank. Further clarification on the items in the assets are given in Note 7 (see Figure 7).

Significant Accounting Policies

BIMB's general policy on financial liabilities as indicated elsewhere in the chapter is also repeated here for ease of reference.

Financial liabilities

All financial liabilities are subsequently measured at amortised cost other than those categorised as fair value through profit or loss.

The financial liabilities measured at amortised cost are deposit from customers, investment accounts of customers, deposits and placement of banks and other financial institutions, derivative financial liabilities, bills and acceptance payables, Subordinated Sukuk Murabahah and other liabilities.

Fair value through profit or loss category comprises financial liabilities that are derivatives or financial liabilities that are specifically designated into this category upon initial recognition.

Derivatives that are linked to and must be settled by delivery of equity instruments that do not have quoted price in an active market for identical instruments whose fair value otherwise cannot be reliably measured are measured at cost.

Financial liabilities categorised as fair value through profit or loss are subsequently measured at their fair values with the gain or loss recognised in profit or loss.

Financial Statement

Statement of Financial Position as at 31 December 2018

		Group		Bank	
		31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
	Note	RM'000	RM'000	RM'000	RM'000
Liabilities and equity					
Deposits from customers	17	**49,895,232**	46,192,910	**49,909,199**	46,209,028
Investment accounts of customers	18	**5,176,819**	4,260,185	**5,176,819**	4,260,185
Derivative financial liabilities	7	**19,520**	74,668	**19,520**	74,668
Bills and acceptance payable		**41,114**	420,258	**41,114**	420,258
Resource obligations on financing sold to Cagamas	19	**1,501,187**	-	**1,501,187**	-
Subordinated Sukuk Murabahah	20	**1,308,634**	1,006,486	**1,308,634**	1,006,486
Other liabilities	21	**706,133**	782,299	**695,714**	773,769
Zakat and taxation	22	**13,687**	46,404	**13,539**	46,340
Total liabilities		**58,662,326**	52,783,210	**58,665,726**	52,790,734

Notes to the Financial Statements

Derivative financial assets/(liabilities)

The following tables summarise the contractual or underlying principal amounts of derivative financial instruments held at fair value through profit or loss and hedging purposes. The principal or contractual amount of these instruments reflects the volume of transactions outstanding at financial position date, and do not represent amounts at risk

Trading derivative financial instruments are revalued on a gross position and the unrealised gains or losses are reflected as derivative financial assets and liabilities respectively.

	31 Dec 2018		
Group and Bank	**Notional amount**	**Fair value**	
		Assets	**Liabilities**
	RM'000	**RM'000**	**RM'000**
Forward contracts	**2,869,455**	**30,653**	**(17,752)**
Profit rate swaps	**578,379**	**3,495**	**(1,768)**
	3,447,834	**34,148**	**(19,520)**

	31 Dec 2017		
Group and Bank	**Notional amount**	**Fair value**	
		Assets	**Liabilities**
	RM'000	**RM'000**	**RM'000**
Forward contracts	**3,218,824**	**63,827**	**(72,767)**
Profit rate swaps	**607,992**	**4,492**	**(1,901)**
	3,826,816	**68,319**	**(74,668)**

Figure 7: Derivative Financial Liabilities

3.7 Provision for Tax and Zakat

3.7.1 Nature and Definition

A provision for tax arises when current (or prior periods) tax charge is unpaid at the end of an entity's accounting period. Current tax is the expected tax payable (or receivable) on the taxable income or loss for the year, using tax rates enacted by the end of the reporting period, and any adjustment to the tax in respect of previous financial years. Current tax is one of the components of income tax expense (in addition to deferred tax expense) in the determination of profit or loss of an entity for the reporting period.

Zakat represents business zakat payable by an entity to comply with the principles of Shariah and as approved by the Islamic banks' Shariah Committee. A business entity only pays zakat on its business and does not pay zakat on behalf of depositors or shareholders.

3.7.2 Recognition and Measurement

MFRS 112 states that the current tax for current and prior periods shall, to the extent unpaid, be recognised as a liability. If the amount already paid in respect of current and prior periods exceeds the amount due for those periods, the excess shall be recognised as an asset. The benefit relating to a tax loss that can be carried back to recover the current tax of a previous period shall be recognised as an asset. When a tax loss is used to recover current tax of a previous period, an entity recognises the benefit as an asset in the period in which the tax loss occurs because it is probable that the benefit will flow to the entity and the benefit can be reliably measured.

Current tax liabilities for the current and prior periods shall be measured at the amount expected to be paid to the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period.

Current tax is usually measured using the tax rates (and tax laws) that have been enacted. However, in some jurisdictions, announcements of tax rates (and tax laws) by the government have the substantive effect of actual enactment, which may follow the announcement by a period of several months. In these circumstances, tax assets and liabilities are measured using the announced tax rate (and tax laws).

According to Technical Release *i*–1 (TR*i*-1), zakat for the current period shall be recognised when:

a. an entity has a current zakat obligation as a result of a zakat assessment; and
b. an outflow of resources embodying economic benefits will be required to satisfy the zakat obligation.

The amount of zakat assessed shall be recognised as an expense in the period in which it is incurred. When an entity pays zakat on its business assets, such amount of zakat is recognised as an expense and included in the income statement for the period in which it is incurred.

Zakat shall be assessed when the entity has been in operation for at least 12 months (i.e. for the period known as *haul*). Zakat on business shall be calculated by multiplying zakat rate with the assets that are subjected to zakat (zakatable assets). The rate of zakat on business, as determined by the National Fatwa Council, is 2.5% of the zakatable assets.

In determining zakatable assets, an entity may apply one of the following methods as recommended by the Malaysian Islamic Development Department (JAKIM) in Panduan Zakat di Malaysia, 2001:

a. the Adjusted Working Capital method; or
b. the Adjusted Growth method.

The adjusted working capital method calculates zakat base as net current assets, adjusted for items that do not meet the conditions for zakat assets and liabilities. The adjusted growth method calculates zakat base as owners' equity and long-term liabilities, deducted for property, plant and equipment and non-current assets, and adjusted for items that do not meet the conditions for zakat assets and liabilities as determined by the relevant zakat authorities. The method used for the determination of zakat base shall be applied consistently from one period to another.

On the date zakat is assessed, an entity shall measure zakat assets and liabilities on the same measurement basis as used in the preparation of its financial statements.

3.7.3 Presentation and Disclosure

The current tax for current and prior periods, to the extent unpaid, are recognised as current tax liabilities and presented in the statement of financial position as such.

An entity shall offset current tax assets and current tax liabilities if, and only if, the entity:

a. has a legally enforceable right to set off the recognised amounts; and
b. intends either to settle on a net basis or to realise the asset and settle the liability simultaneously.

Although current tax assets and liabilities are separately recognised and measured these are offset in the statement of financial position subject to the criteria similar to those established for financial instruments in MFRS 132. An entity will normally have a legally enforceable right to set off a current tax asset against a current tax liability when they relate to income taxes levied by the same tax authority and that the tax authority permits the entity to make or receive a single net payment. The tax expense (income) that is related to the profit or loss from ordinary activities shall be presented as part of profit or loss in the statement of profit or loss and other comprehensive income.

The amount of zakat assessed for the current period shall be presented as a line item on the face of the income statement. An entity shall disclose in the notes accompanying the financial statements the method used in the determination of zakat base, its responsibility towards payment of zakat on business and the major components of zakat. Components of zakat may include current zakat expense, zakat payment, zakat liability and any adjustments recognised in the period for zakat of prior periods.

3.7.3.1 The Practice

Zakat and taxation payable as at 31 December 2018 were RM13,687,000 and RM13,539,000 for the Group and the Bank, respectively. These zakat and taxation are further clarified in Note 22 of the financial statements of BIMB (see Figure 8). It can be observed that in Note 22, zakat payable amounting was RM13,685,000 and taxation payable was RM2,000 for the Group. For the Bank, there was no taxation payable, all the amount of RM13,539,000 represented the zakat payable for the Bank.

Significant Accounting Policies

Income tax

Income tax expense comprises current and deferred tax. Current tax and deferred tax are recognised in profit or loss except to the extent that it relates to a business combination or items recognised directly in equity or other comprehensive income.

Current tax is the expected tax payable or receivable on the taxable income or loss for the year, using tax rates enacted or substantively enacted by the end of the reporting period, and any adjustment to tax payable in respect of previous financial years.

Deferred tax is recognised using the liability method, providing for temporary differences between the carrying amounts of assets and liabilities in the statement of financial position and their tax bases. Deferred tax is not recognised for the following temporary differences: the initial recognition of assets or liabilities in a transaction that is not a business combination and that affects neither accounting nor taxable profit or loss. Deferred tax is measured at the tax rates that are expected to be applied to the temporary differences when they reverse, based on the laws that have been enacted or substantively enacted by the end of the reporting period.

Deferred tax assets and liabilities are offset if there is a legally enforceable right to offset current tax liabilities and assets, and they relate to income taxes levied by the same tax authority on the same taxable entity, or on different tax entities, but they intend to settle current tax liabilities and assets on a net basis or their tax assets and liabilities will be realised simultaneously.

A deferred tax asset is recognised to the extent that it is probable that future taxable profits will be available against which the temporary difference can be utilised. Deferred tax assets are reviewed at the end of each reporting period and are reduced to the extent that it is no longer probable that the related tax benefit will be realised.

Zakat

This represents business zakat that is paid on the Bank's portion. It is an obligatory amount payable by the Group and the Bank to comply with the rules and principles of Shariah.

Financial Statement

Statement of Financial Position as at 31 December 2018

		Group		Bank	
		31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
	Note	RM'000	RM'000	RM'000	RM'000
Liabilities and equity					
Deposits from customers	17	**49,895,232**	46,192,910	**49,909,199**	46,209,028
Investment accounts of customers	18	**5,176,819**	4,260,185	**5,176,819**	4,260,185
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Bills and acceptance payable		**41,114**	420,258	**41,114**	420,258
Resource obligations on financing sold to Cagamas	19	**1,501,187**	-	**1,501,187**	-
Subordinated Sukuk Murabahah	20	**1,308,634**	1,006,486	**1,308,634**	1,006,486
Other liabilities	21	**706,133**	782,299	**695,714**	773,769
Zakat and taxation	22	**13,687**	46,404	**13,539**	46,340
Total liabilities		**58,662,326**	52,783,210	**58,665,726**	52,790,734

Notes to the Financial Statements

22. Zakat and taxation

	Group		Bank	
	31 Dec 2018	31 Dec 2017	31 Dec 2018	31 Dec 2017
	RM'000	RM'000	RM'000	RM'000
Zakat	13,685	13,385	13,539	13,323
Taxation	2	33,019	-	33,017
	13,687	46,404	13,539	46,340

Figure 8: Zakat and taxation

3.8 Amounts Due to Holding and/or Other Related Companies

3.8.1 Nature and Definition

Amounts due to holding and or other related companies arise when an inter-company transaction occurs amongst companies within a group of companies. These transactions can occur for a variety of reasons and often occur because of the normal business relationships that exist between members within a group. These intra-group trading and other transactions may result in members of the group owing to one another sums of money.

3.8.2 Recognition and Measurement

In situations where there are many inter-company transactions, it is more appropriate to maintain a current account to record the amounts due to and from each other. The current account is debited for amounts due and credited for amounts owing.

Bills payable are negotiable financial instruments that the holder can have transactions with another party. For example, if a subsidiary owes its parent RM10,000, the parent may have a bill drawn on which it is stated that the subsidiary owes the parent RM10,000. These legal documents can be used by the parent to pay for another party. At times, these bills are discounted by the parent at discount houses or financial institutions.

All financial liabilities, including amounts due to holding and/or other related companies, are initially measured at fair value and subsequently measured at amortised cost using the effective profit rate method in accordance with MFRS 9.

3.8.2.1 Impairment

For some entity, the amounts due to holding and/or other related companies are unsecured and are not subject to compensation charges for late payment. Additionally, the repayment terms are neither fixed nor expected. These amounts due to holding and/or related entities are reviewed at the end of each reporting period to determine whether there is any indication of impairment. If any such indication exists, then the assets recoverable amount is estimated. An impairment loss is recognised if the carrying amount exceeds its recoverable amount.

The recoverable amount of an asset is the greater of its value in use and its fair value less costs to sell. In assessing the value in use, the estimated future cash flows are discounted to their present value using a pre-tax discount rate that reflects the current market assessment of the time value of money and the risks specific to the assets.

3.8.3 Presentation and Disclosure

Amount due to holding and/ or related companies are presented in the statement of financial position under liability.

3.8.3.1 The Practice

As reflected in the Statement of Financial Position below, as at 31 December 2018, CIMB has amount due to related companies of RM50,000 for the Group and the Bank. Further clarification on the items in the assets are given in Note 15 (see Figure 9).

Significance of accounting policies

None

Financial Statements

Company No: 671380-H
CIMB Islamic Bank Berhad
(Incorporated in Malaysia)

Statement of Financial Position as at 31 December 2018

		The Group		The Bank	
		2018	2017	2018	2017
	Note	RM'000	RM'000	RM'000	RM'000
Liabilities and equity					
Deposits from customers	21	**75,931,556**	64,728,979	**76,216,744**	64,910,083
Investment accounts of customers	22	**1,769,270**	907,763	**1,769,270**	907,763
Deposits and placements of banks and other financial institutions	23	**2,083,580**	2,160,415	**2,083,580**	2,160,415
Investment accounts due to designated financial institutions	24	**8,216,809**	8,145,684	**8,216,809**	8,145,684
Financial liabilities designated at fair value through profit or loss	25	**21,918**	2,233	**21,918**	2,233
Islamic derivative financial instruments	26(a)	**598,975**	692,759	**598,975**	692,759
Amount due to holding company	14	**-**	20,588	**-**	20,588
Amount due to related companies	15	**50**	813	**50**	813
Other liabilities	27	**393,125**	616,505	**465,301**	896,914
Provision for tax		**95,443**	56,150	**95,443**	56,150
Recourse obligations on financing sold to Cagamas	28	**1,915,503**	2,072,300	**1,915,503**	2,072,300
Sukuk	29	**358,265**	463,257	**-**	1,000
Subordinated Sukuk	30	**615,033**	615,006	**615,033**	615,006
Total liabilities		**91,999,527**	80,482,452	**91,998,626**	80,481,708

Notes to the Financial Statements

14. Amount due from/(to)holding company

	The Group and the Bank	
	31 Dec 2018	31 Dec 2017
	RM'000	RM'000
Amounts due from :		
- holding company	**90,731**	-
Amounts due to :		
- holding company	**-**	(20,588)

The amount due from/(to) holding company is unsecured and repayable on demand.

15. Amount due from/(to) related companies

	The Group and the Bank	
	31 Dec 2018	31 Dec 2017
	RM'000	RM'000
Amounts due from :		
- related company	**620**	414
Amounts due to :		
- related company	**(50)**	(813)

Figure 9: Amounts due to holding and/ or other related companies

SUMMARY

- A liability is the present obligation of the enterprise arising from past events and its settlement would result in an outflow of resources from the enterprise.
- The liabilities discussed in this chapter are deposits from customers, investment accounts, bills and acceptance payable, deposits and placement of banks, subordinated sukuk, derivatives financial liabilities, provision for tax and zakat and amounts due to holding and or related companies.
- Typically, the liabilities of Islamic banks are treated as financial liabilities.
- The standards which are relevant are MFRS 9, MFRS 132 and MFRS 7.

BIBLIOGRAPHY FOR CHAPTERS 5 AND 6

Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) Financial Accounting Standards

Annual Report, Bank Islam Malaysia Berhad (2018)

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Malaysian Accounting Standards Board. (2014). A Review of BNM Shariah Policy Documents from a Financial Reporting Perspectives

Malaysian Financial Reporting Standards (MFRSs)

MFRS 3 *Business Combinations*
MFRS 5 *Non-current Assets Held for Sale and Discontinued Operations*
MFRS 6 *Exploration for and Evaluation of Resources*
MFRS 7 *Financial Instruments: Disclosures*
MFRS 9 *Financial Instruments: Recognition and Measurement*
MFRS 10 *Consolidated Financial Statements*
MFRS 11 *Joint Arrangements*
MFRS 13 *Fair Value Measurements*
MFRS 15 *Revenue from Contracts with Customers*
MFRS 16 *Leases*
MFRS 101 *Presentation of Financial Statements*
MFRS 102 *Inventories*
MFRS 107 *Statement of Cash Flows*
MFRS 111 *Construction Contracts*
MFRS 112 *Income Taxes*
MFRS 116 *Property, Plant and Equipment*
MFRS 117 *Leases (will be superseded by MFRS 16 for periods beginning on or after 1*
MFRS 123 *Borrowing Costs*
MFRS 127 Separate Financial Statements
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CHAPTER 7

EQUITY

EQUITY

LEARNING OBJECTIVES

The chapter aims to:

i. equip students with knowledge of MFRS and its applicability to Islamic bank's Equity accounting and reporting
ii. highlight the components of an Islamic bank's equity and the specific MFRS accounting treatment and reporting requirements
iii. illustrate through samples of selected banks' financial statements on how equity is presented or disclosed.
iv. increase students' awareness that MFRS faces an ongoing challenge to consistently comply with Shariah but the overall objective is to promote cross-border comparability by standardizing the reporting of Islamic transactions.

1.0 INTRODUCTION

In this chapter, the accounting treatment and reporting requirements for the equity element in financial statements of Islamic Banks in Malaysia will be examined. It explains the identification, presentation and disclosure of share capital and reserves according to relevant financial reporting requirements. References will be made throughout this chapter to the applicable MFRS for Equity: MFRS 101 *Presentation of Financial Statements*; MFRS 9 *Financial Instruments: Recognition and Measurement*; MFRS 132 *Financial Instruments: Presentation*; MFRS 116 *Property Plant and Equipment*; MFRS 2 *Share-Based Payment*; MFRS 13 *Fair Value Measurement*, the Companies Act, 2016 and Islamic Financial Services Act 2013.

Islamic Banks in Malaysia are known to be highly regulated as they are required to comply with various standards and guidelines in the preparation of financial statements. Firstly, compliance with MASB's '*Malaysian Financial Reporting Standards*' (MFRS), representing convergence to international standards. Secondly, compliance with Bank Negara Malaysia's guidelines on *Financial Reporting for Islamic Banking Institutions* (2016) for more specific compliance with regulatory authorities' and the Shariah requirements. Specific requirements are also given by BNM on the application of the MFRS with minimum disclosure requirements prescribed for Capital and Reserves to ensure conformity with Shariah requirements and to promote financial stability.

Islamic banks in Malaysia generally apply the four MFRS principles as vital guides which influence transactions such as;

i. substance over form;
ii. time value of money;
iii. fair value measurement; and
iv. recognition based on probability (Shafie et al, 2013).

These principles have been endorsed by Shariah scholars to be in line with Shariah precepts.

2.0 ISLAMIC BANKS' EQUITY

2.1 Nature and Definition of Equity

The Conceptual Framework for Financial Reporting defines equity as the "residual interest" in the assets of the entity after deducting all of its liabilities. Equity of an Islamic bank is also defined as the residual interest in the assets of the Islamic bank after deducting all liabilities. It comprises share capital, distributable and non-distributable reserves. It should be noted here that the newly introduced "No Par Value" regime under the Companies Act 2016 has removed the authorised share capital and the ordinary shares will cease to have par or nominal value. The share premium will now become part of the share capital.

2.2 Accounting Equation

It is shown here that the nature of equity is not defined, but equity is merely expressed as a mathematical formula as illustrated below:

Equity = Assets - Liabilities

Although this has been covered extensively under assets and liabilities in previous chapters, it will help students to know the relationship between assets, liabilities and equity in determining the financial position of Islamic banks. Thus, based on this equation, equity is also known as the net asset value of the entity, which is calculated as the difference between the value of the assets and the value of the liabilities of something owned.

The equity element forms part of the accounting equation besides assets and liabilities. All businesses use the same accounting equation and the differences are reflected by their equities. While the components of equity differ among different types of banks, the general characteristics of equity in company accounting remain the same. In accounting parlance, both sides of the accounting equation should balance at all times. The equity accounting of a company is illustrated below:

ASSETS	LIABILITIES	EQUITY
(Debit balance): Non-current assets, accounts receivable, cash, etc	(Credit balance): Accounts payable, accrued expenses, etc	(Credit balance) Capital + Reserves

Table 1: Basic Accounting Equation

2.3 Components of Equity

Equity is often used to encompass an entity's equity instruments. It is sub-classified in the 'Statement of Financial Position' under "Capital" and "Reserves". Capital is mainly the funds contributed directly by shareholders/owners of the company and is normally known as share capital. Reserve is an equity account attributable to the owners of the company other than amounts directly contributed by the owners. Reserves comprise mainly the retained earnings, capital reserves. Retained earnings are profits or losses that are not distributed but maintained in the company to finance operations. A capital reserve is a reserve representing the capital maintenance adjustments, or creation from shareholders' contributions. A revenue reserve is a reserve that is derived from earnings and represents an appropriation of earnings. For revenue reserves, retained earnings are set aside for specific activities and result in reserves such as general reserve, sinking fund reserve, dividend equalization fund, and research and development fund. The components of equity are shown in Figure 2 below:

EQUITY	
CAPITAL	**RESERVES**
Share Capital	Retained earnings are profits or losses that are not distributed but maintained in the company to finance operations.
*Ordinary shares, preference shares	Capital reserves (reserves arising out of capital profits from the revaluation of assets and liabilities, sale of assets, sale of shares and debentures, forfeiture of shares, redemption of debentures and purchase of a business
Rights issue, bonus issues, options, or share warrants. Share buy-back	Revenue reserve is a reserve that is derived from earnings and represents an appropriation of earnings. For revenue reserves, retained earnings are set aside for specific activities and result in reserves such as general reserve, sinking fund reserve, dividend equalization fund, and research and development fund. Other reserves: Statutory reserves, warrant reserve, fair value reserve, translation reserve, regulatory reserve.

Table 2: Equity and its Components

The sub-classification of equity into "share capital" and several types of "reserves" reflects the legal ability (or other restrictions) of the company to distribute or otherwise apply its equity. Such classifications or information will help users make appropriate financial decisions. They may also reflect the fact that parties with ownership interests in an entity have differing rights in relation to the receipt of dividends or the repayment of contributed equity.

Thus, in a corporate entity, funds contributed by shareholders, retained earnings, reserves representing appropriations of retained earnings, and reserves representing capital maintenance adjustments may be shown separately.

To illustrate this, we will use BIMB's statement of financial position. BIMB's equity may consist of the following components as illustrated in the table below on 'Share Capital' and 'Reserves'.

	GROUP		COMPANY	
	31 Dec 2017	31 Dec 2016	31 Dec 2017	31 Dec 2016
	RM'000	RM'000	RM'000	RM'000
Equity				
Share Capital	3,875,270	1,588,680	3,875,270	1,588,680
Reserves	658,669	2,294,172	196,912	2,283,251
Equity attributable to owners of the company.	4,533,939	3,882,852	4,072,182	3,871,931
Non-controlling interests	384,414	334,285	Nil	Nil
Total equity	4,918,353	4,217,137	4,072,182	3,871,931

Example 1: A Typical Islamic Bank Equity

Non-controlling interests at the end of the reporting period, being the equity in a subsidiary not attributable directly or indirectly to the equity holders of the Company, are presented in the consolidated statement of financial position and statement of changes in equity, within equity, separately from equity attributable to the owners of the Company.

Non-controlling interests in the results of the Group is presented in the consolidated statement of profit or loss and other comprehensive income as an allocation of the profit or loss and the comprehensive income for the year between non-controlling interests and the owners of the Company.

GROUP AND COMPANY	NUMBER OF SHARES ('000)	AMOUNT (RM'000)
Issued and fully paid:		
Ordinary shares at 1 January 2016	1,542,210	1,542,210
Issue of shares under conversion of warrants	1	1
Issue of shares pursuant to Dividend Reinvestment Plan	46,469	46,469
Ordinary shares at 31 December 2016/1 January 2017	**1,588,680**	1,588,680
Issue of shares pursuant to Dividend Reinvestment Plan	**49,061**	183,979
Transfer of share premium to share capital pursuant to section 618(2) of Companies Act 2016	Nil -	2,102,611
	1,637,741	**3,875,270**

Example 2: A Typical Islamic Bank Share Capital

Using BIMB as an example, with their adoption and prospective application of the newly enacted Companies Act 2016, the movement in the number of shares and the carrying amount of share capital is shown as follows:

a. Ordinary shares
On 31st January 2017, BIMB increased its issued and paid-up share capital from RM1,588,680,014 to RM1,637,741,014 via the issuance of 49,061,000 new ordinary shares at a consideration of RM3.75 each arising from the Dividend Reinvestment Plan.

b. Warrants
On 11 December 2013, BIMB issued 426,715,958 new ordinary shares of RM1.00 each together with 426,715,958 free detachable warrants at an issue price of RM4.25 per rights share based on two rights share together with two warrants for every five existing shares. The warrants will expire at the end of ten years from the date of issuance.

BY GROUP	GROUP 2017 (RM'000)	GROUP 2016 (RM'000)
Share premium	Nil	2,102,611
Other reserves	**100,522**	1,083,956
Retained earnings	**1,757,894**	307,352
	1,858,416	3,493,919
Acquisition reserve	**(1,199,747)**	(1,199,747)
	658,669	**2,294,172**

BY COMPANY	COMPANY 2017 (RM'000)	COMPANY 2016 (RM'000)
Share premium	Nil	2,102,611
Warrant reserves	**129,300**	129,300
Fair value reserves	**178**	81
Retained earnings	**67,434**	51,529
	196,912	**2,283,251**

Example 3: A Typical Islamic Bank Reserves

Share Premium

Share premium comprises the premium paid on the subscription of shares in the Company over and above the par value of the shares. As a result of the adoption of the newly enacted Companies Act 2016, the ordinary share of the company will cease to have par or nominal value, and the share premium will become part of the share capital. BIMB for instance, during the financial year 2017, transferred RM2,102,611,000 from share premium to its share capital pursuant to the transition provisions set out in section 618(2) of the said Companies Act, 2016.

Acquisition reserve

The acquisition reserve is the difference between the consideration paid and the 49% equity interest in BIMB acquired in December 2013.

Presentation and Disclosure of Equity in the Financial Statements

To reiterate its importance, which have been discussed at great length in chapters 5 and 6 on assets and liabilities, financial statements are a structured representation of the financial position and financial performance of an entity. The objective of general-purpose financial statements is to provide information about the financial position, financial performance and cash flows of an entity that is useful to a wide range of users in making economic decisions.

Financial statements also show the results of management's stewardship of the resources entrusted to it. To meet this objective, financial statements provide information about an entity's (a) assets; (b) liabilities; (c) equity; (d) income and expenses; including gains and losses; (e) contributions by, and distributions to, owners in their capacity as owners; and (f) cashflows. The information on these elements, along with other information in the 'Notes' to financial statements, assist users in predicting the entity's future cash flows, and, the timing and certainty of the generation of cash and cash equivalents.

MFRS 101 *Presentation of Financial Statements*

An entity shall present with equal prominence all the financial statements in a complete set of financial statements [MFRS 101.11]. Presentation is how the event or transaction is disclosed in the financial statements. This section will help students understand how Equity is required to be presented in the financial statements of Islamic banks.

MFRS 101 prescribes the basis for the presentation of general-purpose financial statements in order to ensure comparability with both the entity's own financial statements of previous periods and with the financial statements of other entities. Thus, a complete set of MFRS financial statements is required to include the following components as shown below:

a.	Statement of Financial Position as at the end of the period.
b.	Statement of Profit and Loss and Other Comprehensive Income for the period. This may be presented as a single statement or in two components; an income statement (profit and loss account) and a statement of other comprehensive income. The statement of other comprehensive income would include gains or losses on property, plant and equipment and gains or losses arising from the transaction of financial statements of foreign operations.
c.	Statement of Changes in Equity for the period;
d.	Statement of Cash Flows for the period.
e.	Notes, comprising a summary of significant policies and other explanatory information.
f.	Comparative Information [of (a) to (e)] in respect of the preceding period as specified in the Standard
g.	Statement of financial position as at the beginning of the preceding period when an entity applies an accounting policy retrospectively or makes a retrospective restatement of items in its financial statements, or when it reclassifies items in its financial statements if the retrospective application, restatement or reclassification has a material effect on the information in the statement of financial position at the beginning of the preceding period [MFRS 101.10].

Table 3: A Complete Set of Financial Statements'

To achieve this objective, the Standards set out the overall considerations for the presentation of financial statements, guidelines for their structure and minimum requirements for the content of financial statements. Examples of general-purpose financial statements are the annual financial statements prepared and presented by reporting entities to their owners. Special-purpose financial statements, such as those presented to bankers for lending decisions are not within the scope of the Standards.

Bank Negara's minimum disclosure requirements as prescribed in the Financial Reporting for Islamic Banking Institutions (2016) on Capital and Reserves are as follows:

- A licensed person shall disclose CAPITAL with a breakdown by:

  a. Capital structure which shall be consistent with that specified under paragraphs 10.1, 11.1 and 12.1 of the Capital Adequacy Framework for Islamic Banks (Capital Components); and

  b. Capital adequacy showing separately Common Equity Tier 1 Capital Ratio. Tier 1 Capital Ratio and Total Capital Ratio and expressed as a percentage to three decimal places.

- A licensed person shall disclose RESERVES with a breakdown by type and purpose of reserves maintained. A movement schedule shall also be disclosed.

For Islamic banks, the Notes to the accounts provide additional disclosures on:

a. Capital
b. Shariah advisor or Shariah board and zakat obligations
c. Differentiation between deposits and investments
d. Impact of MFRS 9 on Equity, if any.

Islamic banks are required to comply with BNM Shariah Governance Framework (2011) which requires an Islamic bank to disclose the Shariah Committee's Report as part of the Annual Report and signed by at least two Shariah Committee members. Islamic banks must also make disclosures in the financial statements in accordance with MFRS and to include information on BNM Guidelines on Late Payment Charges for Islamic Financial Institutions which differ from conventional banks.

3.0 ISLAMIC BANKS' SHARE CAPITAL

3.1 Nature and Definition

Share capital or issued share capital is the proportion of a company's equity that came from the issuance of its shares to the shareholders for cash or bonus shares and other consideration. Generally, there are two different classes of shares- ordinary shares and preference shares - and they are distinguished by the rights attached to them which include rights to vote in annual general meetings, rights to share in assets on liquidation of the company, and rights to share proportionately in any new issue of shares of the same class. For BIMB, ordinary shares are classified as equity in the statement of financial position. Cost directly attributable to the issuance of new equity shares is taken to equity as a deduction from the proceeds.

For instance, ordinary shareholders have rights to vote in annual general meetings whilst preference shareholders do not enjoy these rights. On the other hand, preference shareholders have the right to receive their fixed dividends earlier than ordinary shareholders, whereas ordinary shareholders can only receive their dividends if the performance of the company justifies it. The general differences among ordinary shares, preference shares, and liability instruments such as debentures/bonds are illustrated below:

	Ordinary share	Preference share (except liability instruments)	Debenture/bond
Voting rights	Yes	No	No
Rate of returns (dividend/interest)	Not fixed	Fixed rate	Fixed rate
The accounting method for return	Distribution of profits (Change in equity)	Distribution of profits (Change in equity)	Business expense
Reimbursement status	Not necessary	Not necessary	Not necessary
Claims upon liquidation	After preference shareholder	After debenture holder	Before ordinary and preference shareholders

Table 4: Comparison of the Characteristics of Ordinary Shares, Preference Shares and Debenture/Bonds

A company may, in subsequent stages of growth, decide to make changes to the share capital. Thus, share capital may be increased by placement of shares, rights issues, bonus issues, options, or share warrants. Share capital may also be reduced by a share buy-back exercise. Such movements of share capital are normal due to changes made by the company for future expansion.

- A *rights issue* is an issue of new shares to existing shareholders, giving them rights to subscribe to an additional number of shares in proportion to their current shareholdings (pro rata basis) to avoid dilution of or changes in ownership. It is a common way of raising capital by companies which results in additional capital and liquidity.

- A *bonus issue* is an issue of new shares to existing shareholders without having them pay for the shares but also given on a pro-rata basis. In a No-Par Value (NPV) share regime, any increase in the number of shares (the equivalent of a bonus issue) can be made out of “revaluation reserve” or “retained profits” or by increasing the number of shares in contributed capital without changing the carrying amount of contributed capital.

- *Share Buy-back* arises when a company repurchases its own shares it has issued. Previously share buybacks by public listed companies are only allowed through the stock exchange. But now, a public listed company may buy out its own shares held by a minority shareholder by a private arrangement or a tender offer, if allowed by the stock exchange.

3.2 Presentation and Disclosure

MFRS 101 requires the following components of equity to be disclosed separately either in the ‘Statement of Financial Position’ or in the ‘Notes’:

a. For each class of Share Capital:
   - The rights, preferences and restrictions attaching to that class including restrictions on the distribution of dividends and the repayment of capital;
   - Shares in the entity held by the entity or by its subsidiaries or associates;
   - Shares reserved for issuance under options and contracts for the sale of shares, including the terms and amounts; and
   - A reconciliation of the number of shares outstanding at the beginning and at the end of the year;

An Islamic bank may manage capital in several ways and be subject to a number of different capital requirements. Due to the complexity of capital requirements for Islamic banks which is not prepared using the basis similar to financial reporting, a piece of separate information for each capital requirement to which the Islamic bank is subject to shall be disclosed.

b. A description of the nature and purpose of each Reserve within equity.

	GROUP		BANK	
	As at 31 December 2017	As at 31 December 2016	As at 31 December 2017	As at 31 December 2016
	RM'000	RM'000	RM'000	RM'000
Equity				
Share Capital	3,875,270	1,588,680	3,875,270	1,588,680
Reserves	658,669	2,294,172	196,912	2,283,251

Example 4: Share Capital as presented in BIMB Statement of Financial Position as at 31 December 2017

BIMB has disclosed in Note 24, that with the adoption and prospective application of the newly enacted Companies Act 2016, the movement in the number of shares and the carrying amount of share capital is presented as follows:

GROUP AND COMPANY	Note	Number of shares	Amount
Issued and fully paid:			
Ordinary shares as at 1 January 2016	Nil	1,542,210	1,542,210
Issues of shares under the conversion of warrants	Nil	1	1
Issuance of shares pursuant to the Dividend Reinvestment Plan	Nil	46,469	46,469
Ordinary shares at 31 December 2016/ 1 January 2017	Nil	1,588,680	1,588,680
Issue of shares pursuant to Dividend Reinvestment Plan	24(a)	49,061	183,979
Transfer of share premium to share capital pursuant to section 618(2) of Companies Act. 2016	25.1	Nil	2,102,611
As at December 2017		1,637,741	3,875,270

Example 5: BIMB's Share Capital by Group and Company

Share premium comprises the premium paid on the subscription of shares in the company over and above the par value of the shares. As a result of the newly introduced no par value regime under the Companies Act 2016, ordinary shares will cease to have par or nominal value, and the share premium will become part of the share capital. During the financial year or as at 31 December 2017, BIMB has transferred RM2,102,611,000 from share premium to its share capital pursuant to the transition provisions set out in section 618 (2) of 2016 (the new act).

4.0 ISLAMIC BANKS' RESERVES

BNM in its policy document *Financial Reporting for Islamic Banking Institutions* (2016) has imposed a mandatory requirement for a licensed person (the Islamic bank) to disclose reserves with a breakdown by type and purpose of reserves maintained. It further requires disclosure of the movement schedule.

Hedging reserve which can arise as a result of hedges a bank has taken on to protect itself against volatility in certain input cost
Foreign exchange reserve
Fair value reserve
Translation reserve
Acquisition reserve
Long term investment plan reserve
Warrant reserve
Statutory reserve
Share-based payment reserve

Table 5: Typical Examples of Reserves used by Islamic Banks

4.1 Regulatory Reserves

4.1.1 Nature and Definition

Regulatory or reserve fund is a prudential requirement and is now no longer relevant. This reserve fund requirement is set by regulators to maintain a percentage of net profit as reserves, which effectively restrains banks from declaring dividends and thereby acts as an additional "buffer" that a banking institution can draw down during periods of stress. However, in May 2017, Bank Negara Malaysia removed the reserve fund requirement due to the implementation of the "capital conservation buffer", which is a part of the global "Basel 3" rules enforced by regulators after the 2008 financial crisis aimed at bolstering the defenses of banks worldwide. With the issuance of the BNM Revised Policy Documents on Capital Funds for Islamic Banks (Revised Policy Document), it has superseded two guidelines issued by BNM previously, namely Capital Funds and Capital Funds for Islamic Banks dated 1 July 2013. The key changes in the Revised Policy Document are the removal of the requirement on the maintenance of a reserve fund as mentioned earlier, and the revised component of capital funds shall exclude share premium and reserve fund.

4.1.2 Recognition and Measurement

Even though the rules have been relaxed, banks are still required to continue maintaining a minimum amount of capital:

- Domestic banks should maintain 2 billion ringgit as minimum capital funds;
- Islamic banks and locally incorporated foreign banks are required to maintain 300 million ringgits; while
- Stand-alone investment banks should maintain 500 million ringgits.

4.2 Statutory Reserves

4.2.1 Nature and Definition

Statutory reserves are reserves that a bank is required by law or regulation to establish and that cannot be paid out as dividends. The statutory reserve requirement (SRR) is a monetary policy instrument available to BNM to manage liquidity and hence credit creation in the banking system. It is used to withdraw or inject liquidity when the excess or lack of liquidity in the banking system is perceived by BNM to be large and long term. Effective 1 February 2016, the SRR rate for banking institutions is 3.5% of EL (eligible liabilities).

4.2.2 Recognition and Measurement

SRR is the amount of money set aside by banks (all commercial, merchant, investment, Islamic banks) to be placed in their Statutory Reserve Accounts with BNM with zero interest.

- By lowering the SRR, the banks will have a reduced cost of funds, and can help to preserve their profit margins by lending out the liquidated money and earn interest,
- Higher SRR means that banks in Malaysia will have to keep more money as their reserve.

4.2.3 Presentation and Disclosure

Statutory reserves are presented in the financial statements under "other reserves" in the Consolidated Statement of Financial Position. It can also be disclosed separately in the Statement of Changes in Equity if this is a material disclosure.

4.3 Capital Reserves

The term capital reserve is used for the capital buffers that banks must establish to meet regulatory requirements. It is an account on the balance sheet that can be used for contingencies or to offset capital losses. It represents the accumulated capital surplus of a company, created out of capital profit, such as the upward revaluation of its assets. Sums allocated to a capital reserve are permanently invested and cannot be used to pay dividends.

5.0 TYPES OF ISLAMIC BANK'S RESERVES HELD BY BANKS

A comparison is made on the type of reserves used by four (4) Islamic banks in Malaysia, namely, BIMB, Maybank Islamic, Bank Muamalat and CIMB Islamic.

(1) BIMB Reserves	(2) Maybank Islamic Reserves	(3) Bank Muamalat Reserves	(4) CIMB Islamic Reserves
Statutory reserve	Statutory reserve	Statutory reserve	Statutory reserve
Capital reserve	Regulatory reserve	Exchange fluctuation reserve	Revaluation reserve
Warrant reserve	Available for Sale (AFS) reserve	Available for Sale (AFS) reserve	Merger reserve
Fair value reserve	Nil	Nil	Capital reserve
Translation reserve	Nil	Nil	Regulatory reserve
Regulatory reserve	Nil	Nil	Share based payment reserve
Long Term Incentive Plan reserve	Nil	Nil	Nil
Acquisition reserve	Nil	Nil	Nil

Table 6: Comparison on Types of Reserves held by Islamic Banks as at 31 December 2017

5.1 BIMB Reserves

Below is an illustration of BIMB's presentation of reserves and the explanation of their reserves as stated in their Notes to Financial Statements:

GROUP	31 December 2017 rm'000	31 December 2016 RM'000
Non-distributable:		
Share premium	Nil	Nil
Capital reserves	See notes below	Nil
Statutory reserve	See notes below	1,392,159
Warrant reserve	See notes below	Nil
Fair Value reserve	(22,064)	(50,429)
Translation reserve	(102,777)	(148,685)
Regulatory reserve	64,645	Nil
Long term incentive plan reserve	See notes below	Nil
Acquisition reserve	See notes below	Nil
Distributable:		
Retained profits		
Total reserves		

Example 6: BIMB's Presentation of Reserves as at 31 December 2017

Capital Reserves

Capital reserves are reserves arising out of capital profits from the revaluation of assets and liabilities, sale of assets, sale of shares and debentures, forfeiture of shares, the redemption of debentures and purchase of a business. For BIMB, the capital reserve arose out of the issuance of bonus issue in a subsidiary of RM6,863,000.

Statutory Reserve

BIMB's statutory reserve was maintained in compliance with section 57(2)(f) of the Islamic Financial Services Act, 2013 and is not distributable as cash dividends. However, as a result of the issuance of the Revised Policy Document, it is no longer required to maintain the statutory reserves. During the financial year ended 31 December 2017, the Bank transferred RM1, 392,158.939 from the statutory reserve to retained earnings pursuant to the Revised Policy Document issued by BNM on 3 May 2017.

Warrant Reserve

The warrant reserve arose from the company's issuance of 426, 715,958 free detachable warrants.

Fair Value Reserve

The fair value reserves include adjustments for available-for-sale securities and assets. The fair value reserve comprises the cumulative change in the fair value of available-for-sale financial assets recognized in other comprehensive income until the investments are derecognized or impaired.

Translation Reserve

The translation reserve comprises all foreign currency differences arising from the translation of the financial statements of foreign operations and offshore banking operations – Federal Territory of Labuan.

Regulatory Reserve

The regulatory reserve represents Bank Islam's compliance with BNM's Policy on Classification and Impairment Provisions for Financing to maintain, in aggregate, collective impairment allowances and regulatory reserve of no less than 1.2% of total outstanding financing, net of individual impairment allowances.

Long Term Incentive Plan (LTIP) Reserve

The LTIP reserve comprises the cumulative value of employee services received for the issue of a Restricted Share Plan and Performance Share Plan in Takaful Malaysia. When the LTIP is exercised, the amount from the LTIP reserve is transferred to share premium. When the LTIP expires, the amount from the LTIP reserve is transferred to retained earnings. LTIP is disclosed in Note 26.

Acquisition Reserve

The acquisition reserve is the difference between the consideration paid and the 49% equity interest in Bank Islam Malaysia Berhad acquired in December 2013.

GROUP	31 December 2018 RM'000	31 December 2017 RM'000
Share premium	Nil-	2,102,611
Other reserves	100,522	1,083,956
Retained earnings	1,757,894	307,352
	1,858,416	**3,493,919**
Acquisition reserve	(1,199,747)	(1,199,747)
	658,669	2,294,172

Example 7: BIMB's Breakdown of Reserves by Group as at 31 December 2018

BANK	31 December 2018 RM'000	31 December 2017 RM'000
Share premium	Nil-	2,102,611
Warrant reserves	129,300	129,300
Fair value reserves	178	81
Retained earnings	67,434	51,529
	196,912	2,283,251

Example 8: BIMB Breakdown of Reserves by Bank as at 31 December 2018

5.2 Maybank Islamic Reserves

Below is an illustration of Maybank Islamic presentation of reserves and the explanation of their reserves as stated in their Notes to Financial Statements:

GROUP	31 December 2017 RM'000	31 December 2016 RM'000
Non-distributable:		
Share premium	Nil (see notes below)	5,200,227
Equity contribution from the holding company	1,697	1,697
Statutory reserve	Nil	409,672
AFS Reserve	(32,318)	(55,264)
Regulatory reserve	508,700	393,700 Note that in 2016, there is an dditional reserve which is the Profit equalisation reserve.
Distributable:		
Retained profits	3,351,547	2,857,087
Total reserves	3,829,626	8,807,119

Example 9: Maybank Islamic Presentation of Reserves as at 31 December 2017

Statutory Reserve

The Revised Policy Document issued on 3 May 2017 has been updated to remove the requirement for a banking institution to maintain a reserve fund. The Bank had transferred the statutory reserve to retained profits as at 31 December 2017 amounting to RM409,672,000.

Regulatory Reserve

The regulatory reserve is maintained in addition to the collective impairment allowance that has been assessed and recognized in accordance with MFRS and which has been transferred from the retained profits, in accordance with BNM's Revised Policy Document on Classification and Impairment Provisions for Loans/Financing issued on 6 April 2015.

Retained Profits

The retained profits of the bank as at 31 December 2017 and 31 December 2016 are distributable profits and may be distributed as dividends under the single-tier system.

5.3 Bank Muamalat Reserves

Below is an illustration of Bank Muamalat presentation of reserves and the explanation of its reserves as stated in its Notes to the Financial Statements:

GROUP	31 March 2017 RM'000	31 March 2016 RM'000
Non-distributable:		
Statutory reserve	656,561	581,225
Exhange fluctuation reserve	2,183	2,054
AFS Reserve	(33,734)	212
Distributable:		
Retained profits	289,726	214,387

Example 10: Bank Muamalat Presentation of Reserves as at 31 March 2017

Statutory Reserve

During the year, the Group and the bank have transferred RM658,158,000 and RM656,561,000 respectively from statutory reserves to retained profit.

Regulatory Reserve

On 2 February 2018, BNM issued the revised policy document on Financial Reporting for Islamic Banking Institutions which prescribes the regulatory reserves to be maintained by banking institutions. With effect from 1 January 2018, the bank must maintain, in aggregate, loss allowance for non-credit impaired exposures and regulatory reserves of no less than 1% of total credit exposures, net of loss allowance for credit-impaired exposures.

The adoption of this requirement is expected to have minimal impact to the capital ratios of the bank as the bank is currently maintaining, in aggregate, collective impairment provisions and regulatory reserves of no less than 1.2% of total outstanding financing, net of individual impairment provisions

Exchange Fluctuation Reserve

The exchange fluctuation reserve represents exchange differences arising from the translation of the financial statements of foreign operations whose functional currencies are different from that of the Group's presentation currency.

Available For Sale Reserve

This represents the cumulative fair value changes, net of tax, of available-for-sale financial assets until they are disposed or impaired.

Retained Profits

The Bank may distribute dividends out of its entire retained profits as at 31 March 2017 under the single tier system.

5.4 CIMB Islamic Reserves

Below is an illustration of CIMB presentation of reserves and the explanation of their reserves as stated in their Notes to Financial Statements:

GROUP	2017 RM'000	2016 RM'000
Non-distributable:		
Statutory reserve	Nil	1,080,953
Revaluation reserve-financial investments available-for-sale	20,873	26,697
Merger reserve	2,457	2,457
Capital reserve	458	458
Regulatory reserve	291,600	201,344
Share-based payment reserve	766	580
Distributable:		
Retained profits	3,305,512	1,674,994
Total	4,575,006	3,930,175

Example 11: CIMB Islamic Presentation of Reserves

As explained by CIMB Islamic, which applies to all Islamic banks, there is no requirement to maintain statutory reserves for banking entities in Malaysia, in accordance with BNM Guidelines-Capital Funds and is not distributable as a cash dividend.

Revaluation Reserve

Movement of the revaluation reserve of financial investments available-for-sale as shown in the statements of comprehensive income.

Merger Reserves

Merger reserves are non-distributable and it relates to the difference between the cost of the merger between the Bank and the Islamic banking operation of CIMB Bank Berhad, and the value of the net assets and reserves transferred to the Bank.

Capital Reserves

Merger reserves are non-distributable and they relate to the retained earnings of the Islamic banking business of CIMB Bank Berhad which were transferred to the Bank, arising from the business combination under common control using the predecessor basis of accounting in the financial year 2007.

Regulatory Reserves

Regulatory reserves are maintained as an additional credit risk absorbent to ensure robustness on the financing impairment assessment methodology with the adoption of MFRS 139 beginning 1 January 2010.

Share-Based Payment Reserve

Share-based payment reserve represents the Bank ‘s commitments for Employee Ownership Plan under share-based compensation benefits.

6.0 CHANGES IN EQUITY

For reporting purposes, the equity section is further presented in the 'Statement of Changes in Equity'. This statement shows the movements in equity items that arise from comprehensive income and transactions with equity holders or owners of the company. It portrays how an entity's net worth or shareholders' funds have changed during the reporting period.

MFRS 101 deals purely with the presentation of owner changes in equity. MFRS 101 requires a statement of changes in equity that distinguishes "owner changes in equity" from "non-owner changes in equity".

- Owner changes in equity arising from transactions with owners in their capacity as owners, such as the issue of equity shares, buy-back of equity shares and changes in stake in a subsidiary without a loss of control.
- Non-owner changes in equity are gains or losses recognised in profit or loss and other comprehensive income, the net amounts of which are presented in the statement of changes in equity separately from owner changes in equity. The revenue, expenses and components of other comprehensive income (which are non-owner changes in equity) shall not be presented in this statement, except for the totals of profit or loss, other comprehensive income, which are included to reflect the total change in equity.

Islamic banks shall present either in the 'Statement of Changes in Equity' or in the 'Notes', the number of dividends recognised as distributions to owners during the period, and the related amount per share.

However, this disclosure of dividends per share requirement may not apply to Islamic banking activities carried out by a conventional bank or financial institution. The descriptions and ordering of items are necessary for the overall understanding of an Islamic bank's financial performance and application of more specific requirements of regulatory authorities.

Group	Share Capital (RM'000)	Non-Distributable Share Premium (RM'000)	Non-Distributable Other Reserves (RM'000)	Distributable Retained Earnings (RM'000)	Total (RM'000)	Non-controlling interests (RM'000)	Total Equity (RM'000)
As at January 2017	1,588,210	2,102,611	115,791	307,352	3,882,852	344,285	4,217,137
Profit for the year	Nil	Nil	Nil	619,838	619,838	83,792	703,630
Other Comprehensive income:	Nil	Nil	Nil	Nil	Nil	Nil	Nil
*Remeasurement of defined benefit liabilities	Nil	Nil	Nil	(141)	(141)	(174)	(315)
*Currency translation differences in respect of foreign operations	Nil	Nil	42,376	Nil	42,376	(1,253)	41,123
Fair Value reserve:							
*Net Change in Fair Value	Nil	Nil	47,298	Nil	47,298	3,092	50,390
*Net amount reclassified to profit or loss	Nil	Nil	(6,695)	Nil	(6,695)	(453)	(7,148)
*Income tax credit relating to components of other comprehensive income	Nil	Nil	(8,958)	Nil	(8,958)	Nil	(8,958)
Total Comprehensive Income for the year	Nil	Nil	74,021	619,697	693,718	85,004	778,722
Transfer of reserve fund to retained earnings [Notes 2.1(a)]	Nil	Nil	(1,124,774)	1,124,774	Nil	Nil	Nil
Transfer of retained earnings to regulatory reserve [note 25.2]	Nil	Nil	64,645	(64,645)	Nil	Nil	Nil
Dividends payable to shareholders [Note 42]	Nil	Nil	Nil	(229,264)	(229,284)	Nil	(229,284)
Dividends paid to non-controlling interests	Nil	Nil	Nil	Nil	Nil	(39,528)	(39,528)
Share-based payment transactions	Nil	Nil	4,376	Nil	4,376	2,951	7,327
Long Term incentive plan exercised	Nil	Nil	(1,702)	Nil	(1,702)	1,702	Nil
Issue of shares pursuant to dividend reinvestment plan	183,979	Nil	Nil	Nil	183,979	Nil	183,979
Transfer of share premium to share capital [Note 2.1(a)]	2,102,611	(2,102,611)	Nil	Nil	Nil	Nil	Nil
At 31 December 2017	3,875,270	Nil	(1,099,225)	1,757,894	4,533,939	384,414	4,918,353

Figure 1: BIMB's Statement of Changes in Equity for the Financial Year Ended 31 December 2017 attributable to owners of company

Group	Share Capital (RM'000)	Non-Distributable Share Premium (RM'000)	Non-Distributable Other Reserves (RM'000)	Distributable Retained Earnings (RM'000)	Total Equity (RM'000)
At 1 January 2017	2,404,384	264,790	1,193,045	523,247	4,385,466
Profit for the year	Nil	Nil	Nil	566,118	566,118
Currency translation differences in resepect of foreign operations	Nil	Nil	45,908	Nil	45,908
Fair Value reserve:					
- net change in fair value	Nil	Nil	43,480	Nil	43,480
- net amount reclassified to profit or loss	Nil	Nil	(6,157)		(6,157)
Income tax effect relating to components of other comprehensive income	Nil	Nil	(8,958)	Nil	(8,958)
Total Comprehensive Income for the year	**Nil**	**Nil**	**74,273**	**566,118**	**640,391**
Transfer of share premium to share capital [Note 23]	264,790	(264,790)	Nil	Nil	Nil
Transfer of reserve fund to retained earnings [Note 24]	Nil	Nil	(1,392,159)	(1,392,159)	Nil
Transfer to regulatory reserve [Note 24]	Nil	Nil	64,645	(64,645)	Nil
Dividends paid on ordinary shares [Note 38]	Nil	Nil	(266,477)	(266,477)	
Issue of shares pursuant to Dividend Reinvestment Plan [Note 38]	200,324	Nil	Nil	Nil	200,324
At 31 December 2017/ 1 January 2018	2,869,498	Nil	60,196	2,150,402	4,959,704
Adjustment on adoption of MFRS 9 (Net of tax)	Nil		13,190	143,408	130,218
Adjusted total equity at 1 January 2018	2,869,498	Nil	47,006	2,006,994	4,829,486
Profit for the year	Nil	Nil	Nil	593,887	593,887
Currency translation differences in respect of foreign operations	Nil	Nil	8,290	Nil	8,290
Fair Value reserve:					
- net change in fair value	Nil	Nil	42,581	Nil	42,581
- net amount reclassified to profit or loss	Nil	Nil	27,444	Nil	27,444
Income tax effect relating to components of other comprehensive income	Nil	Nil	3,633	Nil	3,633
Total comprehensive income for the year	Nil	Nil	3,214	593,887	597,101
Transfer from regulatory reserve to retained earnings [Note 24]	Nil	Nil	(54,645)	54,645	Nil
Dividends paid on ordinary shares [Note 38]	Nil	Nil	Nil	293,050	293,050
Issue of shares pursuant to Dividend Reinvestment Plan [Note 38]	142,870	Nil	Nil	Nil	142,870
At 31 December 2018	**3,012,368**	Nil	(98,437)	2,362,476	5,276,407
			Note 24		

Figure 2: BIMB's Statement of Changes in Equity for the Financial Year Ended 31 December 2018

Explanatory notes to Figure 2

Note 23
On Share Capital

BIMB increased its share capital on 20 September 2018 by RM142,870,000 via the issuance of 43,960,00 new ordinary shares at a consideration of RM3.25 each arising from the Dividend Reinvestment Plan of one hundred percent of the final dividend of approximately 5.79 sen in respect of financial year ended 31 December 2018, as disclosed in Note 38.

During the financial year ended 31 December 2017, the Bank transferred RM264,790,400 share premium to its share capital pursuant to the transition provisions set out in Section 618(2) of the Companies Act 2016.

The Bank further increased its share capital during the financial year ended 31 December 2017 by RM200,323,500 via the issuance of 41,282,000 and 20,356,000 new ordinary shares at a consideration of RM3.25 per share respectively arising from the Dividend Reinvestment Plan of one hundred percent and fifty percent respectively of dividends declared and paid, as disclosed in Note 38.

Note 24
On Non-Distributable Other Reserves maintained by BIMB

The statutory reserve was previously maintained in compliance with the requirements of Bank Negara Malaysia and was not distributable as cash dividends. During the financial year ended 31 December 2017, the Bank has transferred RM1,392,158,939 from statutory reserve fund to its retained earnings pursuant to the Revised Policy Document issued by BNM on 3 May 2017.

The fair value reserve includes the cumulative net change in the fair value of financial assets available-for-sale, until the financial asset is derecognized.

The FVOCI includes the cumulative net change in the fair value of financial assets FVOCI, until the financial asset is derecognized.

The translation reserve comprises all foreign exchange differences arising from the translation of the financial statements of the offshore banking operations in the FEDERAL Territory Of LABUAN.

The regulatory reserve represents the Bank’s compliance with BNM’S Guideline on Financial Reporting for Islamic Banking Institution to maintain, in aggregate, loss allowance for non-credit-impaired exposures and regulatory reserves of no less than 1% of total credit exposures, net of loss allowance for credit-impaired exposures.

Note 38

On 4 June 2018, BIMB/BANK paid a final dividend of approximately 6.09 sen per ordinary share totaling RM150.2 million for the financial year ended 31 December 2017. The total dividend amounting to RM150.2 million was paid wholly in cash.

From the total dividend amount paid of RM142.9 million on 20 September, 100% or RM142.9 million was reinvested to subscribe for 43,960,000 new ordinary shares at RM3.25 each via the Dividend Reinvestment Plan.

From the total dividend amount paid of RM134.2 million on 15 June 2017, 100 % or RM134.2 million was reinvested to subscribe for 41,282,000 new ordinary shares at RM3.25 each via the Dividend Reinvestment Plan.

From the total dividend amount paid of RM132.3 million on 20 September 2017, approximately 50% or RM66.1 million was distributed as cash dividend whilst the remaining 50% amounting to RM66.2 million was reinvested to subscribe for 20,356,000 new ordinary shares at RM3.25 each via the Dividend Reinvestment Plan.

The dividend was reinvested by the sole shareholder, BIMB Holdings Berhad to strengthen the Bank's capital position to fund the business growth of the Bank.

After the end of the financial year, the following dividend was proposed by the Directors. This dividend will be recognized in the subsequent financial year upon approval by the shareholder.

SUMMARY

- This chapter highlights the importance of recognition, measurement, presentation and disclosure of equity issues which cannot be neglected in preparing financial statements.
- It explains the identification, recognition, measurement, presentation and disclosure of share capital and reserves according to the latest financial reporting requirements.
- All Islamic financial institutions are required to prepare their financial statements in accordance with the approved accounting standards like MFRS and other standards mentioned in this chapter.
- Islamic banks will need to recognize, measure using a fair valuation unit, and present and disclose truthfully which is in line with the Quranic exhortation: “Give full measure when ye measure and weigh with a balance that is straight; that is better and fairer in the final determination” (17:35). This makes Islamic financial institutions unique in its presentation and disclosure of information.

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CHAPTER 8

INCOME AND EXPENSES

INCOME AND EXPENSES

LEARNING OBJECTIVES

The chapter aims to:

i. increase students' understanding of the significance of income and expenses in measuring Islamic banks' financial performance according to MFRS (Standard) for greater comparability and consistency.
ii. highlight the different types of income and expenses and the Standard's criteria for recognition and measurement.
iii. examine the reporting of income and expenses in the Statement of Profits or Losses and Other Comprehensive Income using selected banks' income and expense statements.
iv. highlight the accounting and reporting issues in income and expenses.

1.0 INTRODUCTION

Users of financial statements must be furnished with information about both an entity's financial position and its financial performance. Earlier chapters have discussed "Assets", "Liabilities" and "Equity" to be the elements in determining Islamic banks' financial position. In this chapter, "Income" and "Expenses" are discussed as two elements that are directly related to the measurement of Islamic banks' financial performance.

Generally, in accounting parlance, and as defined under the MFRS Framework, "income" is regarded as an increase in economic benefits during the accounting period in the form of inflows or enhancements of assets or decreases of liabilities, that result in increases in equity, other than those relating to contributions from equity participants. "Expenses" on the other hand are decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrences of liabilities that result in decreases in equity, other than those relating to distributions to equity participants. The definition of income encompasses both revenue and gains, whilst expenses encompass losses as well as those expenses that arise during the ordinary activities of the entity.

Standards that will be referred to in this chapter are the MFRS 101 *Presentation of Financial Statements*; the recognition and measurement criteria of income and expenses under MFRS 9 *Financial Instruments*: and MFRS 132 *Financial Instruments: Presentation*; and MFRS 13 *Fair Value Measurement* and MFRS 15 *Revenue from Contracts with Customers*. Recourse is also made to BNM's 'Financial Reporting Guidelines' issued in February 2018 which apply to all financial institutions in Malaysia that cover licensed banks, licensed investment banks, licensed Islamic banks and licensed insurers.

2.0 INCOME

2.1 Nature and Definition of Islamic Bank's Income

Income is defined in the Conceptual Framework for Financial Reporting as increases in economic benefits during the accounting period in the form of inflow or enhancement of assets, or decreases of liabilities, that result in increases in equity other than those relating to contributions from equity participants.

A financier in Islamic banking institutions earns "returns" (rather than interests) from permitted transactions that broadly include: "Mark-up" (in purchase and sale contracts with deferred payment) as in *Murabahah* and other contracts; "Profit-share" (in venture and other partnership-like contracts such as *Musharakah, Mudarabah* and other contracts; "Rent" in lease contracts known as *Ijarah*; "Fees" from agency contracts like *Wakalah*;, and "Profit, profit-share, rent or fees" from undivided pro-rata ownership contracts as in Sukuk.

2.2 Sources of Income

The income of an Islamic bank includes income derived from investment of Depositors' funds, Investment Accounts' funds and investment of Shareholders' funds. It comprises all income from investment of general investment accounts, specific investment accounts, and other depositors' fund and includes income from financing, trading, and investment activities which come from dealing with investment securities within and outside Malaysia.

The other sources of income for Islamic banks are from income derived from the investment of Islamic banking capital funds; income attributable to the shareholders; and income attributable to the Bank/Group, and other income.

Table 1 shows a summary of the typical sources of income for Islamic banks:

INCOME (revenue, gain, profit, returns)
Income derived from the investment of Depositors' Funds (and others);
Income derived from Investment Account Funds; and
Income derived from the investment of Shareholders' Funds
Income derived from rendering of services or fee income (*wakalah* fees)
Realised Gains on the disposal of Investment
Fees and commissions on sukuk issuance
IPO
Underwriting arrangements
Rental income
Commitment fees
Handling fees
Financing arrangement fees

Table 1: Types of Income for Islamic Banks

Generally in an Islamic transaction, there are many types of fees involved such as financing arrangement fees, commitment fees and handling fees which comprise the sources of income for Islamic banks.

For Islamic banks, income is recognised in the statement of profit or loss and other comprehensive income as illustrated by BIMB's 'Statement of Profit or Loss and other Comprehensive Income' as shown in Table 2.

GROUP	Note	2018 RM'000	2017 RM'000
Income derived from investment of Depositors' Funds	26	**2,601,825**	2,324,187
Income derived from Investment Account Funds	27	**257,915**	247,046
Income derived from the investment of Shareholders' Funds	28	**476,277**	434,353
Net allowance for impairment on financing and advances, net of recoveries	29	**(81,454)**	15,613
Net allowance for impairment on other financial assets		**43**	(243)
Direct expenses		**(17,870)**	(18,421)
Total distributable income		**3,236,736**	3,002,535
Wakalah fees from Restricted Investment Accounts (RIA)	18	**485**	2,595
Income attributable to Depositors	30	**(1,289,275)**	(1,103,036)
Income attributable to Investment Account Holders (IAH)	31	**(94,559)**	(105,301)
Total net income		**1,853,387**	1,796,793
Personnel expenses	32	**(595,319)**	(569,343)
Other overhead expenses	33	**(391,099)**	(419,101)
		866,969	808,349
Finance cost on Subordinated Sukuk Murabahah	20	**(56,711)**	(41,296)
Profit before zakat and taxation		**810,258**	767,053
Zakat		**(13,664)**	(13,373)
Tax expense	36	**(202,707)**	(187,562)
Profit for the period		**593,887**	566,118
Earnings per share (sen)	37	**23.96**	23.27

Table 2: BIMB's condensed Statement of Profit or Loss and other Comprehensive Income for the Financial Year Ended 31 December 2018

Table 2 also shows the types of income streams for BIMB derived from various sources: (i) income derived from investment of Depositor's Funds; (ii) income derived from Investment Account Funds; (iii) income derived from investment of Shareholders' Funds and (iv) income derived from rendering of services (fee income) and (v) realised gains on disposal of investment. As a general accounting rule, all items that meet the definition of income should be included in the income statement.

GROUP	Note	2018 RM'000	2017 RM'000
Income derived from investment of Depositors' Funds and others	35	**3,488,997**	2,935,552
Income derived from Investment of investment Account	36	**555,563**	252,058
Income derived from investment of Shareholders' Funds	37	**414,535**	311,753
Expected credit losses/allowance made for impairment losses on financing, advances and other financing/loans	38	**(107,458)**	(85,762)
Expected credit losses written back for commitments and contingencies	27	**1,837**	Nil
Other expected credit losses/allowance made for other impairment losses	39	**474**	1
Total distributable income		**4,353,000**	3,413,600
Income attributable to Depositors and others	40	**(2,275,874)**	(1,870,381)
Profits distributed to investment account holder	41	**(438,686)**	(188,508)
Total net income		**1,638,440**	1,354,711
Personnel costs	42	**27,751**	30,820
Other overheads and expenditures	43	**(577,466)**	(511,526)
Profit before taxation and zakat		**1,033,223**	812,365
Taxation and zakat	45	**(202,914)**	(172,544)
Profit after taxation and zakat		**830,309**	639,821
Earnings per share (sen)	46	**83.03**	63.98

Table 3: CIMB Statements of Income for the Financial Year Ended 31 December 2018

Similarly, CIMB Islamic has presented the same sources of income as shown under note 35, 36 and 37 which are income derived from investment of Depositor's Funds and others; income derived from Investment of Investment Account; and income derived from investment of Shareholders' Funds respectively.

2.3 Measurement of Income

The fair value measurement basis is greatly used by MFRS which is in line with Islamic principles which emphasizes on fair dealing and just commercial transactions. Islamic commercial transactions must be carried out based on fair value.

According to BNM regulatory requirements, for financial instruments that are measured at fair value, a licensed person shall ensure that sound risk management and control processes around their measurement are in place. The rationale of MFRS 13 *Fair Value Measurement* is to provide guidance on how to measure fair values of assets, liabilities and equity instruments, and specify the disclosures about fair value measurements.

- **Historical cost** - the amount of cash or cash equivalents paid, or the fair value of the consideration given, to acquire an asset at the date of acquisition.
- **Current cost** (*value to the business/deprived value*) - the current cost for an asset is the amount of cash or cash equivalents that would have to be paid if the same or equivalent asset was acquired currently.
- **Realisable (settlement) value** - the realisable value of an asset is the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal.
- **Present value** - the present value of an asset is the present discounted value of the future net cash inflow that the asset is expected to generate in the normal course of the business.
- **Fair value** - the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (MFRS 13.9)

All Islamic banks in Malaysia use the historical cost convention, except for financial assets at fair value through profit or loss, debt instruments at fair value through other comprehensive income, equity instruments at fair value through other comprehensive income, derivative financial instruments, investment properties and non-current assets/disposal groups held for sale and financial liabilities designated at fair value through profit or loss, that have been measured at fair value.

There are other measurement bases which are not listed down in the Framework and these are:
(a) Cost combined with other measurement bases, such as lower of cost and net realisable value; and lower of cost and market value;
(b) Amortised cost basis; and
(c) Revaluation basis.

However, in practice, the measurement bases currently applied in financial statements consist of a mixed measurement attributes of historical cost, amortised cost, lower of cost and net realisable value, revalued amount, present value and fair value.

For example, inventories are usually carried at the lower of cost and net realisable value, marketable securities are carried at market value and pension liabilities are carried at their present value.

2.4 Recognition of Profit Income and Profit Expense

Profit income and profit expense for all profit-bearing financial instruments are recognised within "profit income" and "profit expense" in the statement of income using the effective profit method.

The effective profit method is a method of calculating the amortised cost of a financial asset or a financial liability and of allocating the profit income or profit expense over the relevant period. The effective profit rate is the rate that exactly discounts estimated future cash payments or receipts throughout the expected life of the financial instruments, or when appropriate, a shorter period to the net carrying amount of the financial asset or financial liability.

When calculating the effective profit rate, the Bank takes into account all contractual terms of the financial instrument and includes any fees or incremental costs that are directly attributable to the instrument and are an integral part of the effective profit rate, but does not consider future credit losses. The calculation includes all fees and transaction costs integral to the effective profit rate, as well as premium or discounts.

Profit income is calculated by applying effective profit rate to the gross carrying amount of a financial asset except for financial assets that subsequently become credit-impaired. For credit-impaired financial assets, the effective profit rate is applied to the net carrying amount of the financial assets (after deduction of the loss allowance). Thus, once a financial asset or a group of financial assets has been written down as a result of an impaired loss, income is recognised using the profit rate used to discount the future cash flows for the purpose of measuring the impairment loss.

2.5 Financing Income

Financing income is recognised in the profit or loss using the effective profit rate method. For instance, income from a sale-based contract is recognised on effective profit rate basis over the period of the contract based on the principal amounts outstanding; whereas income from *Ijarah* (lease-based) contract is recognised on effective profit rate basis over the lease term. For *murabahah*, income is recognised on effective profit rate basis over the expected life of the contract based on the principal amounts outstanding.

2.6 Placements from Investment Accounts

For *mudarabah*, profit shall be recognised on accrual basis by actual liquidation of assets of *mudarabah* contract or constructive basis according to acceptable profit recognition method which may include valuation according to acceptable market methodology, independent valuation or valuation based on estimated figures.

2.7 Recognition of Fees and Other Income

Income from financing and receivables based on mutual accounting policy on Shariah contracts according to the nature of the transactions. Financing arrangement fees and commissions are recognised as income when all conditions precedent is fulfilled.

Commitment fees for financing, advances and other financing/loans that are likely to be disbursed are deferred (together with direct cost), and income which forms an integral part of the effective profit rate of a financial instrument is recognised as an adjustment to the effective profit rate on the financial instrument.

2.8 Fee and Other Income Recognition

Financing arrangement, management and participation fees, underwriting commissions, brokerage fees and *wakalah* performance incentive fees are recognised as income based on contractual arrangements.

Guarantee fees, portfolio management fees and income from asset management and securities services are recognised as income based on a time apportionment method.

Brokerage fees are recognised as income on inception of such transactions.

Fees from advisory and corporate finance activities are recognised net of service taxes and discounts on completion of each stage of the assignment.

Dividend income from subsidiaries and other investments are recognised when the Bank's rights to receive payment is established.

2.9 Islamic Banks' Revenue Streams/Sources of Income

Islamic banks need funds to operate its banking activities which are sourced from (a) shareholders' working capital, and (b) deposits and investments collected from customers. Banks (including Islamic banks) as financial intermediaries, collect these deposits and investments from the surplus units and use them for provision of finance to the economic deficit units (such as customers).

Islamic banks are also required under the Islamic Financial Services Act (IFSA 2013) to strictly differentiate between "deposits" and "investments" based on the true nature of the Islamic contracts. Thus, Shariah contracts of *Mudarabah, Musharakah* and *Wakalah* are classified as "investments"; whilst deposits from customers are collected from various contracts such as *Wadiah* deposits and *Tawarruq* (Commodity Murabahah).

A deposit is defined as the money received from customers and will be repaid in full with or without gains or returns, whereas investments are defined as money paid or accepted for purposes of investment and the principal is secured by the asset of the bank whilst return is subject to the performance of the underlying portfolio.

Islamic bank's revenue streams are illustrated below using BIMB's statement of profit or loss and other comprehensive income.

GROUP **Revenue Streams:**	**Note**	**31 December 2018** **RM'000**	**31 December 2017** **RM'000**
(i) Income derived from investment of Depositors' Funds	26	**2,601,825**	2,324,187
(ii) Income derived from Investment Account Funds	27	**257,915**	247,046
(iii) Income derived from the investment of Shareholders' Funds	28	**476,277**	434,353

Table 4: Types of Income as illustrated by BIMB's condensed Statement of Profit or Loss and Other Comprehensive Income for the financial year ended 31 December 2018

(i) Income Derived from Investment of Depositors' Funds

Using BIMB's financial statements, the details of income derived from the investment of depositors' funds are classified under 4 categories as shown below.

GROUP	31 December 2018 RM'000	31 December 2017 RM'000
(i) General investment deposits	**19,074**	22,296
(ii) Term deposit-i	**1,596,723**	1,370,064
(iii) Saving and demand deposits	**790,472**	739,255
(iv) Other deposits	**195,556**	192,572
Total Income	**2,601,825**	2,324,187

Table 5: Classification of Deposits

Islamic banks use *Al-Wadiah* contract for General Investment deposits, savings and demand deposits. Due to the risky nature of *Al-Wadiah*, the contract is combined with another contract of guarantee known as *al Wadiah Yad Dhamanah* where the bank guarantees the return of the principal sum of the depositor. Under the strict principle of *Al-Wadiah*, banks cannot give any return for *al Wadiah* deposits. Nevertheless, in practice, Islamic banks are giving a certain return as '*hibah*' as shown below under Finance income & *hibah*. This is allowed under principles of '*maslahah*' (public interest) as they need to compete with deposits in conventional banks. *Tawarruq* deposit (Commodity Murabahah) is similar to fixed/term deposit where the returns are fixed upfront as part of the *Murabahah* structure.

GROUP & BANK	31 December 2018 RM'000	31 December 2017 RM'000
Finance Income & Hibah		
Financing, advances and others	**688,992**	630,634
Financial assets:		
• Fair value through profit or loss (FVTPL)	**4,984**	Nil
• Fair value through other comprehensive income (FVOCI)	**67,395**	Nil
• Other financial assets at amortised cost:	**175**	Nil
- Held for trading	**Nil**	5,192
- Available for sale	**Nil**	78,063
- Held-to-maturity	**Nil**	2,202
Money at call and deposits with financial institutions	**19,142**	726,168
Other Dealing Income		
Net gain from the sale of financial assets at fair value through profit or loss (FVTPL)	**1,394**	Nil
Net gain on revaluation of financial assets at fair value through profit or loss (FVTPL)	**114**	Nil
Net loss from sale of financial assets held-for-trading	**Nil**	275
Net gain on revaluation of financial assets held-for-trading	**Nil**	1,649
	1,508	1,374
Other operating income		
Net gain from sale of financial assets at fair value through other comprehensive income (FVOCI)	**8,276**	Nil
Net gain from sale of financial assets at available for sale (AFS)	**Nil**	1,866
Net gain from sale of financial assets held-to-maturity	**Nil**	9,847
	8,276	11,713
	790,472	739,255
of which		
Financing income earned on impaired financing	**10,924**	10,288

Table 6: Income derived from Investment of Saving and Demand Deposits

BIMB has categorised their income under (i) finance income and hibah; (ii) money at call and deposits with financial institutions; (iii) other dealing income; and (iv) other operating income. As at 31 December 2018, the income derived from their investment of savings and demand deposits total up to RM790,472,000 which is an increase of RM 51,217,000 from previous accounting period in 2017.

In 2018, BIMB raked in a total income of RM2,601,825,000 from investment of depositors' funds. It is shown in the above income statement that MFRS 9 has been implemented by BIMB since its introduction in January 2018.

(ii) Income derived from Investment Account Funds

Under IFSA 2013, an investment account is an account under which money is paid and accepted for the purposes of investment, including for the provision of finance, in accordance with Shariah terms. Further, 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. There is no express or implied obligation to repay the money in full.

Thus, any investment product is not principle guaranteed, unlike deposit products like *Wadiah* deposits and *Tawarruq* (Commodity Murabahah) deposits which guarantee returns and are insured under PIDM.

Investment accounts are either Unrestricted Investment Accounts (URIA) or Restricted Investment Accounts (RIA). URIA refers to a type of investment account where the investment account holder provides the Group with the mandate to make the ultimate decision without specifying any particular restrictions or conditions.

The URIA is structured under *Mudarabah* and *Wakalah* contracts. Any impairment allowances required on the assets for investment accounts are charged to and borne by the investors. The table below gives a breakdown of finance income from URIA.

	Group & Bank	
Finance income Unrestricted investment accounts (URIA)	**31 December 2018 RM'000**	**31 December 2017 RM'000**
Mudarabah	**122,522**	94,386
Wakalah	**135,393**	152,660
	257,915	247,046

Table 7: Breakdown of Finance Income from URIA

Unlike conventional banks where the depositors will get a fixed return regardless of how the bank performs, investment account holders (IAH) of Islamic banks will earn higher returns when profits on investment ventured by the Islamic banks are higher or vice versa. The table below shows the deduction of profit to depositors and investment accounts from total revenue.

RM million	31 December 2018	31 December 2017
Total revenue	1,991.5	
Profit to depositors & investment accounts	(643.5)	
Net income	**1,348.1**	

Table 8: Deduction of Profits to Depositors and Investment Accounts

Restricted Investment Accounts (RIA) on the other hand refers to a type of investment account where the IAH provides a specific investment mandate to the Group such as purpose, asset class, economic sector and period of investment.

RIA is accounted for as off-balance sheet as the Group has no risk and rewards in respect of the assets related to the RIA or to the residual cash flows from those assets except for the fee income generated by the Group for managing the RIA. The Group also has no ability to use power over the RIA to affect the amount of the Group's return.

The RIA is structured under a *Wakalah* contract. Under *Wakalah* contract, IAH appoints the Group as the agent to invest the funds provided by IAH to finance customers with a view of earning profits and the Group will receive fees for the agency service provided.

Islamic banks are committed to safeguarding the investment account holders' interest and this is confirmed in their Annual Report that the profit allocation for IAHs is in accordance with Shariah rules and principles. The performance of the Investment Account is also disclosed and reported via issuance of Fund Performance Report (FPR), made available on the Bank's website.

(iii) Income Derived from Investment of Shareholders' Funds

BIMB GROUP	31 December 2018 RM'000	31 December 2017 RM'000
Finance Income & Hibah		
Financing, advances and others	**7,345**	6,951
Financial assets:		
- Fair value through other comprehensive income (FVOCI) - Available for sale (AFS)	**184,280** **Nil**	Nil 147,372
Money at call and deposits with financial institutions	**6**	4
	191,631	154,327
Other Dealing Income		
Net gain from foreign exchange transactions	**54,716**	66,396
Net derivatives loss	**52**	(779)
Net gain on revaluation of financial assets at FVTPL	**2**	Nil
	54,770	65,617
Other operating income		
Net gain from sale of financial assets available-for-sale	**Nil**	272
Gross dividend income from unit trust in Malaysia	**1,763**	2,600
	1,763	2,872
Fees and commission		
Card fees and commission	**70,627**	70,751
Takaful service fees and commission	**29,791**	28,436
Financing fees	**18,976**	22,810
Sales charges on unit trust	**24,210**	8,450
Unit trust management fees	**15,254**	10,158
Commission on MEPS	**13,444**	13,184
Ar-Rahnu fees	**10,863**	11,984
Mobile banking fees	**6,630**	6,808
Corporate advisory fees	**6,549**	5,877
Deposit and payment service fees	**5,959**	6,677
Processing fees	**2,212**	4,202
Commission on bills payment system	**3,006**	2,831
Commission from wealth management services	**31**	58
Ta'widh charges	**975**	698
Others	**16,754**	15,842
	225,281	209,766
Other income		
Rental income	**2,266**	2,446
Net gain/loss on disposal of property and equipment	**372**	(71)
Others	**194**	396
	2,832	2,771
	476,277	434,353

Table 9: Investment Income from Shareholders' Funds as illustrated by BIMB Group

2.10 MFRS 15 Revenue from Contracts with Customers

Before the introduction of MFRS 15, the past accounting for revenue had limited guidelines in many areas. There were different and inconsistent revenue practices. For instance, there was limited guidance on emerging transactions like licensing arrangements and warranties included in the service component. Taking into consideration the past issues in revenue recognition, MFRS 15 was subsequently developed and issued to overcome these problems.

Thus, unlike its predecessors, MFRS 15 adopts a "contract-based" revenue recognition principle which is different from the "risk and reward" principle of the former MFRS 118; the "activity-based" principle of the former MFRS 111; and the "earning and realization" principle of the former US GAAP. MFRS 15 supersedes the following: MFRS 111 *Construction Contracts*; MFRS 118 *Revenue*; IFRIC 13 *Customer Loyalty Programmes*; IFRIC 15 *Agreements for the Construction of Real Estate*; IFRIC 18 *Transfers of Assets from Customers* and SIC 31 *Revenue: Barter Transactions Involving Advertising Services.*

MFRS 15 introduced a common model of accounting treatment for revenue. It sets up the principles for reporting useful information to users of financial statements about the nature, amount, timing and uncertainty of revenue and cash flows arising from an entity's contract with their customers.

The objective of MFRS 15 is to improve the financial reporting of revenue by eliminating inconsistencies and weaknesses in prior revenue recognition arrangements; provide a more forceful and sounder framework on revenue issues; improve revenue recognition practices across entities, industries, jurisdictions and capital markets and present a more useful information to users of financial statements through better requirements on disclosures. Also, it will simplify the preparation of financial statements and manage emerging complex revenue transactions.

2.11 MFRS 15 Revenue Recognition

MFRS 15 adopts the core principle in revenue recognition in which an entity should depict the transfer of promised goods or services to customers at an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services. Moreover, an entity must consider the terms of the contract, and all relevant facts and circumstances, and apply the standard consistently to contracts with similar characteristics and in similar circumstances. Accordingly, revenue can be recognised either at a point in time or over time.

MFRS 15 establishes a new five-step model that will apply to revenue arising from contracts with customers. Under MFRS 15, revenue is recognised at an amount that reflects the consideration to which an entity expects to be entitled in exchange for transferring goods or services to a customer. The principles in MFRS 15 provide a more structured approach (5 step model) to measure and recognise revenue. Under MFRS 15, an entity recognises revenue in accordance with the core principle by applying the following steps:

Step 1: Identify the contract(s) with customer
Step 2: Identify the performance obligations in the contract
Step 3: Determine the transaction price
Step 4: Allocate the transaction price to the performance obligations in the contract, and
Step 5: Recognise the revenue when (or as) the entity satisfies a performance obligation.

The standard requires entities to exercise judgement, taking into consideration all of the relevant facts and circumstances when applying each step of the model to contract with their customers. The standard also specifies how to account for the incremental costs of obtaining a contract and the costs directly related to fulfilling a contract. New disclosure requirements under MFRS 15 include disaggregated information about revenue and information about the performance obligations remaining at the reporting date.

A contract between an entity and a customer under MFRS 15 is identified when all of the following criteria are met:

i. The parties to the contract have approved the contract in writing, orally or in accordance with other customary business practices and are committed to performing their respective obligations. Thus, to fall within MFRS 15, the contract must be a contract to transfer control of goods and services that are the output of an entity's ordinary activities.
ii. The entity can identify each party's rights regarding the goods or services to be transferred;
iii. The entity can identify the payment terms for the goods or services to be transferred;
iv. The contract has commercial substance (i.e. the risk, timing or amount of the entity's future cash flows are expected to change as a result of the contract); and
v. It is probable that the entity will collect the consideration to which it will be entitled to in exchange for the goods or services that will be transferred to the customer. An entity should only consider the customer's ability and intention to pay that amount of consideration when it is due.

2.12 MFRS 15 Measurement

Once the entity has decided to recognise revenue (because it has satisfied a performance obligation), the next issue is the measurement of the amount of the revenue to be recognised.

a. *Measurement basis*
As mentioned earlier, MFRS 15 requires, as its core principle, an entity to measure its revenue based on "an amount that reflects the consideration which the entity expects to be entitled". Thus, the amount recognised may or may not be equal to the fair value of goods and services transferred.

b. *Allocation basis*
Where there are multiple performance obligations within a contract, MFRS 15 requires an entity to allocate the transaction price to each separate performance obligation that depicts the amount of consideration to which the entity expects to be entitled in exchange for satisfying each separate performance obligation.

c. *Variable consideration*
Where the consideration promised in a contract includes a variable amount (because of discounts, rebates, performance bonuses and penalties), MFRS 15 requires an entity to estimate the amount of consideration to which the entity will be entitled.

2.13 Recognition of a Financing Effect

A financial instrument is defined in MFRS 132 *Financial Instruments: Presentation* as any contract that gives rise to both a financial asset of one entity and a financial liability or equity instrument of another entity. MFRS 132 also stresses on the importance of contractual rights or contractual liability.

As interest on loans is excluded, a financier in Islamic banking institutions earns "returns" from permitted transactions that broadly include:

i. The mark-up in purchase and sale contracts with deferred payment – *Murabahah* and other contracts;
ii. Profit-share in the venture and other partnership-like contracts – *Musharakah, Mudarabah* and other contracts;
iii. Rent in lease contracts – *Ijarah*
iv. Fees from agency contracts – *Wakalah*, and
v. Profit, profit-share, rent or fees from undivided pro-rata ownership contracts – Sukuk.

Although the IFI's ordinary activities are the provision of Shariah-compliant financing and are not the sales of cars, real estate, or commodities, it is nonetheless substantially different from a conventional bank because of the following:

a. It has an obligation to pay a third party for the goods purchased to be sold to a customer on the basis of *Murabahah* so it is not an agent in the contract;
b. It must own the goods, not only the legal title, even for a short period of time, with all risks and rewards incidental to ownership; and
c. It has an obligation to deliver the goods (not the cash) to the customer.

It is common for Islamic banks to use a trade contract (buy-and-sell) to underlie a financing transaction. The question that is raised here is whether revenue from such a contract is recognised as a "sale" or as "finance income" or both? The following assessment must be considered:

- Is the contract a "contract with a customer" under MFRS 15?
- Is the deferred payment sale carried out in the course of the bank's ordinary activities?

It is viewed that if an IFI controls the asset before it is sold to the customer for deferred consideration – MFRS 15 may apply.

If an IFI purchases the asset and instantaneously "sells" it for deferred consideration – it appears that the IFI has no control over the asset hence MFRS 15 may not apply.

It is to be noted here that the existence of the financing element in the Shariah contract is considered part of the arrangement of collection of the consideration where the following paragraph of MFRS 15 will apply – "It is probable that the entity will collect the consideration to which it will be entitled to in exchange for the goods or services that will be transferred to the customer".

It is common also for Islamic banks to use a trade contract (buy-and-sell) to underlie a financing transaction. The question that is raised here is whether revenue from such a contract is recognised as a "sale" or as "finance income" or both? It is viewed that if an IFI controls the asset before it is sold to the customer for deferred consideration – MFRS 15 may apply. If an IFI purchases the asset and instantaneously "sells" it for deferred consideration – it appears that the IFI has no control over the asset. Hence, MFRS 15 may not apply.

To date, all Islamic banks in Malaysia have adopted the standard on its effective date (1 January 2018), using the modified retrospective method of adoption. The standard does not apply to income or revenue associated with financial instruments scoped in MFRS 9 such as loan, advances and financing and financial investment securities. The adoption of this standard has no material financial impact other than the disclosures made in Islamic Banks' financial statements.

2.14 Impact of MFRS 9 on Islamic Banks' Financial Statements

With effect from the financial year beginning on/after 1 January 2018, all banks including Islamic banks must adopt MFRS 9 *Financial Instruments* in their financial statements. This standard replaces MFRS 139 *Financial Instruments: Recognition and Measurement*. The adoption of this standard resulted in changes in accounting policies and adjustments to the financial statements.

MFRS 9 largely retains the existing requirements in MFRS 139 for the classification and measurement of financial liabilities and so there is no change on the Group's and the Bank's accounting policies related to financial liabilities. However, the standard eliminates the previous MFRS 139 categories for financial assets held-to-maturity, financing and receivables, and available for sale (AFS).

Under MFRS 9, on initial recognition, a financial asset is classified and measured at:

- Amortised cost;
- FVOCI (Fair Value through other Comprehensive Income) - Debt investment;
- FVOCI (Fair Value through other Comprehensive Income)- Equity investment; or
- FVTPL (Fair Value through Profit or Loss)

The classification of financial assets depends on the Group's and the Bank's business model in which a financial asset is managed and its contractual cash flow characteristics.

The following table summarises the impact, net of tax, of transition to MFRS 9 on the opening balance of reserves and retained earnings for BIMB Group and the Bank as on 30 September 2018.

BIMB Group and the Bank	Impact of adopting MFRS 9 on Opening Balance (RM'000) 30 September 2018
Fair Value Reserve	
Remeasurement of equity investment at fair value through other comprehensive income (FVOCI)	18,104
Reclassification of fair value gain from financial assets available-for-sale to fair value through profit or loss (FVTPL)	(749)
Related tax	(4,165)
Impact at 1 January 2018	13,190
Retained earnings	
Recognition of expected credit losses (ECL) under MFRS 9	(189, 444)
Reclassification of fair value gain from financial assets available-for-sale to (FVTPL)	749
Related tax	45, 287
Impact at 1 January 2018	(143, 408)

Table 10: BIMB Group and Bank on Impact of Adopting MFRS 9 on Opening Balance

BIMB envisages that changes on the above classification of financial assets and liabilities are not expected to have a material impact on the value of the assets of the Group.

The impact on classification and measurement to the BIMB Bank's financial assets on the initial application of MFRS 9 on January 1 2018 are summarised below:

		Measurement category		Carrying amount	
BIMB-Bank	**Note**	**Original classification under MFRS 139**	**New classification under MFRS 9**	**Original classification under MFRS 139**	**New classification under MFRS 9**
Financial assets:					
Cash and short-term funds		**Financing and receivables**	**Amortised cost**	**4,185,697**	**4,185,697**
Deposits and placements with banks and other financial institutions		**Financing and receivables**	**Amortised cost**	**Nil**	**Nil**
Financial assets held-for-trading		**FVTPL**	**FVTPL**	**380,925**	**380,925**
Derivative financial assets		**FVTPL**	**FVTPL**	**68,319**	**68,319**
Financial assets available-for-sale (Debt instruments)	**(a) See explanatory notes**	**Available for sale (AFS)**	**FVOCI**	**9,215,834**	**9,215,834**
Financial assets available-for-sale (Equity instruments)	**(b) See explanatory notes**	**Available for sale (AFS)**	**FVOCI**	**22,912**	**41,016**
Financial assets available-for-sale	**(c) See explanatory notes**	**Available for sale (AFS)**	**FVTPL**	**13,937**	**13,937**
Financial assets held-to-maturity	**(d) See explanatory notes**	**Held-to-maturity**	**Amortised cost**	**Nil**	**Nil**
Financing, advances and others		**Financing and receivables**	**Amortised cost**	**42,113,420**	**41,924,321**
Other financial assets		**Financing and receivables**	**Amortised cost**	**123,503**	**123,503**

Table 11: Impact of MFRS 9 on BIMB's Financial Assets

Explanatory Notes:

a. Debt investment securities are held to meet everyday liquidity needs. BIMB Group and the Bank seek to minimise the costs of managing those liquidity needs and therefore, actively manage the return on the portfolio. The return consists of collecting contractual payments as well as gains and losses from the sale of financial assets. The investment strategy often results in sales activity that is significant in value. The Group and the Bank consider that under MFRS 9, these securities are held within a business model whose objective is achieved by both collecting contractual cashflows and selling financial assets.

b. Comprises non-traded equity instruments for which BIMB Group and the Bank have elected to designate at FVOCI under MFRS 9. Accordingly, the assets remain to be accounted for at FVOCI with no subsequent recycling of realised gains and losses permitted. Before the adoption of MFRS 9, these securities were measured at cost because their fair value was not considered to be reliably measurable. MFRS 9 has removed this cost measurement exception.

c. Comprises investments in unit trust previously classified as AFS under MFRS 139. These investments were designated as at FVTPL because they were managed on a fair value basis and their performance was monitored on this basis.

d. Certain debt securities are held for long term yield. These securities may be sold, but such sales are not expected to be frequent. The Group and the Bank consider that these securities are held within a business model whose objective is to hold assets to collect the contractual cash flows. These assets are classified and measured at amortised cost under MFRS 9.

Thus, with the introduction of MFRS 9, Islamic banks made changes to the financial statements in the areas of classification and measurements for financial assets and liabilities and they are:

- Financing, advances and others that are classified as 'financing and receivables' as well as investments in debt securities classified as held-to-maturity under MFRS 139, are expected to be classified as financial asset measured at amortised cost under MFRS 9;
- Most of the debt securities classified as available-for-sale (AFS) under MFRS 139 are expected to be classified as investment securities measured at fair value through other comprehensive income (FVOCI);
- Financial assets and liabilities held-for-trading are expected to continue to be measured at fair value through profit or loss (FVTPL);
- Investment in equity instruments that are currently classified as available-for-sale (AFS) and measured at cost due to the absence of quoted market price is expected to be classified and measured at FVTPL; and
- Investments in debt securities classified as held-to-maturity under MFRS 139, are expected to be classified as financial asset measured at amortised cost under MFRS 9;

3.0 EXPENSES

3.1 Nature and Definition of Islamic Bank's Expenses

Expenses are treated as decreases in assets or increases in liabilities that result in decreases in equity, other than those relating to distributions. The Framework defines expense as "decreases in economic benefits during the accounting period in the form of outflows or depletions of assets or incurrence of liabilities that result in decreases in equity, other than those relating to distributions to equity participants".

In general, expenses take the form of an outflow or depletion of assets such as cash and cash equivalents, inventory, property, plant and equipment. When losses are recognised in the income statement, they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions.

3.2 Type of Expenses

The expenses of an Islamic bank usually consist of allowance for financing and advances categorized under specific and general allowance, as well as bad debts recovered and written-off during the financial year.

It also includes expenses directly attributable to the investment of the depositors and shareholders/Islamic banking capital funds; personnel expenses, and other expenditure such as Shariah committee members' remuneration, hire of equipment, general administrative expenses and other overhead expenses.

Allowances for impairment on financing and advances:	Other expenditure:
• Specific and general allowance	• Shariah committee members' remuneration
• Bad debts recovered and written-off during the financial year	• Hire of equipment
	• General administrative expenses and other expenses

Table 12: Islamic Bank's Expenses

3.3 Compliance with MFRS and BNM Policies

Where Islamic bank's compliance to MFRS is concerned, MFRS 9 standard introduces new requirements for classification and measurement of financial instruments, impairment of financial assets, and hedge accounting, and replaces the guidance in MFRS 139 *Financial Instruments, Recognition and Measurement*.

The approach for classification of financial assets is driven by cash flow characteristics and the business model in which an asset is held, with three measurement categories – (i) amortised cost, (ii) fair value through profit or loss ("FVTPL") and (iii) fair value through other comprehensive income ("FVOCI").

It is stated in BNM's *Financial Reporting for Islamic Banking Institutions* 2018 (BNM's policy document) that a licensed person (an Islamic bank) is required to present the carrying amount and income and expenses related to Islamic deposit and investment account in separate line items in its separate financial statements and consolidated financial statements. This statement represents the regulator's specific requirements for Islamic banks' application of MFRS.

Under the same policy document, minimum disclosure requirements for Islamic banks were also laid down relating to income and expenses:

- "A licensed person shall disclose income and expenses with a breakdown by the source of funds (eg. Islamic deposit and shareholder's funds) and by categories of financial assets or liabilities. Profit income recognised for impaired financing and receivables shall be disclosed separately."

- "A licensed person shall disclose non-profit income and other operating expenses with a breakdown of major items of income or expense."

Furthermore, Islamic banks must comply with the following key principles on disclosure of information:

a. Information should be timely and up to date, to avoid undue delays in disclosure which may affect the relevance of the information being disclosed;
b. The scope and content of information disclosed and the level of disaggregation and detail should be sufficient to provide comprehensive, meaningful and relevant information to users;
c. Adequate disclosures should be provided on areas of uncertainty, in particular, information on key estimates, and if sensitivity analysis is used, a discussion

3.4 Recognition of Expenses

A bank recognises or records expenses when there is a decrease in future economic benefits which is related to a decrease in an asset, or an increase in liability. However, the bank can only record the expenses if the amount can be measured reliably. Therefore, the recognition of expenses must occur simultaneously with the recognition of an increase in liabilities or a decrease in assets, for example, the accrual of employee entitlements, or the depreciation of equipment.

3.4.1 Measurement

Measurement involves determining how recognised items should be measured. It is the process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the financial position and income statement. There are a number of different measurement bases which are employed to different degrees and in varying combinations in financial statements. All these bases are forms of accrual accounting, that is, they are intended to measure income as it is earned and costs as they are incurred as opposed to simply recording cash flows. The commonly used bases include the following where the last four are forms of current value measurement:

- **Historical cost** - the amount of cash or cash equivalents paid, or the fair value of the consideration given, to acquire an asset at the date of acquisition.
- **Current cost** (*value to the business/deprived value*) - the current cost for an asset is the amount of cash or cash equivalents that would have to be paid if the same or equivalent asset was acquired currently.
- **Realisable** (settlement) **value** - the realisable value of an asset is the amount of cash or cash equivalents that could currently be obtained by selling the asset in an orderly disposal.
- **Present value** - the present value of an asset is the present discounted value of the future net cash inflow that the asset is expected to generate in the normal course of the business.
- **Fair value** - the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date (MFRS 139)

3.4.2 Impairment Loss

MFRS 9 replaces the 'incurred loss model' in MFRS 139 with an "expected credit loss" (ECL) impairment model which will require more timely recognition of expected credit losses to reflect changes of the credit risk of financial instruments as well as future economic conditions. The new impairment model applies to financial assets measured at amortised cost, contract assets and debt investments at FVOCL, but not to investments in equity instruments.

The financial assets at amortised cost consist of cash and short-term funds, deposits and placements with banks and other financial institutions, financing advances and others, other assets and statutory deposits with Bank Negara Malaysia.

Under the new expected-loss impairment model, the BIMB Group, for instance, expects that the allowance for impairment on financing and investment in securities to increase by approximately 20-30% as compared to the balance as at December 2017. The BIMB Group is reported to continue refining and validating the impairment models which may change the actual impact on adoption.

At each reporting date, the BIMB Group and the Bank first assess individually whether objective evidence of impairment exists for significant financial assets and collectively for financial assets that are not individually significant. If it is determined that objective evidence of impairment exists, i.e. credit impaired, for individually assessed financial assets measured at amortised cost and FVOCI, a lifetime ECL will be recognised for impairment loss which has been incurred.

Group and Bank	2018 RM'000	2017 RM'000
Net allowance for impaired financing, advances and others:		
Collective assessment allowance	**127,601**	34,706
Individual assessment allowance	**58,801**	71,735
Bad debts and financing recovered	**(104,948)**	(122,054)
	81,454	15,613

Table 13: Net Allowance for Impairment on Financing and Advances

Under collective assessment, BIMB's group and bank apply a three-stage approach to measuring ECL on financial assets measured at amortised cost and FVOCI.

BIMB assume that the credit risk on a financial asset has increased significantly when it is more than 30 days past due.

	Group		Bank	
	31 December 2018 RM'000	31 December 2017 RM'000	31 December 2018 RM'000	31 December 2017 RM'000
Deposits from customers:				
Mudarabah fund	**9,730**	11,445	**9,730**	11,445
Non-*Mudarabah* fund	**1,236,386**	1,088,245	**1,236,653**	1,088,245
Deposits and placements of banks and other financial institutions:				
Non-*Mudarabah* fund	**409**	3,346	**409**	3,346
Recourse obligation on financing sold to Cagamas	**42,750**	Nil	**42,750**	Nil
	1,289,275	1,103,036	**1,289,542**	1,103,036

Table 14: Income attributable to Depositors

	GROUP AND BANK	
	31 December 2018 RM'000	31 December 2017 RM'000
Unrestricted investment accounts		
Mudarabah	**5,530**	1,938
Wakalah	**89,029**	103,363
	94,559	105,301

Table 15: Income attributable to Investment Account Holders

	BANK	
	31 December 2018 RM'000	31 December 2017 RM'000
Personnel Expenses		
Salaries and wages	**309,152**	286,154
Allowances and bonuses	**156,754**	147,529
Employees Provident Fund	**56,170**	53,273
Directors and Shariah Supervisory Council member's remuneration	**6,362**	11,182
Medical benefits	**20,537**	28,209
Staff sales commission	**14,104**	14,645
Others	**20,381**	19,455
	583,460	560,447

Table 16: Other Expenses of Islamic Banks

GROUP		
Other Overhead Expenses	**31 December 2018 RM'000**	**31 December 2017 RM'000**
Promotion		
Credit and debit card expenses	**30,802**	31,114
Advertisement and publicity	**9,336**	9,454
Others	**9,319**	10,111
	49,457	50,679
Establishment		
Depreciation of property and equipment.	**47,723**	54,220
Information technology expenses	**50,842**	59,535
Office rental	**54,152**	54,254
Security services	**9,954**	16,267
Utilities	**14,235**	13,992
Office maintenance	**11,107**	11,169
Takaful	**8,329**	8,037
Rental of equipment	**4,619**	4,429
Others	**320**	320
	201,281	222,223
General expenses		
Indirect tax expenses	**11,847**	23,317
Outsourcing fees		
- Management of self-service terminal	**12,608**	12,128
- Credit recovery		
- Others	**2,417**	2,516
Office supplies	**2,674**	4,169
Licenses	**8,067**	9,462
Travelling and transportation	**8,246**	9,500
Bank and service charges	**7,947**	7,813
Security services for cash in transit	**6,958**	7,601
Postage and delivery charges	**6,523**	6,419
Management fees	**6,387**	4,963
Subscription fees	**8,589**	4,633
Professional fees	**3,739**	4,061
Mobile banking expenses	**6,078**	4,203
Auditors' remuneration	**1,602**	1,359
- Statutory audit fee		
- Others	**848**	700
Processing charges	**1,365**	642
Property and equipment written off	**980**	655
Others	**332**	56
	22,821	38,535
	120,028	142,732

Table 17: Other Overhead Expenses

Expenses on Remuneration

The following table describes the expenses on CEO, Directors of the company and Shariah Supervisory Council Members' Remuneration:

	GROUP	
	31 December 2018 RM'000	31 December 2017 RM'000
Directors of the Bank		
Executive Director		
Salaries, bonuses and EPF contributions Fees and other emoluments Benefits in kind	**Nil**	7,479
CEO		
Salaries, bonuses and EPF contributions Fees and other emoluments Benefits in kind	**2,776**	693
Non-executive directors		
Fees and other emoluments Benefits-in-kind	**3,321**	2,829
	6, 097	11,001
Directors of subsidiaries		
Executive Director Salaries and other remuneration, including meeting allowances	**742**	502
Non-executive Directors	**137**	139
Total	**6,976**	11,642
Members of Shariah Supervisory Council (SSC)		
- SSC of the Bank	**592**	575
- SSC of a subsidiary	**9**	6
	601	581
Grand total (excluding benefits-in-kind) (Note 32)	**7,312**	11,875

Table 18: Expenses on Remuneration

The Directors of a Bank are responsible for the preparation of financial statements of the Group and of the Bank to give a true and fair view in accordance with Malaysian Reporting Standards, International Financial Reporting Standards and the requirements of the Companies Act 2016 in Malaysia. The Shariah Supervisory Council is responsible for the Shariah governance of the Bank. Expenses on their remuneration have been cut back in 2018 as shown above.

	GROUP		BANK	
	2018 RM'000	**2017 RM'000**	**2018 RM'000**	**2017 RM'000**
Malaysian income tax				
Current year	**231,420**	191,736	**231,287**	191,620
Over provision in prior years	**(6,818)**	(6,306)	**(6,756)**	(6,298)
	224,602	185,430	**224,531**	185,322
Deferred tax expense relating to origination and reversal of temporary differences arising from:				
Current year	**(22,070)**	2,024	**(20,527)**	2,024
Under provision in prior years	**175**	108	**175**	108
	(21,895)	2,132	**(20,352)**	2,132
	202,707	187,562	**204,179**	187,454

Table 19: Tax Expenses

	GROUP		BANK	
	2018 RM'000	**2017 RM'000**	**2018 RM'000**	**2017 RM'000**
Profit before tax	**810,258**	767,053	**808,237**	766,109
Income tax calculated using Malaysian tax rate of 24%	**194,462**	184,093	**193,977**	183,866
Income not subject to tax	**(394)**	(11,924)	**(352)**	(11,924)
Non-deductible expenses	**4,967**	9,591	**5,135**	9,702
	199,035	181,760	**198,760**	181,644
Derecognition of deferred tax assets	**10,315**	12,00	**12,000**	12,000
Over/under provision in prior years - income tax - deferred tax	 **(6,818)** **175**	 (6,306) 108	 **(6,756)** **175**	 (6,298) 108
	202,707	187,562	**204,179**	187,454

Table 20: A reconciliation of effective tax expense for the Group and the Bank

3.5 Presentation and Disclosure

On 2 February 2018, BNM issued a revised "Financial Reporting Guidelines". The revised guidelines apply to financial institutions in Malaysia that cover licensed banks, licensed investment banks, licensed Islamic banks and licensed insurers. The revised guidelines have superseded two guidelines issued by BNM previously, namely, *Financial Reporting* dated 28 January 2015 and *Classification and Impairment Provision for Loans/Financing* dated 6 April 2015.

The revised guidelines were updated to include as follows:

i. Require a banking institution to maintain, in aggregate, loss allowance for non-credit impaired exposures (commonly known as Stage 1 and Stage 2 provisions) and regulatory reserves of no less than 1% of total credit exposures, net of loss allowance for credit-impaired exposures;
(Islamic banks have presented the regulatory reserves in their Unaudited Statement of Changes in Equity)

ii. Additional disclosure in annual financial statements i.e. intercompany charges with a breakdown by types of services received and geographical distribution;
(Islamic banks will present this information in the annual financial statements for the year ending 31 December 2018 accordingly).

iii. Additional disclosure on the placement of funds in an investment account with an Islamic banking institution;

a. Present the placement, as a separate line item in the statement of financial position, as either "investment account placement" or "investment account placement – (asset description)", and
b. Disclose in the explanatory notes the nature of the underlying assets for the investment.

iv. Clarity on the classification of a credit facility as credit-impaired:

a. Where the principle or profit or both of the credit facility is past due for more than 90 days or 3 months. In the case of revolving credit facilities (e.g. Overdraft facilities), the facility shall be classified as credit-impaired where the outstanding amount has remained more than the approved limit for a period of more than 90 days or 3 months.
b. Where the amount is past due or the outstanding amount has been in excess of the approved limit for 90 days or 3 months or less, and the credit facility exhibits weaknesses in accordance with the banking institution's credit risk measurement framework; or
c. When the credit facility is classified as rescheduled or restructured in the Central Credit Reference Information System (CCRIS) in accordance with the CCRIS reporting requirements in Appendix 1 of the revised guidelines.
(Islamic banks have adopted the above classification criteria in deriving the Banks' credit-impaired exposures, which leads to the computation of regulatory reserves and loss allowance for credit-impaired exposures as required in (i) above.)

3.6 BIMB's Accounting Policy on Estimates and Judgement

3.6.1 Probability from the Shariah perspective

The principle of "probability" in accounting and financial reporting from the Shariah perspective refers to the practice of recording a transaction even though the effects of the contract have not yet been entirely concluded (Shafii et. Al, 2013). Although Islam recognises certainty as to the highest level of confidence, the SAC of BNM has resolved that the application of the probability principle in Islamic financial reporting is permissible as it does not contradict the general *Fiqh* principles. Accordingly, BIMB applies the principle of probability in the following manner:

> (d) Use of Estimates and Judgement
>
> The preparation of the financial statements requires management to make judgements, estimates and assumptions that affect the application of accounting policies and the reported amounts of assets, liabilities, income and expenses. Actual results may differ from these estimates. Estimates and underlying assumptions are reviewed on an ongoing basis. Revisions to accounting estimates are recognised in the financial statements in the period in which the estimates are revised and in any future periods affected.

3.6.2 Accrual basis and realisation concept and fair value measurement

In recording revenue, the two main accounting concepts and assumptions - "accrual basis[1]" and "realisation"- must be complied with. Accrual basis is where the effect of a transaction and other events are recognised when it occurs (and not as cash or its equivalent is received or paid) and is recorded in the accounting records and reported in the financial statements of the periods to which it relates. This means the revenue is recognised or recorded if the entity has earned the revenue, irrespective of whether cash is already received or not.

3.6.3 Accrual from the Shariah perspective

The issue as to whether Islamic banks may adopt the "accrual method" to recognise revenue was referred to the SAC. According to Shariah, both cash and accrual methods are acceptable in recognising the revenue due to contemporary commercial practices which have become more diversified and complex. The accrual method is permissible on the basis that a party is entitled to the "realised revenue" even though it has not been received in cash yet. The accrual method, due to its effectiveness in recording credit transactions, is regarded as consistent with Islam that ordains credit transactions (such as sale with deferred payment) to be properly recorded. This is in line with the following verse of the Al-Quran:

> *"O, believers! When you contract a debt from one another for a fixed, put it (its amount and period of repayment) in writing. And let a scribe write it down between you justly (truthfully)"* [Surah al-Baqarah, 282]

Notwithstanding the above, there is no Shariah objection on the adoption of the accrual method and this is consistent with the necessity (*hajah*) that arises from current practices. This is also in line with the following *fiqh* maxim: "*Decrees of a transaction goes around based on the custom of a particular state and ambience of a place*". In addition, the amount of revenue to be recognised or recorded is measured at the "fair value" of the consideration received or receivable (cash to be collected or received in the future).

[1]*Accrual basis - where the effect of a transaction and other events is recognised when it occurs (and not as cash or its equivalent is received or paid) and is recorded in the accounting records and reported in the financial statements of the periods to which it relates.*

Investors and other users use the revenue for making comparisons and investment decisions. It is therefore important for Islamic banking institutions to have a sound accounting treatment for revenue so that it could present relevant and faithfully represented financial information. The materiality of the recognised revenue item must also be taken into account and the point at which revenue is recognised is also a crucial determinant.

For Islamic banks, financing income is recognised in the profit or loss using the effective profit rate method. Income from a sale-based contract is recognised on effective profit rate basis over the period of the contract based on the principal amounts outstanding; whereas income from *Ijarah* lease-based contract is recognised on effective profit rate basis over the lease term.

Due to the inadequacy of MFRS 118 to provide clearer guidance for revenue recognition, specifically on accounting for arrangements with multiple elements, MFRS 15 *Revenue from Contracts with Customers* was developed to overcome this limitation and to provide a common model of the accounting treatment for revenue.

Islamic banking institutions when reporting in the 'Statement of Comprehensive Income', are required to present in the notes, an analysis of income according to types of investments and financing of customers.

SUMMARY

- This chapter highlights the significance of income and expenses as they are used to measure Islamic banks' financial performance.
- It shows the impact of MFRS 9 on classification and measurement of financial instruments and impairment of financial assets.
- It also shows the application of MFRS 15 on revenues from contracts with customers.
- As investors and other users use income and expenses statements for making comparisons and investment decisions, it is important for Islamic banking institutions to have a sound accounting treatment for income and expenses so that it could present relevant and faithfully represented financial information.
- Lastly, it is crucial for Islamic banks to ensure compliance with international or MFRS standard for universality, and for greater comparability and consistency and to comply with Shariah principles relating to recognition, measurement and disclosure of Income and Expenses.

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CHAPTER 9

INTRODUCTION TO TAKAFUL

INTRODUCTION TO TAKAFUL

LEARNING OBJECTIVES

The chapter aims to:

i. explain the differences between takaful and insurance business;
ii. explain and contrast types of takaful;
iii. explain the relationship between takaful participants, takaful funds and takaful operator; and
iv. provide an overview of the financial statements of takaful companies.

1.0 INTRODUCTION

The history of Takaful is believed to have started as far back as in fourteen centuries ago where the first Islamic community practised schemes of cooperative risk sharing associated with long-distance trade. This practice was then evolved into a system of community self-help and financial assistance and been applied until today[1].

As at 31 December 2016, Malaysia has 11 registered direct takaful operators with total net contributions income of RM7,543.6 million[2]. The chart below summarises total net contribution income and net benefits and claims payments for both general takaful and family takaful.

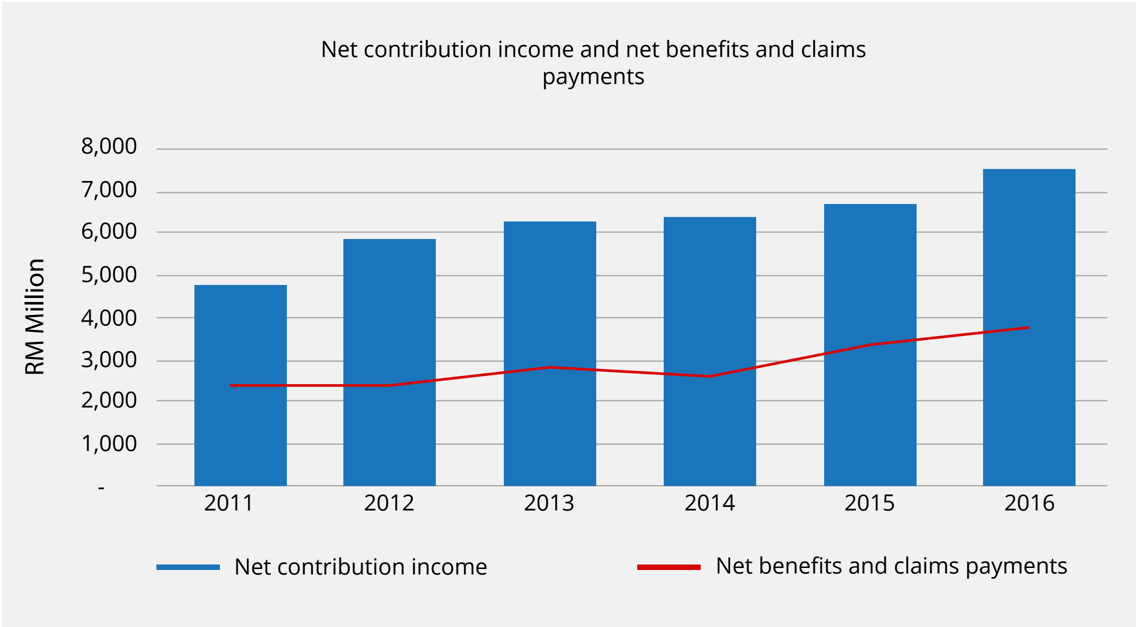

Chart 1: Total net contribution income and net benefits and claims payments from 2011 to 2016

[1] *Prospects for the Evolution of Takaful in the 21st Century by Omar C. Fisher and Dawood Taylor (2000), Proceedings of the Fifth Harvard University Forum on Islamic Finance: Islamic Finance: Dynamics and Development Cambridge, Massachusetts. Center for Middle Eastern Studies, Harvard University available at: http://ifpprogram.com/login/view_pdf/?file=Prospects%20for%20the%20Evolution%20of%20Takaful%20in%20the%2021st%20Century.pdf&type=Project_Publication*
[2] *BNM Annual Takaful Statistic 2016 accessible at http://www.bnm.gov.my/index.php?ch=statistic&pg=stats_takaful&ac=24&lang=en*

2.0 DIFFERENCES BETWEEN TAKAFUL AND CONVENTIONAL INSURANCE

To appreciate takaful business and operation, it is important for readers to understand the differences between conventional insurance and takaful and reasons why conventional insurance is prohibited in Islam.

In the conventional insurance business, customers (or policyholders) would purchase or buy insurance policies from insurance companies to insure or transfer the risk arising from unfortunate events to the insurance company.

In return, policyholders would pay premium periodically to the insurance companies where insurance companies accept their responsibilities to indemnify policyholders when the unfortunate event(s) materialised.

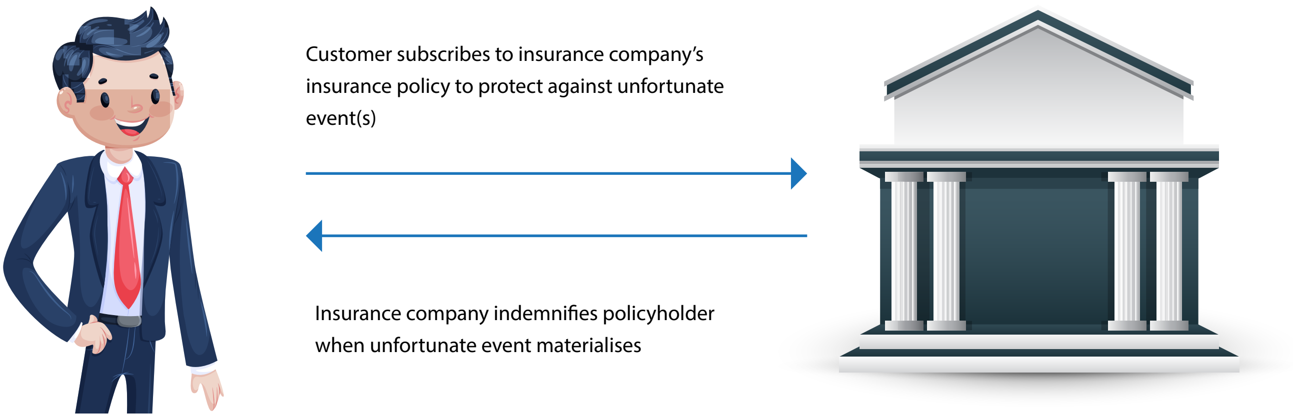

Figure 1: Conventional insurance business

Such business structure is viewed as prohibited in Islam because it involves three prohibited elements as follows:

1. *Riba*' (interest) – it was argued that conventional insurance contract is affected by *riba'* as the premium paid to and the compensation paid by the insurance companies are not equal.
2. *Gharar* (uncertainty) – the *gharar* element existed in conventional insurance contract whereby the subject matter of the contract is uncertain until the unfortunate event has taken place.
3. *Maysir* (gambling) – with regard to *maysir* element, it was argued that conventional insurance scheme contains such element where policyholders are paying a premium on the condition that the insurance companies will indemnify policyholders upon the occurrence of unfortunate events.

Unlike conventional insurance business, takaful business is built based on the concept of mutual responsibility and mutual protection from losses. Under this concept, participants' mutual intention is to protect each other – i.e. to compensate any of the participants who are inflicted with a specific risk from an unfortunate event.

In this way, the whole pool of participants is responsible for one another and the burden inflicted by any participant becomes much lighter. As such, takaful business emphasises on brotherhood among the participants who are willing to help and assist each other at the time of difficulty.

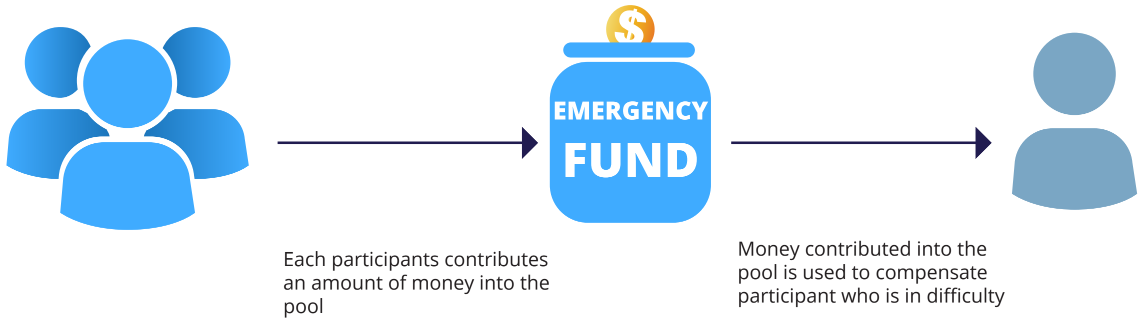

Figure 2: Takaful business

	Takaful	Conventional Insurane
Relationship between participants/policyholders and takaful operator/insurance company	A combination of *tabarru'* (donation) and profit-sharing/wakalah/hybrid contract	Buyer and seller (sale and purchase) where policyholders buy the policy from an insurer to insure their risks
Obligations of the participants/policyholders	To make periodic contributions to mutually participate to assist other participants and where necessary, to pay takaful operator an agent fee and share profit/surplus	To pay premiums to the insurance company for protection
Obligations of the takaful operator/insurance company	To act as an agent to the participants and/or as an administrator of the takaful fund as well as to make the necessary payment of benefits to participants	To pay the policy holders the claims or insured amount as agreed in the policy
Investment of funds	To be invested in Shariah-compliant assets	No restriction on the investment of funds and depending on the risk appetite of the insurance company/policyholder
Return to the takaful operator/insurance company	Return on rendering of services (agent fee, service fee, management service fee) and/or sharing on surplus or profits	Profit from underwriting surplus and investment profit from premium paid by policyholders

Table 1: Difference between takaful and conventional insurance

2.1 TERMINOLOGIES USED IN TAKAFUL BUSINESS

This section introduces terminologies which are commonly used in takaful operation. These terminologies are also used in other takaful chapters when we discuss financial reporting for takaful companies.

2.1.1 PARTICIPANT'S RISK FUND

Participant's risk fund is a fund to credit a portion of the participants' contributions for the purpose of *tabarru'*. Participant's risk fund is used to pay participants' benefits.

2.1.2 PARTICIPANT'S INDIVIDUAL FUND

Participant's Individual Fund (also sometimes known as Participant's Investment Fund) is a fund to credit a portion of the participants' contributions for investment or savings.

2.1.3 TABARRU'

Participant's Individual Fund (also sometimes known as Participant's Investment Fund) is a fund to credit a portion of the participants' contributions for investment or savings.

2.1.4 UNDERWRITING

Underwriting is a process of selecting, assessing, and classifying the degree of risk of an applicant. Underwriting is the most important process in takaful business and unfavourable underwriting results may affect the solvency of the risk fund and the takaful operator's profitability.

Underwriting consideration consists of age, medical and non-medical (e.g. occupation, lifestyle, insurable interest, habits, and personal finances) risk factors.

2.1.5 RIDER

A rider serves as a sweetener to the main takaful product. The rider is an attachment to a certificate that expands its conditions by providing additional benefits for optimum coverage. Example of riders is critical illness, accidental death, accidental medical reimbursement, hospitalisation, Badal hajj and umrah cash booster.

2.1.6 INCURRED BUT NOT REPORTED (IBNR)

IBNR is defined as losses which have occurred but have not yet been reported to the takaful operator as of the date under consideration.

2.1.7 Claims/Benefits

Claims/benefits refer to the notification given to a takaful operator for payment of an amount is due under the terms of the certificate.

2.2 Takaful components

This section discusses the following components involved in takaful business:
- Relationship between takaful participants;
- Types of protection; and
- Relationship between takaful participants and takaful operator

2.2.1 RELATIONSHIP BETWEEN TAKAFUL PARTICIPANTS

In takaful business, participants to the takaful policy are not known to one another and one takaful policy may consist thousands of participants at one time. However, in the spirit of brotherhood and mutual responsibility, takaful participants agree to relinquish or waive their contribution (or a portion of their contribution) for the purpose of providing mutual indemnity to other takaful participants who are in difficulty. The relinquishment or waiver of contribution (or a portion of contribution) can be done through various forms such as donation or endowment.

2.2.2 Type of Takaful Protection

Takaful business is divided into two types of protection which are general takaful and family takaful.

2.2.3 GENERAL TAKAFUL

General takaful contract is normally short-term protection (renewable at certain intervals) where participants contribute for motor takaful protection (e.g. coverage for cars, motorcycles and commercial vehicles) and/or non-motor protection such as home takaful/fire, personal accident and marine coverage.

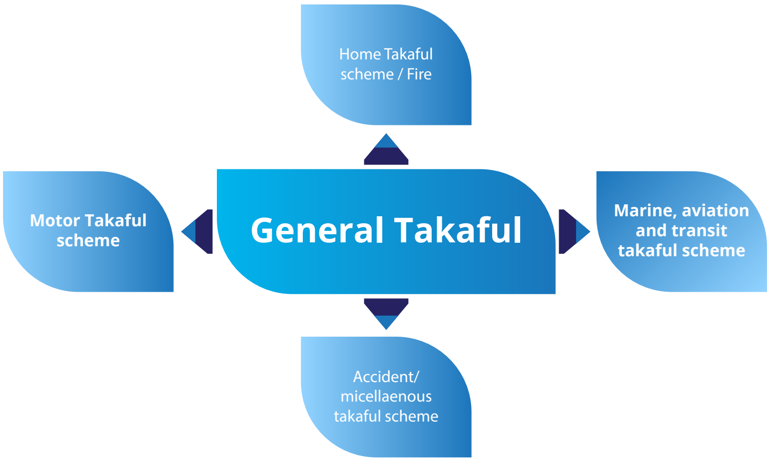

Figure 3: Grouping of general takaful

There are two types of home takaful/fire scheme which are (i) house owner takaful and (ii) householder takaful. Houseowner takaful provides protection on the physical of the house while householders takaful provides coverage for the content of the house.

Motor takaful scheme is the most common takaful scheme involving motorist where it provides two types of coverage to the participants: (i) third party cover – protection against losses to a third party (whether injury or damage to property); and (ii) comprehensive cover – protection against losses to third party as well as to policyholders.

Marine, aviation and transit takaful scheme provides protection on risks involving transportation of goods and people from one location to another.

There are many other takaful products in the market such as workmen compensation takaful, engineering takaful scheme and others[3].

In General Takaful, all contributions made by participants are credited into participants' risk fund (PRF) and be treated as *tabarru'* (donation). This fund is then invested to generate profits and the profits generated from the investments (after deduction of expected participants' claims) will be channelled back into the participants' risk fund.

[3] *Takaful Realities & Challenges (2013), written by Prof Datuk Dr Syed Othman Alhabshi, Prof Dato' Dr Kamaruddin Sharif, Dr Shaikh Hamzah Abdul Razak and Ezamshah Ismail, published by Pearson Malaysia Sdn Bhd.*

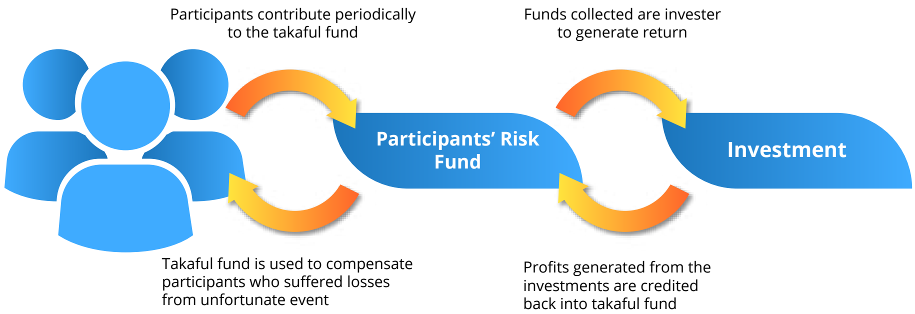

Figure 4: General takaful process

2.2.4 FAMILY TAKAFUL

Family takaful contract is normally a long-term contract where takaful contribution is made for participants' long-term needs such as education and compensation in the event of death, critical illness or disability of the participants.

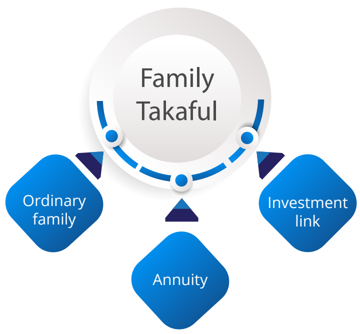

Figure 5: Grouping of family takaful

Ordinary family takaful can either be individual family takaful or group family takaful (employers, clubs, associations and societies). While participants of individual family takaful receive benefits arising from death, permanent disability as well as long terms savings, participants of group family takaful, receive protection for death and permanent disability.

Group family takaful normally requires a minimum number of participants to enrol into the programme. Annuity family takaful provides regular income to the participants on retirement while investment-linked family takaful provides benefits to participants through takaful protection as well as investment profits.

In contrast to general takaful, contributions made by participants for family takaful are divided into two parts where one part will go to participants' investment fund and the second part will go to participants' risk fund based on the concept of *tabarru'*. The split between the two parts varies from one takaful operator to another, depending on the contribution apportionment method applied by the takaful operator.

However, the contribution made into participants' investment fund and participants' risk fund will be invested to generate profits. Participants' investment fund is individually owned by the participant. Similar to general takaful, participants' risk fund in family takaful is used to meet claims on events/risks covered under the takaful contracts.

It should also be noted that the participants' investment fund can also be used to meet future *tabarru'* apportionment into the participants' risk fund when the participants no longer contribute to the participants' risk fund.

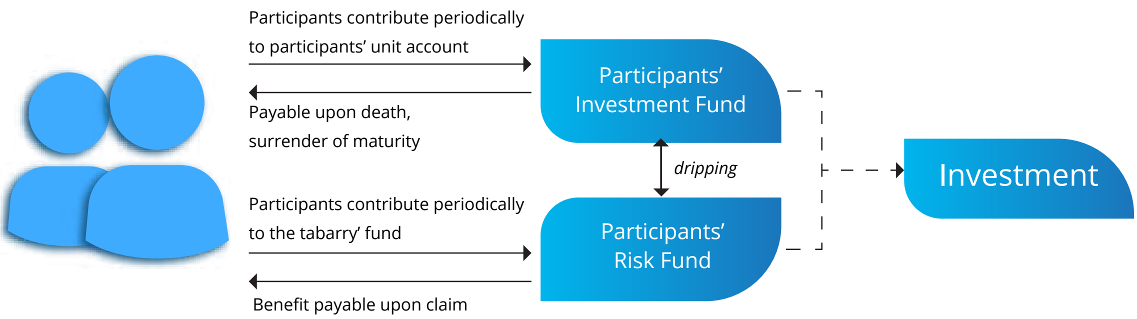

Figure 6: Family takaful process

There are two methods to allocate contribution between participants' investment fund and participants' risk fund. The first method is where the contributions are explicitly split between risk and investment portions.

Under this method, the split for a participant's risk account increases in tandem with the risk factor and is generally more suitable for contracts with moderate duration and moderate sums covered where the risk is not overwhelming. The table below illustrates this method:

Age factor	Contribution (RM)	Risk allocation (RM)	Investment allocation (RM)	Ratio of risk to investment allocation
0-5	160	8	152	5:95
6-10	160	16	144	10:90
11-15	160	24	136	15:85
16-20	160	32	128	20:80

Table 2: Explicit split between the participant's risk fund and investment fund

The other method to allocate contribution between participants' investment fund and participants' risk fund is the 'dripping' method. The drip method is the method where the actual risk contributions will be deducted from the investment fund and paid into the risk fund.

It is important to note that participants' investment fund comprises individual accounts of each participant and serves as a saving element to pay for rising risk in the future. The diagram below illustrates the **'dripping' method**:

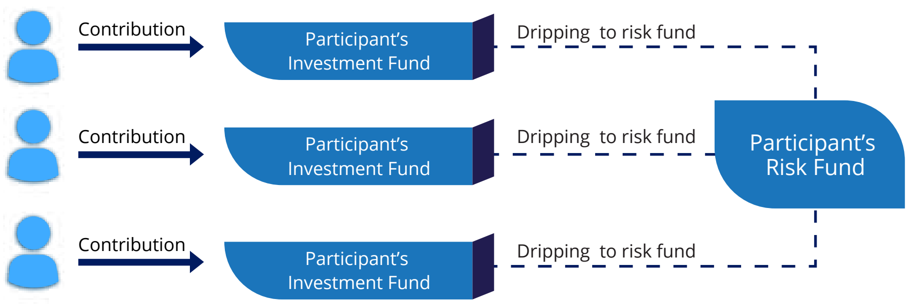

Figure 7: The 'dripping' method

In addition, the dripping method also allows the participant's risk fund to be used to meet future tabarru'/donation into participant's risk fund to ensure continuity on the risk protection when the participants no longer contribute to the participant's risk fund.

The following chart summarises the contribution of both general and family fund assets in Malaysia (takaful fund assets consist of both the participants' investment fund and participants' risk fund).

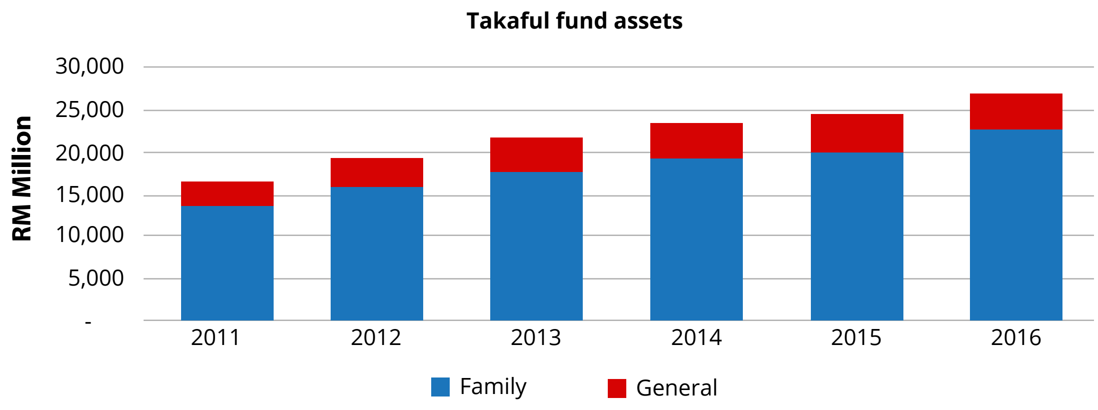

Chart 2: Total asset for general and family takaful from 2011 to 2016

In Malaysia, section 16(1) of the Islamic Financial Services Act 2013 (IFSA 2013) clearly states that a licensed takaful operator, other than a licensed professional retakaful operator, shall not carry on both family takaful business and general takaful business, subject to exception in section 16(2) of IFSA 2013.

This requirement is different from the previous repealed Takaful Act 1984 that allows dual takaful businesses. Section 286 of IFSA 2013 gives a transitional period of 5 years for licensed takaful operators to comply with conversion into a single takaful business – which was due in July 2018.

Bank Negara Malaysia has granted a license to eleven takaful operators to provide takaful services in Malaysia[4] as follows:

1. AIA Public Takaful Bhd
2. AmMetLife Takaful Berhad
3. Etiqa Family Takaful Berhad
   Etiqa General Takaful Berhad
4. Great Eastern Takaful Berhad
5. HSBC Amanah Takaful (Malaysia) Berhad
6. Hong Leong MSIG Takaful Berhad
7. Prudential BSN Takaful Berhad
8. Sun Life Malaysia Takaful Berhad
9. Syarikat Takaful Malaysia Am Berhad
   Syarikat Takaful Malaysia Keluarga Berhad
10. Takaful Ikhlas Family Berhad
    Takaful Ikhlas General Berhad
11. Zurich General Takaful Malaysia Berhad
    Zurich Takaful Malaysia Berhad

[4] *Extracted from BNM's website on 12 March 2019 at http://www.bnm.gov.my/index.php?ch=li&cat=insurance&type=TKF&fund=0&cu=0*

2.3 Relationship between takaful participants and takaful operator

2.3.1 Takaful operator

Takaful operator is established as a legal entity (i.e. a company) incorporated under the Companies Act, 2016 (or Companies Act, 1965) and is regulated by BNM, similar to other financial services industry. Section 2(1) of IFSA 2013 defines takaful business as a business relating to the administration, management and operation of a takaful fund for its takaful participants which may involve elements of investment and savings and includes retakaful business and a reference to carrying on takaful business may include all or any of the activities set out in paragraph 5(4)(a) which includes the following activities:

i. receiving proposals to participate in takaful arrangements;
ii. negotiating on proposals to participate in takaful arrangements on behalf of a takaful operator;
iii. issuing of takaful certificates for takaful arrangements;
iv. collection or receipt of takaful contributions on Takaful
v. settlement or recovery of takaful claims on takaful certificates for takaful arrangements.

The conduct of takaful operator is further detailed out in Takaful Operational Framework, a guideline issued by BNM. This framework outlines the principles of conducting a takaful business in Malaysia. The guideline requires takaful operators to document its operational model which would include the following information:

a. Contract underlying relationship between participants and takaful operator, which includes the limit of profit/surplus that can be shared with the takaful operator.
b. Contract underlying relationship between participants.
c. Fund segregation policy, with details of sub-fund if applicable.
d. Policy on investment strategy and method used for the calculation of investment profit for participants' investment fund.
e. Policy on recognition of surplus/deficit and its allocation/ distribution.
f. Policy on deficit rectification mechanism including the repayment of *Qard*.
g. Remunerations to takaful operator policy and relevant Shariah principle/contract underlying the remunerations.
h. Any other relevant information which is necessary for a holistic understanding of takaful operator's operational model.

The main responsibilities of takaful operators are as follows:

Chart 3: Main responsibilities of takaful operators

2.3.2 Maintain a register of takaful certificates and claims

Takaful certificate is a takaful cover note or any contract of takaful that stipulates the types of risk covered for each participant while takaful claim is a demand for payment of an amount due under a takaful certificate. Takaful operators are required to maintain a register that contains information relating to takaful certificates and claims to ensure proper identification of the liabilities underwritten and processing and validation of liabilities and claims against takaful certificates.

2.3.3 Underwrite of takaful risks

Underwriting process involves measuring risk exposure of the individual participant and determining the premium that needs to be charged with regard to the risk. Takaful operators are responsible to objectively evaluate and assess the underwriting risks and exposures of potential participants, to ensure that risks accepted are within that assumed in pricing the contributions.

2.3.4 Retakaful of takaful risks

IFSA 2013 defines retakaful as *"takaful cover arranged by a takaful operator with a second takaful operator on the risk of the takaful fund it administers, wholly or partly, and includes any similar arrangement by a branch of the takaful operator in Malaysia with its branch outside Malaysia"*. In this regard, all Islamic commercial laws that are applicable to takaful are also applied to retakaful. The main difference is that in retakaful operations, the participants are takaful operators instead of individual policyholders or participants in takaful business.

There are two types of retakaful arrangement which are (1) treaty retakaful and (2) facultative retakaful. Both types of retakaful arrangement which could be either proportional or non-proportional. Under the proportional retakaful, risk is shared proportionally between the takaful operators and retakaful operators as per the amount contributed on the original risk covered. Whereas for non-proportional retakaful, the takaful operators bear all losses up to an agreed amount (deductible level), beyond which all losses (up to an agreed upper limit) are covered by the retakaful operator.[5]

BNM guideline requires takaful operators to ensure the excess risks (risks above the takaful operator's risk appetite) is ceded to the retakaful operator, except in the following circumstances where the takaful risks can be ceded to insurance or reinsurance companies:

- There is no existing takaful or retakaful operator that accepts a particular risk;
- There is no existing takaful or retakaful operator that has the capacity or expertise to accept a particular risk; or
- A retakaful arrangement with existing takaful or retakaful operator willing to accept the risk will be detrimental to the takaful fund.

[5] *ISRA Research Paper No.85/2015 Retakaful: Risk Sharing vs Risk Transfer. An examination from the Shariah Perspective.*

2.3.5 Investment of takaful funds

As explained in the earlier section of this Chapter, the takaful operator is responsible to manage the fund arises from the contribution made by participants. As such, it is important for the takaful operator to have sound investment management to achieve appropriate returns to meet the different objective of the takaful funds and also to ensure that the funds can meet the obligations when takaful benefits fall due, including on surrender and maturity of takaful certificates.

In ensuring takaful operators' fiduciary duty is met, BNM has issued *Guidelines on Investment Management* for Takaful Operators which outlines comprehensive policies that should be observed by takaful operators in managing investment portfolios and the associated risks.

2.3.6 Valuation of liabilities

As takaful operator has the fiduciary duty in the management of takaful fund, it is important for takaful operators to ensure that they have put in sufficient and appropriate provisions for liabilities to ensure that adequate funds would be available to meet all contractual obligations and commitments as they fall due, with a reasonable level of certainty.

To ensure takaful operators observe this responsibility, BNM has issued two guidelines on the valuation of liabilities for takaful operators which are (i) *Guidelines on Valuation Basis for Liabilities of General Takaful Business;* and (ii) *Guidelines on Valuation Basis for Liabilities of Family Takaful Business.*

2.3.7 Claims management

It is important for takaful operators to ensure that proper management of claims is in place including assessment of claims validity (genuine claims), and processing of claims and payment are done promptly without unnecessary delays.

2.4 Relationship between Takaful Participants and Takaful Operators

The earlier section states that the contributions made by takaful participants are systematically managed by takaful operations. There are several takaful models used by takaful operators to manage such takaful contributions (i.e. type of contracts between takaful operator and participants) as follows:

1. Mudarabah (profit-sharing) model;
2. Wakalah (agency model) model;
3. Waqf-based model; and
4. Hybrid model.

Selection of the appropriate takaful model is based on 5 main considerations which are (i) Shariah compliance and governance; (ii) business and technical aspects; (iii) regulatory aspects; (iv) regional acceptance; and (v) target population. The following section discusses the application of the above model/contract in takaful business.

2.4.1 Mudarabah model

In general, under the Mudarabah model, capital provider (known as *rabbul mal)* contributes capital to another person who will manage the capital within the approved mandate (known as *mudarib*), for the purpose of sharing the profit according to the agreed ratio.

Applying the Mudarabah model in takaful business, participants (as capital provider) contribute an amount of money periodically (takaful premium/contributions) to the takaful fund. Participants also agreed for takaful operator to manage the takaful fund, including investing the takaful contribution received to generate return and payment of claims to participants in the event of misfortune.

Any investment profit or underwriting surplus generated from the takaful fund will be shared based on the agreed profit-sharing ratio between participants and takaful operator.

Figures below illustrate the application of the Mudarabah model in both general takaful and family takaful business.

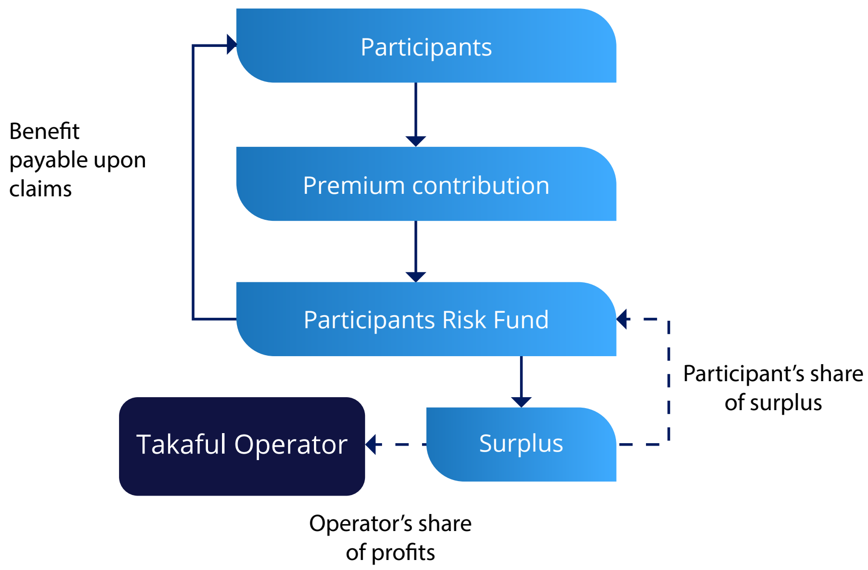

Figure 8: General takaful under Mudarabah model

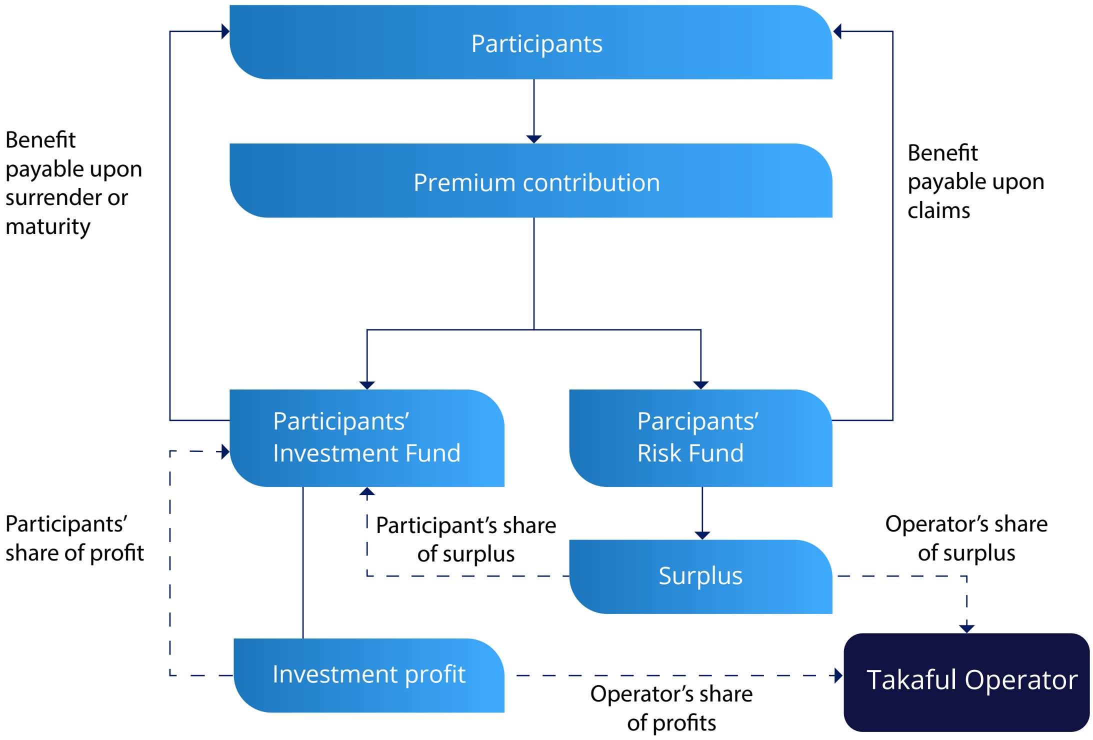

Figure 9: Family takaful under Mudarabah model

2.4.2 Wakalah model

As Wakalah is an agency model, participants are the owner of the takaful fund where takaful operator is appointed as an agent to manage the takaful fund based on determinable (or pre-agreed) agency fee. The agency fee is normally deducted or paid upfront from the contributions received. In addition to pre-agreed agency fee, takaful operator is also remunerated with performance fee (i.e. commission) on an agreed percentage when the fund meets certain expected performance agreed upfront with the participants.

Figures 10 and 11 illustrate the application of wakalah model in general and family takaful.

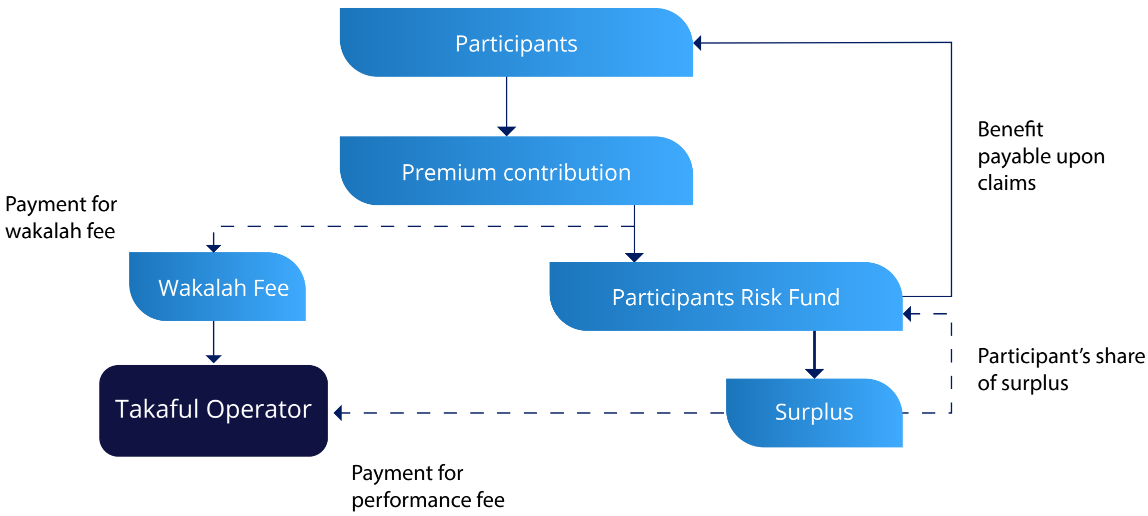

Figure 10: General takaful under Wakalah model

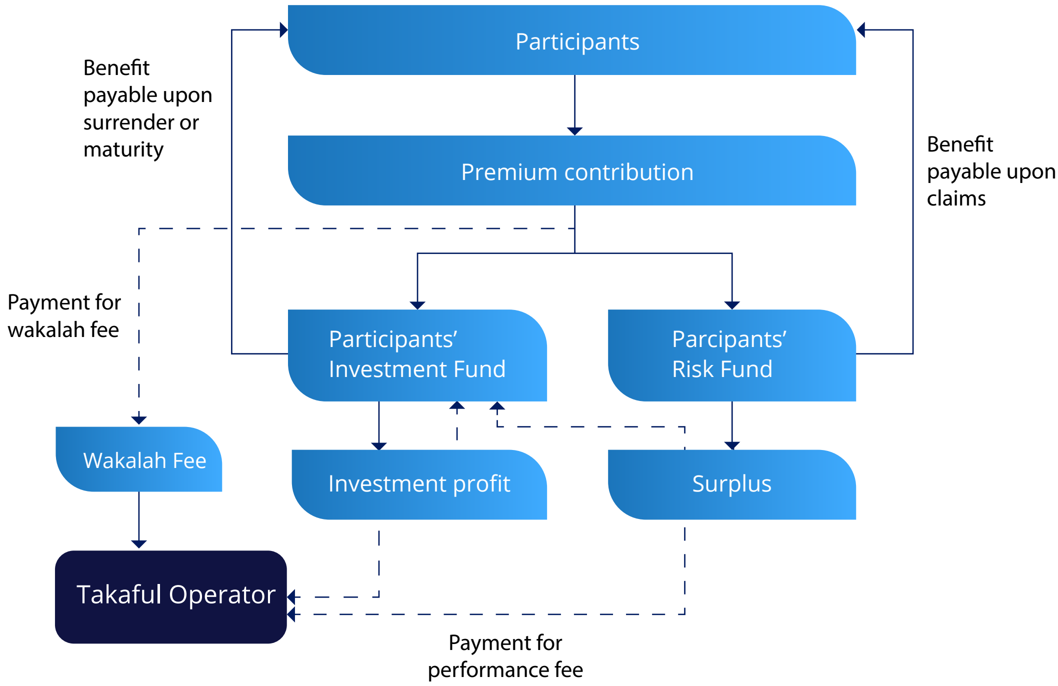

Figure 11: Family takaful under Wakalah model

In a typical takaful wakalah model, the wakalah fee payable to takaful operator is made from the periodic contribution made by participants and such fee has no bearing on the performance of the takaful fund (i.e fixed fee regardless whether the takaful fund makes a profit).

Also, the periodic contribution made is also subject to other fees such as service charges and asset management charges payable to the takaful operator for acting on behalf of the participants.

2.4.3 Waqf model

Waqf model is relatively a new model to takaful business and this model has emerged from Pakistan[6] where the concept is designed to enable participants to save money in the fund that can be left as donation. The contribution made by participants is treated as the property of the Waqf fund which can only be used for the benefit of all the participants.

Under this structure, takaful operator is appointed by participants to manage the fund and accordingly, earn wakalah fee or share of profits. Figure 10.12 below illustrates the mechanism of Waqf model.

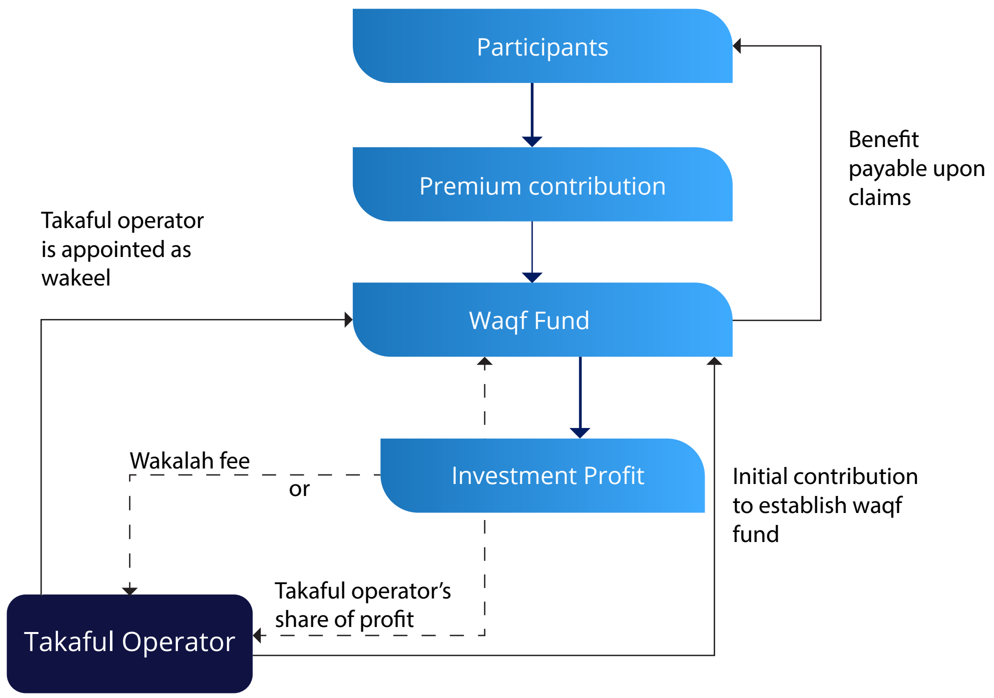

Figure 12: Structure for Waqf model

[6] *Chapter 12: Takaful and Retakaful, Islamic Financial System: Principles and Operations (2nd Edition), ISRA, 2016, Kuala Lumpur*

2.4.4 Hybrid model

Under the hybrid model, takaful business is structured in a combination of two of the previous models, either:

a. Wakalah and mudarabah model;
b. Wakalah and Waqf model; or
c. Mudarabah and Waqf model

Figures below illustrate the typical structure of a hybrid model for reference:

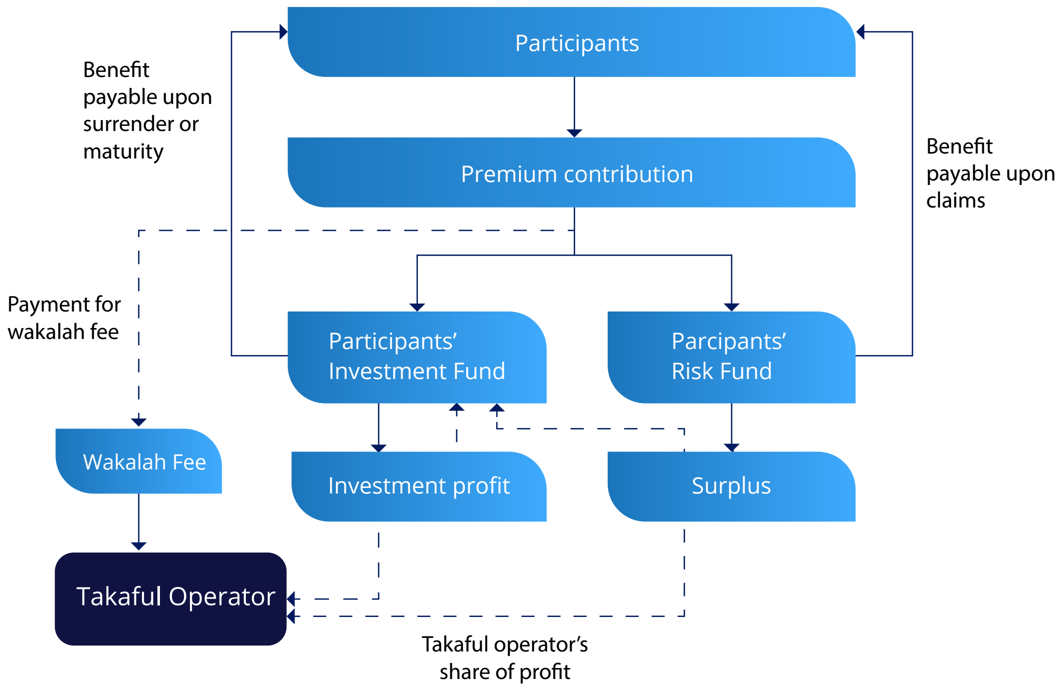

Figure 13: Structure for Wakalah and Mudarabah hybrid model

It is noted that under the Wakalah and Mudarabah hybrid model, takaful operator is entitled to both Wakalah fee for acting as the agent for participants to administer participants' investment and risk funds as well as a share of profits for being a mudarib in managing the participants' investment fund.

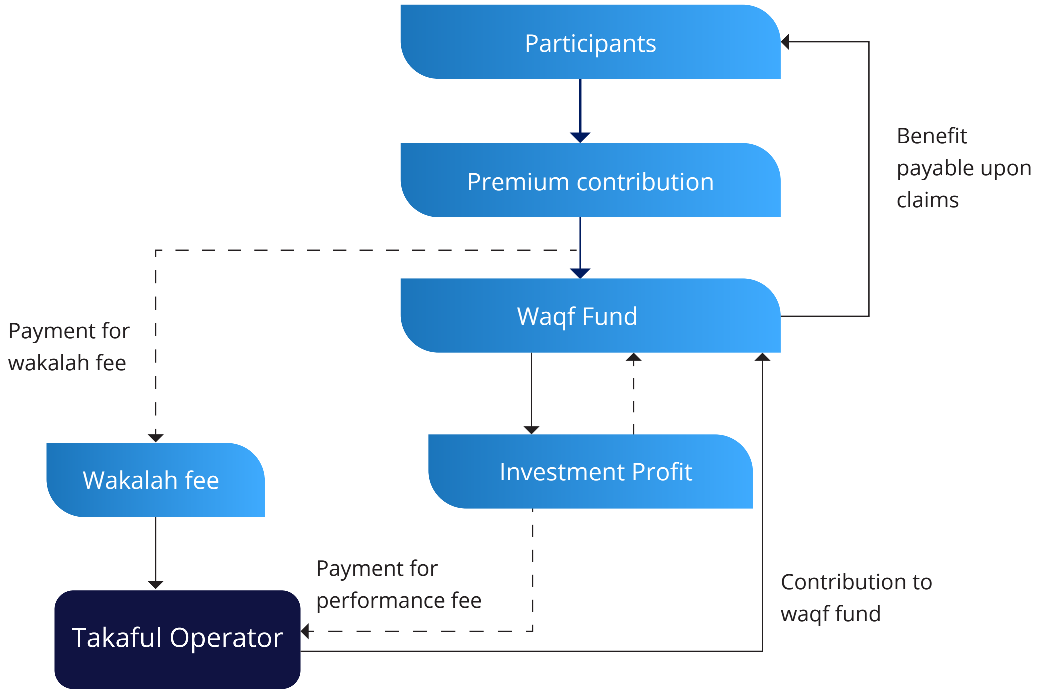

Figure 14: Structure for Wakalah and Waqf hybrid model

Under the Wakalah and Waqf hybrid model, both the shareholders of takaful operator and participants contribute capital to the Waqf fund. However, the contributions made by participants is first, be deducted for Wakalah fee payable to the takaful operator who acts as an agent for the participants.

The contributions made by the shareholders and participants are then be invested in financial assets to generate profits. Profits from those investments are credited back to the Waqf fund and given to takaful operator as performance incentive if they exceeded the performance expectation on investment. At the same time, the Waqf fund is also used to pay any benefit claims made by participants.

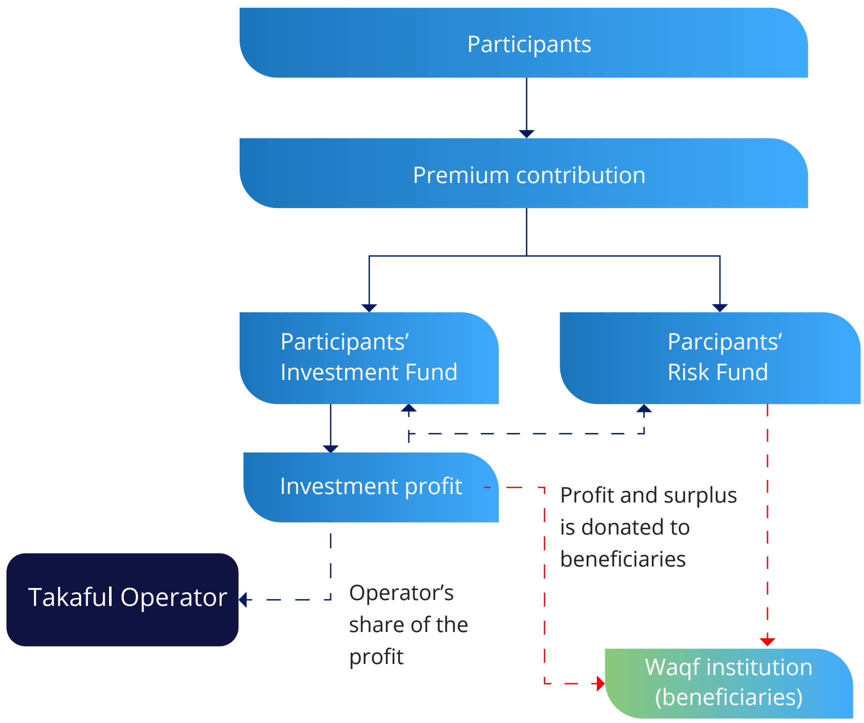

Figure 15: Structure for Mudarabah and Waqf hybrid model

The Mudarabah and Waqf hybrid model is normally used to allow participants to accumulate the desired amount of fund that can be left as a donation under the Waqf system either upon maturity of Waqf plan or unexpected death of the participant.

As noted in Figure 15 above, the contributions made by participants in the Mudarabah and Waqf hybrid model is divided into two pools, participants' investment fund and participants' risk fund. The contribution made to participants' investment fund is managed by takaful operator under the Mudarabah principle and as such, any profits from the investment of participants' investment fund is shared between takaful operator and participants based on agreed profit-sharing ratio.

On the other side, participants' share of profit from the investment is credited back to the participants' investment fund and a small portion of it is credited into participants' risk account. The contribution made by participants in both participants' investment account and participants' risk account is utilised in two different scenarios:

a. Upon maturity of the Waqf plan, the takaful operator will pay the Waqf beneficiary the balances from both participants' investment fund and participants' risk fund; and

b. In the event of the death of any participant before the maturity of his/her Waqf plan, takaful operator will pay Waqf beneficiary the takaful benefits from the participant's investment fund and total participant's tabarru' (paid and unpaid) amount.

c. The unpaid tabarru' amount is coming from other participants of the plan who are still alive. This approach will allow the deceased participant to fulfil his/her wishes to contribute the agreed amount for Waqf purpose with the help of other surviving participants.

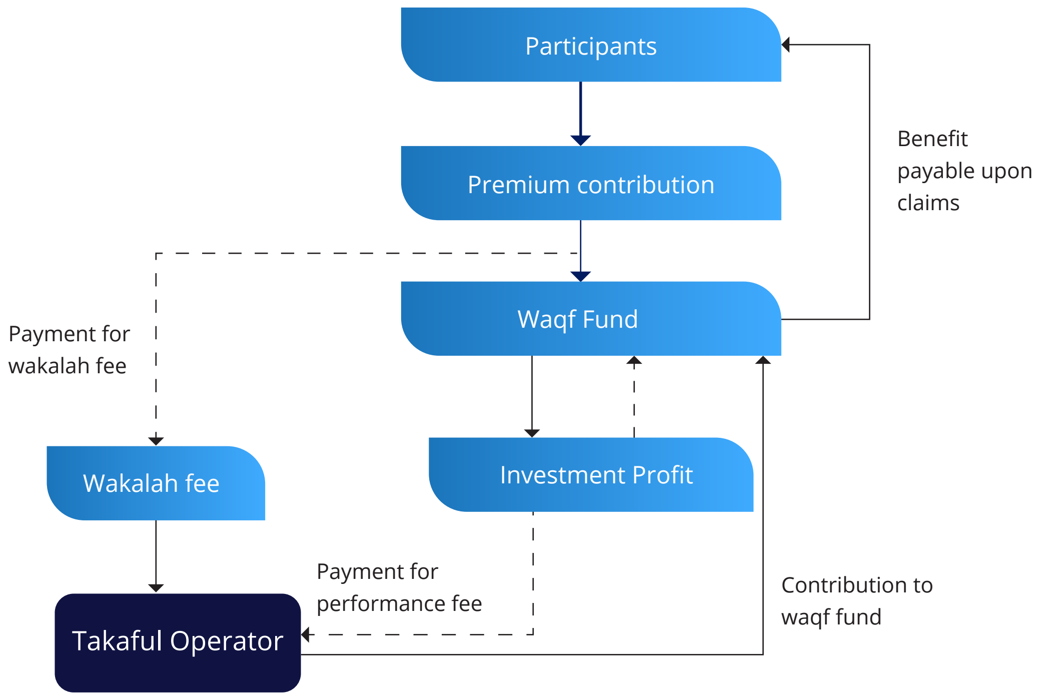

Figure 14: Structure for Wakalah and Waqf hybrid model

Under the Wakalah and Waqf hybrid model, both the shareholders of takaful operator and participants contribute capital to the Waqf fund. However, the contributions made by participants is first, be deducted for Wakalah fee payable to the takaful operator who acts as an agent for the participants.

The contributions made by the shareholders and participants are then be invested in financial assets to generate profits. Profits from those investments are credited back to the Waqf fund and given to takaful operator as performance incentive if they exceeded the performance expectation on investment. At the same time, the Waqf fund is also used to pay any benefit claims made by participants.

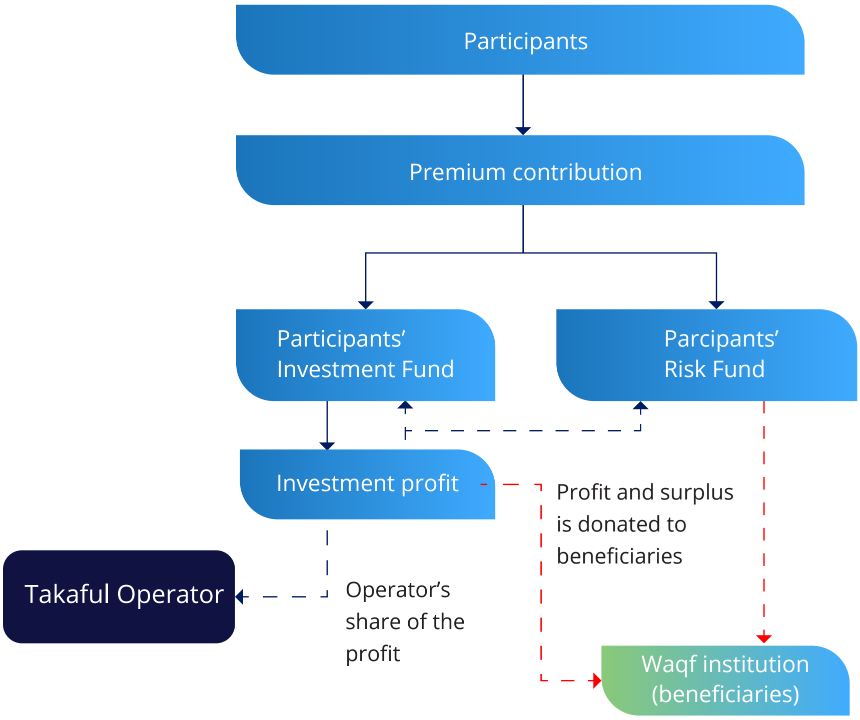

Figure 15: Structure for Mudarabah and Waqf hybrid model

The Mudarabah and Waqf hybrid model is normally used to allow participants to accumulate the desired amount of fund that can be left as a donation under the Waqf system either upon maturity of Waqf plan or unexpected death of the participant.

As noted in **Figure 15** above, the contributions made by participants in the Mudarabah and Waqf hybrid model is divided into two pools, participants' investment fund and participants' risk fund. The contribution made to participants' investment fund is managed by takaful operator under the Mudarabah principle and as such, any profits from the investment of participants' investment fund is shared between takaful operator and participants based on agreed profit-sharing ratio.

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b. In the event of the death of any participant before the maturity of his/her Waqf plan, takaful operator will pay Waqf beneficiary the takaful benefits from the participant's investment fund and total participant's *tabarru'* (paid and unpaid) amount.

The unpaid *tabarru'* amount is coming from other participants of the plan who are still alive. This approach will allow the deceased participant to fulfil his/her wishes to contribute the agreed amount for Waqf purpose with the help of other surviving participants.

2.5 The role of Qard in takaful model

Qard is a loan given by takaful operators when there is a deficit in participants' risk fund (normally is *Qard Hassan* (interest-free loan)). In Malaysia, Guidelines on Takaful Operational Framework issued by BNM on 26 June 2013 requires takaful operators to rectify the deficit (i.e. where the assets of the participants' risk fund are insufficient to meet the liabilities) via *Qard* from shareholder's fund.

The *Qard* given is expected to be repaid from the excess of assets over liabilities arising in the participants' risk fund in the future years.

2.6 Financial reporting framework for takaful companies

As explained in the earlier section of this Chapter, takaful companies are under the purview of BNM and as such, by virtue of that, need to prepare their financial statements under the Malaysian Financial Reporting Framework (MFRS). This is consistent with the clarification by the Malaysian Accounting Standards Board (MASB) where a company that needs to submit their financial statements to BNM is required to apply MFRS.

The earlier section has also explained the very different nature of the takaful business as compared to the conventional insurance business. Conventional insurance companies use MFRS 4 *Insurance Contracts* to account insurance contracts. However, there was a debate on whether MFRS 4 can be applied to takaful contracts, particularly because of the risk-sharing feature in takaful contracts. MFRS 4 defines insurance contracts as:

> *"A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder."*

One school of thought argue that takaful contracts do not fall under the above definition which emphasises on risk-transfer from customer to insurance company in the conventional insurance business.

However, for those who support that takaful contracts still fall under MFRS 4 believe that (i) the risk-sharing feature in takaful contracts is similar to mutual insurance, which is within the scope of MFRS 4; and (ii) regulations requiring a takaful operator to provide financial assistance to 'top-up' deficits in participants' funds may indirectly, and effectively, expose the takaful operator to insurance risk[7].

Because of these considerations, the Asian-Oceanian Standard-Setters Group (AOSSG) in its research paper on *Financial Reporting Issues relating to Islamic Finance* issued in 2010 concludes that takaful contracts would also be subject to MFRS 4.

Applicability of financial reporting standards to takaful companies

As explained above, takaful companies are no different with other business entities which need to prepare financial statements under the MFRS framework. As at the date of writing this Chapter, all standards under the MFRS framework are applicable to takaful companies except for the following:

a. MFRS 9 *Financial Instruments*

Beginning 1 January 2018, all companies under the MFRS framework need to apply MFRS 9 to account for its financial instruments. MFRS 9 replaces MFRS 139 *Financial Instruments: Recognition and Measurement*. Among the significant changes introduced in MFRS 9 are:

i. <u>Classification and measurement of financial assets and liabilities</u>

MFRS 9 requires an entity to classify its financial assets based on the business models within which they are held as well as their contractual cash flow characteristic. As such, the previous four classifications of financial assets under MFRS 139 (i.e. financial asset at fair value through profit or loss, held-to-maturity, loans and receivables and available-for-sale) are no longer available under MFRS 9.

Under MFRS 9 financial assets are classified and measured as either at amortised cost, at fair value through other comprehensive income or at fair value through profit or loss.

In relation to classification and measurement of financial liabilities, in cases where fair value option is applied, MFRS 9 requires the fair value change due to entity's own credit risk to be recorded in other comprehensive income rather than in profit or loss, unless this creates an accounting mismatch.

ii. <u>Impairment methodology</u>

MFRS 9 replaces the 'incurred loss model' in MFRS 139 with the 'expected credit loss model'. Under the expected credit loss model, an entity is required to recognise loss allowance for a financial instrument at an amount equal to the 12-month expected credit losses or lifetime expected credit losses. Impairment methodology introduces under MFRS 9 also emphasises on forward-looking information to reflect instruments' expected credit losses.

iii. <u>Hedge accounting</u>

MFRS 9 aligns hedge accounting more closely with risk management, establishes a more principle-based approach to hedge accounting and addresses inconsistencies and weaknesses in the hedge accounting model in MFRS 139.

Unlike other business entities, takaful companies have an option to defer the application of MFRS 9, mainly to reduce the temporary volatility in reported results in applying MFRS 9 before the application of the new insurance standard, MFRS 17 Insurance Contracts.

As such, takaful companies have an option not to apply MFRS 9 until 2022 (i.e. the expected effective date of the new insurance standard) if they are eligible for deferral approach. Following this, some of the takaful companies are applying MFRS 9 and some may still apply MFRS 139 for its financial instruments.

b. <u>MFRS 17 Insurance Contracts</u>

As at the date of writing this textbook, MFRS 17 is effective for the financial period beginning on or after 1 January 2021. As such, all takaful companies are still applying the existing insurance standard, which is MFRS 4. *Discussion* on the application of MFRS 17 is covered specifically under Chapter 15 Future Consideration.

[7] AOSSG Research Paper titled "Financial Reporting Issues relating to Islamic Finance" issued in 2010. The research paper is accessible at: http://www.aossg.org/index.php?option=com_content&view=article&id=42&Itemid=35

2.7 Presentation of financial statements of takaful companies

Generally, the presentation of primary financial statements of takaful business are similar to the presentation of primary financial statements of the conventional insurance business, except for the statement of financial position, statement of profit or loss and comprehensive income as well as a statement of changes in equity.

The presentation of statement of financial position, statement of profit or loss and comprehensive income and statement of changes in equity of takaful business is prepared based on a columnar basis where takaful operator is required to present the three statements for each takaful fund, takaful operator and takaful company.

The table below illustrates the presentation of statements of financial position and statements of profit or loss and other comprehensive income in the financial statements of a composite takaful company (i.e. before the license split requirement).

	Takaful operator RM'000	Family takaful fund RM'000	General takaful fund RM'000	Company RM'000
ASSETS				
Property and equipment	22,602	—	—	22,602
Intangible assets	15,738	—	—	15,738
Investments	216,005	1,9555,949	—	2,170,561
Deferred tax assets	745	—	65	810
Retakaful assets	—	14,518	562	15,080
Takaful receivables	—	—	71	71
Trade and other receivables	169,974	14,583	55	37,385
Current tax assets	8,111	—	—	8,111
Cash and bank balances	27,611	142,532	24.201	194,344
Total assets	**460,786**	**2,127,582**	**24,954**	**2,464,702**
EQUITY, LIABILITIES AND PARTICIPANTS' FUNDS				
Equity				
Share capital	58,824	—	—	58,824
Reserves	195,101	—	—	195,101
Total equity	253,925	—	—	253,925
Liabilities and Participants' Funds				
Participants'funds	—	1,877,452	8,751	1,884,810
Takaful contract liabilities	—	52,201	11,493	63,694
Provision for wakalah fees	29,697	—	—	29,697
Takaful payables	—	13,175	1,092	14,267
Trade and other payables	177,164	177,169	3,353	210,459
Current tax liabilities	—	3,811	265	4,076
Deferred tax liabilities	—	3,774	—	3,774
Total liabilities and participants' funds	206,861	2,127,582	24,954	2,210,777
Total equity, liabilities and participants' fund	460,786	2,127,582	24,954	2,464,702

Table 3: Extract of Statements of Financial Position of Prudential BSN Takaful Berhad for the financial year ended 31 December 2016

	Takaful operator RM'000	Family takaful fund RM'000	General takaful fund RM'000	Company RM'000
Operating revenue	633,026	1,402,445	9,231	1,426,550
Wakalah fee income	617,659	—	—	—
Gross contributions	—	1,364,708	8,618	1,372,833
Contributions ceded to retakaful	—	(33,131)	(1,447)	(34,578)
Increase in unearned contribution reserves	—	—	(2,515)	(2,515)
Net unearned contributions	—	**1,331,577**	**4,656**	**1,335,740**
Surplus sharing from family takaful fund	47,500	—	—	—
Investment income	15,367	37,737	613	53,717
Realised gains/(losses)	(871)	2,838	—	1,967
Fair value gains/(losses)	1,035	(35,241)	—	(34,206)
Other operating income	308	3,670	247	4,225
Other income	**63,339**	**9,004**	**860**	**25,703**
Gross benefits and claims incurred	—	(464,672)	(834)	(465,506)
Claims ceded to retakaful	—	20,973	151	21,124
Gross change to contract liabilities	—	17,921	212	18,133
Change in contract liabilities ceded to retakaful	—	5,785	5	29,697
Net benefits and claims	—	**(419,993)**	**(466)**	**(420,459)**
Surplus sharing to takaful operator	—	(47,500)	—	—
Wakalah fee expense	—	(614,941)	(2,718)	—
Management expenses	(285,956)	—	—	(285,956)
Commission expenses	(315,123)	—	—	(315,123)
Decrease/(increase) in provision for wakalah fees	34	—	—	34
Other operating expenses	(11,124)	(4,652)	—	(15,776)
Other expenses	**(612,169)**	**(667,093)**	**(2,718)**	**(616,821)**
Surplus attributable to participants before taxation	—	253,495	2,332	—
Tax expense attributable to participants	—	(1,172)	(596)	(1,768)
Surplus distributed to participants	—	(10,778)	—	(10,778)
Net surplus attributable to participants	—	**(241,545)**	**(1,736)**	**(242,788)**
Profit before zakat and taxation	68,829	—	—	68,829
Zakat	(2,401)	—	—	(2,401)
Tax expense	(15,289)	—	—	(15,289)
Net profit and total comprehensive income for the year	51,139	—	—	51,139

Table 4: Extract of Statements of profit or loss and other comprehensive income of Prudential BSN Takaful Berhad for the financial year ended 31 December 2016

	Non-distributable Takaful operator		← Distributable Retained earnings →				
	Share capital RM'000	Share Premium RM'000	Takaful operator RM'000	Family takaful fund RM'000	General takaful fund RM'000	Company RM'000	Total RM'000
At 1 January 2015	58,824	41,176	92,589	-	-	92,589	192,580
Net profit and total comprehensive income for the year	-	-	10,197	-	-	10,197	10,197
At 31 December 2015/1 January 2016	58,824	41,176	102,786	-	-	102,786	202,786
Net profit and total comprehensive income for the year	-	-	51,139	-	-	51,139	51,139
At 31 December 2016	**58,824**	**41,176**	**153,925**	-	-	**153,925**	**253,925**

Table 5: Extract of Statement of changes in equity of Prudential BSN Takaful Berhad for the financial year ended 31 December 2016

The columnar presentation is driven mainly by the requirement in the Guidance on Special Matter No. 2 *Presentation of Financial Statements for Takaful Companies and Classification and Measurement of Qard* (Guidance on Special Matter No. 2) issued by the Malaysian Institute of Accountants (MIA) in 2013.

Presentation of financial statements of takaful companies

The columnar presentation recommended by the Guidance on Special Matter No. 2 addresses the expectations by both BNM guideline on *Financial Reporting for Takaful Operators* and the requirements in MFRS. For instance, paragraph 10.5(b) of the guideline requires a takaful operator to present the assets and liabilities of the takaful fund separately from the assets and liabilities of the takaful operator.

However, MFRS 10 *Consolidated Financial Statements* requires a takaful operator to consolidate the results of takaful fund when takaful operator could demonstrate its control over the respective takaful fund. Based on the table above, the financial positions of the takaful operator is presented in the first column, the general and family takaful funds represent the financial position of the takaful funds and the last column represents the consolidated result of the takaful company based on MFRS 10.

Classification of Qard

The columnar presentation is also prepared to reflect the Qard (interest-free loan) transaction between the takaful operator and the takaful fund. BNM guideline requires a takaful operator to provide loan to takaful funds via Qard when the assets of takaful funds are insufficient to meet their liabilities. This is also consistent with the requirement in section 95 of the IFSA 2013 which state that "*where the value of the assets of the takaful fund is less than the value specified under paragraph 92(1)(b), the licensed takaful operator shall provide qard or other forms of financial support to the takaful fund from the shareholders' fund for an amount and on such terms and conditions as may be specified by the Bank*".

Again, the AOSSG in its research paper on Financial Reporting Issues relating to Islamic Finance highlighted that there were three main views on how Qard should be treated in the financial statements of takaful companies which are:

a. Qard to be treated as an expense of the takaful operator – Under this view, Qard is viewed as an operational cost of engaging in takaful and repayment is not expected. Hence, Qard should be treated as an expense.

b. Qard to be treated as equity of takaful operator in the fund – Under this view, Qard is treated as an investment in a subsidiary because takaful operator has control over the fund.

c. Qard to be treated as a financial instrument – Supporters of this approach argue that takaful operator, like other businesses, would expect Qard to be repaid from a fund's surplus irrespective of the tenure of the Qard. Moreover, supporters insist that participants should ultimately bear the risks of takaful, and therefore participants have a liability to repay the Qard.

In Malaysia, the guidance on Special Matter Guidance No. 2 clarifies that Qard given to takaful funds is in substance, an investment by the takaful operator as it carries more features of an equity instrument rather than a debt instrument based on the following factors:

a. The recoverability of Qard is dependent on the performance of the underlying assets and liabilities of the takaful fund;
b. Qard is only provided in specific circumstances – i.e. when the takaful fund has a shortfall of assets to cover its obligations;
c. There is no fixed repayment period;
d. Qard acts as a temporary capital to determine that the takaful fund will be able to continue as a going concern and provides returns to the operator via profit sharing or management fee arrangement; and
e. Qard is subordinated below other liabilities of takaful fund as it can only be refunded via surplus assets of the takaful fund.

Detailed discussion on the accounting treatment for Qard will be covered in **Chapters 10** and **11**.

SUMMARY

- This chapter has provided readers with an overview of takaful, the difference between Takaful and insurance, differences between family and general takaful as well as the relationship between participants, takaful funds and takaful operator.
- This chapter also analyses different types of takaful models and takaful products available in the markets.
- In addition, this chapter introduces an overview of financial reporting for takaful companies.
- The next few chapters will further discuss in detail the items available in the financial statements of takaful companies and the financial reporting consideration.

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CHAPTER 10

FINANCIAL REPORTING OF ASSETS BY TAKAFUL OPERATORS

FINANCIAL REPORTING OF ASSETS BY TAKAFUL OPERATORS

LEARNING OBJECTIVES

The chapter aims to:

i. explain the definition of an asset in the context of a takaful operator.
ii. provide analysis of different types of assets as reported by the takaful operators in Malaysia.
iii. provide overview of the accounting standards applied for financial reporting of assets by the takaful operators in Malaysia.
iv. provide clarification on columnar presentation of assets by the takaful operators in Malaysia.

1.0 INTRODUCTION

Similar to Islamic banks, takaful operators apply the asset definition provided in Paragraph 4.2 of *The Conceptual Framework for Financial Reporting* (hereinafter, *Conceptual Framework*) (2018). It defines an asset as a present economic resource controlled by the entity as a result of past events. An economic resource is a right that has the potential to produce economic benefits.

Three key conditions can be identified from the above definition in recognition of an asset by a takaful operator. These are:

i. **Control:** The takaful operator must have control over the asset. Control usually arises from the entity's ability to enforce legal rights. However, control can also arise if the entity has other means of ensuring that it, and no other party, has the present ability to direct the use of the economic resource and obtain the benefits that may flow from it[1].

ii. **Result of a past event:** An asset must be a result of a past event[2]. This means that an item cannot be recognised as an asset if it will be a result of a future event.

   For example, a takaful operator's commitment to purchase an asset in the future will not result in recognition of that asset at the time of commitment. In this case, the asset can only be recognised in the balance sheet of the takaful operator once the purchase transaction is completed.

iii. **Future economic benefits expected:** The economic benefit might be received by using the asset, by selling it for cash, by exchanging it for another asset, or by exchanging it for a decrease in liability or equity.

   For example, a computer equipment is an asset as future economic benefits from this will flow to the entity while the employees will be using it for the purposes of its business. To recognise an item as an asset, the entity need not be certain, or it need not be even likely that the item will produce economic benefits. It is sufficient that the item has the potential to produce economic benefits and the entity has right over it[3].

[1] *Paragraph 4.22 of Conceptual Framework, 2018.*
[2] *Paragraph 4.42 of Conceptual Framework, 2018*
[3] *Paragraph 4.14 of Conceptual Framework, 2018*

For the purposes of financial reporting, the management of the takaful operators often applies certain estimates and judgements. These are based on their best knowledge of current events and actions. The accounting standards, as well as regulatory pronouncements, also assist them in applying reasonable estimates and sound judgements. Similar to financial reporting of other components of the financial statements, these estimates and judgements affect the reported amounts of assets, contingent assets and their disclosures.

The users of financial statements should also note that the amounts presented in the financial statements are not always a verbatim reflection of actual events. The actual results may differ than what is reported in the financial statements.

For example, a takaful operator may have reported a receivable amount of RM1,000,000 in its assets as there was no indication that the customer will default. However, the customer eventually defaulted and the takaful operator managed to recover only a portion of the receivables reported. This means that the receivables previously reported were overstated due to unavailability of future information at the time of reporting.

Nonetheless, as explained in Chapter 9, the unique nature of financial reporting practices of takaful operators in Malaysia is that they present shareholders' fund and takaful funds separately, i.e. each fund as a single economic entity. Each fund at their own rights can recognise assets and liabilities. This is known as segregation of fund concept, which follows Section 91 of the Islamic Financial Services Act (IFSA) 2013. The separate balances are then consolidated by eliminating inter-fund balances and transactions. Examples 1 and 2 show presentation of assets in the statement of financial position of Etiqa General Takaful and Etiqa Family Takaful respectively.

Etiqa General Takaful Berhad
Unaudited Condensed Interim Statement of Financial Position[4]

As at 30 June 2018

		30 June 2018		
		Shareholder's fund	**General takaful fund**	**Company**
	Note	**RM'000**	**RM'000**	**RM'000**
Assets				
Property, plant and equipment		—	—	—
Intangible assets		**1,074**	—	**1,074**
Investments	13	**1,054,627**	1,598,306	**2,652,933**
Retakaful assets	14	—	268,261	**268,261**
Takaful receivables		—	100,694	**100,694**
Other receivables		**67,881**	17,876	**85,757**
Deferred tax assets		**3,211**	6,575	**9,786**
Current tax assets		—	3,883	**3,883**
Cash and bank balances		**7,474**	48,732	**56,206**
Total assets		1,134,267	2,044,327	3,178,594

Example 1: Presentation of Assets by Etiqa General Takaful

[4]Unaudited report is used to provide the latest available information at the time of writing. The components presented here are expected to remain the same in the audited statement.

Etiqa Family Takaful Berhad **Unaudited Condensed Interim Statement of Financial Position** **As at 30 June 2018**				
		30 June 2018		
		Shareholder's fund	**Family takaful fund**	**Company**
	Note	**RM'000**	**RM'000**	**RM'000**
Assets				
Property, plant and equipment		**774**	—	**774**
Intangible assets		**4,568**	—	**4,568**
Investments	13	**2,094,959**	9,733,691	**11,803,672**
Financing receivables		**17,132**	—	**17,132**
Retakaful assets	14	—	63,915	**63,915**
Takaful receivables		—	121,129	**121,129**
Other receivables		**63,517**	298,161	**351,078**
Deferred tax assets		**13,541**	17,810	**31,351**
Current tax assets		**29,296**	20,213	**49,509**
Cash and bank balances		**16,852**	77,608	**94,460**
Total assets		2,240,639	10,332,527	12,537,588

Example 2: Presentation of Assets by Etiqa Family Takaful

The elimination of inter-fund balances and transactions in the consolidation process means that the sum of individual fund columns may not be always equal to the amount presented in the aggregate or company column.

Accordingly, Table 1 shows that it is common among the takaful operators in Malaysia that the sum of assets reported in individual fund columns is not equal to the amount presented in the company column.

No.	Takaful operators in Malaysia	Shareholder's fund	General takaful fund	Family takaful fund	Total	Company	Differences
		(A)	(B)	(C)	(D) = (A+B+C)	(E)	(D-E)
		RM'000	RM'000	RM'000	RM'000	RM'000	RM'000
1	AIA Public	**201,989**	—	**915,976**	1,117,965	**1,042,006**	75,959
2	AmMetLife	**77,036**	—	**216,690**	293,726	**276,834**	16,891
3	Etiqa - General	**1,134,267**	2,044,327	—	3,178,594	**3,178,594**	—
4	Etiqa - Family	**2,240,639**	—	**10,332,527**	12,573,166	**12,537,588**	35,578
5	Great Eastern	**135,378**	—	**641,797**	777,175	**754,339**	22,836
6	Hong Leong MSIG	**118,634**	164,784	**436,157**	719,575	**685,746**	33,829
7	HSBC Amanah	**214,677**	96,176	**1,208,122**	1,518,975	**1,500,532**	18,443
8	Ikhlas	**461,022**	638,649	**3,188,213**	4,287,884	**4,227,066**	60,818
9	Prudential BSN	**572,765**	22,167	**2,705,110**	3,300,042	**3,182,905**	117,137
10	Sun Life	**458,526**	35,005	**1,132,460**	1,625,991	**1,551,910**	74,081
11	Syarikat	**1,439,484**	1,129,703	**6,205,158**	8,774,345	**8,673,818**	100,527
12	Zurich	**195,668**	2,092,654	**591,436**	787,104	**773,106**	13,998

Table 1: Total Assets of Takaful Operators in Malaysia[5]

Two interesting observations can be made from the amounts presented in Table 1.

1. The elimination volume varies from one takaful operator to another depending on their level of inter-fund activities, and as high as above six per cent of the total amounts get eliminated in consolidation due to inter-fund activities (depicted in Figure 1).

2. The shareholder's fund contributes only a small share of the total takaful activities. Most of he activities are funded by the participants, i.e. general takaful fund and family takaful fund (depicted in Figure 2).

[5]As discussed in Chapter 9, at the time of writing this book, the takaful operators in Malaysia were going through a transition in terms of business model (i.e. separation of general and family takaful business) and financial reporting standards (i.e. application of MFRS 9). Hence, for this chapter, in providing updated information to readers the latest available annual (audited) or interim (unaudited) financial statements are used (unless otherwise stated). The reporting date of the statement of financial position are: 1. AIA Public, 30 June 2018; 2. AmMetLife, 30 September 2018; 3. Etiqa - General, 30 June 2018; 4. Etiqa - Family, 30 June 2018; 5. Great Eastern, 30 June 2018; 6. Hong Leong MSIG, 30 June 2018; 7. HSBC Amanah, 30 June 2018; 8. Ikhlas, 30 September 2018; 9. Prudential BSN, 30 June 2018; 10. Sun Life, 30 June 2018; 11. Syarikat, 30 September 2018; 12. Zurich, 30 June 2018.

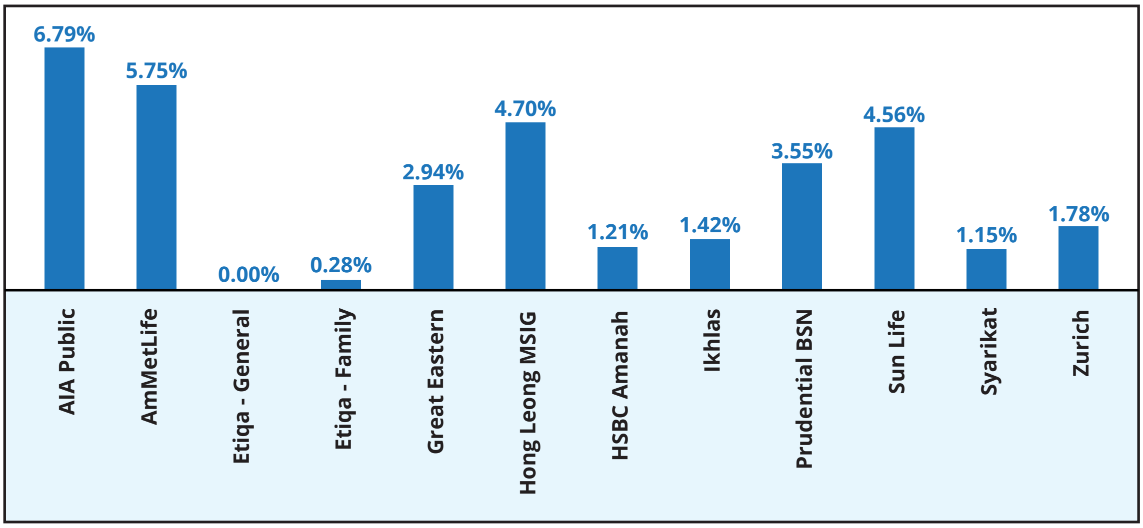

Figure 1: Elimination of Inter-Fund Activities in Total of Individual Funds

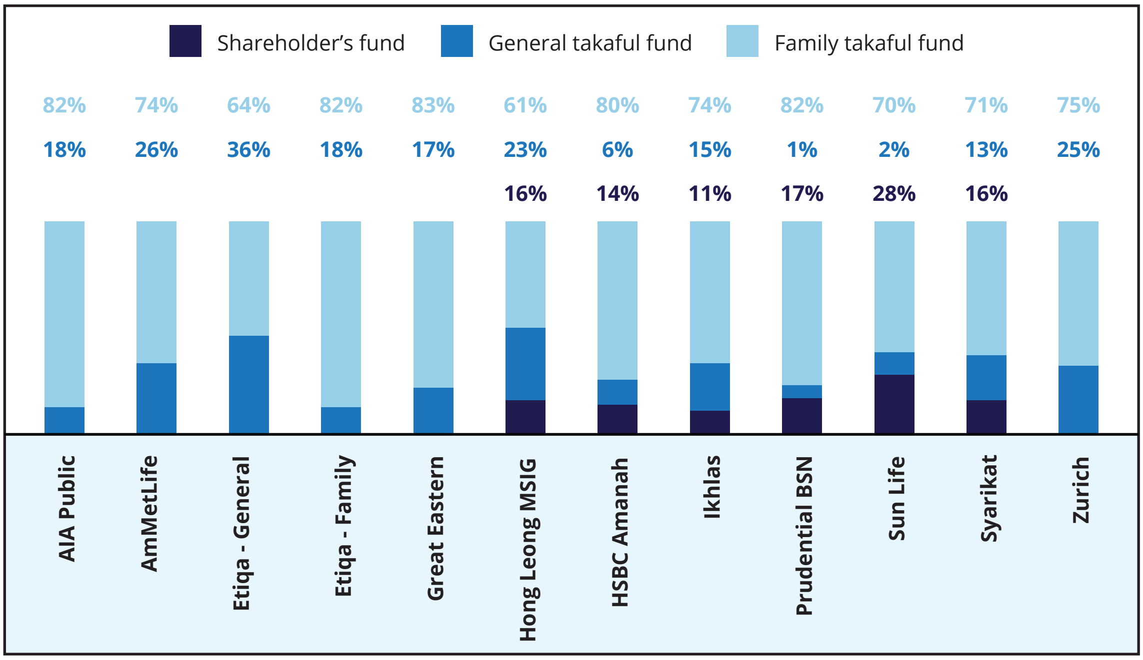

Figure 2: Share of Shareholder's Fund and Takaful Funds in Total of Individual Funds

The Guidelines on Takaful Operational Framework (2013) issued by BNM contains an asset exclusion clause, according to which certain assets shall not be included as assets of a takaful fund. This is provided in Example 3.

Guidelines on Takaful Operational Framework measurement component
9.8 With respect to the assets of a takaful fund, takaful operators shall not include any of the following as assets of a takaful fund: (a) any amounts on account of goodwill; (b) development expenditure or any amount capitalised in respect of such expenditure; and (c) any other items similar to items in subparagraph (b) which is not realizable apart from the business or part of the business of the takaful operator.

Example 3: Assets of Takaful Funds and Shareholders' Fund

The following sections provide an in-depth analysis of the asset line items presented by the takaful operators in Malaysia in their statement of financial position.

2.0 PROPERTY, PLANT AND EQUIPMENT

2.1 Background

Property, plant and equipment are tangible assets that are held by the takaful operator for its own use. The use can be for administrative purposes or to provide services to the customers. These assets are expected to be used during more than one period. However, a practical issue to be noted here is that a takaful operator may have a policy not to capitalise small value items as assets.

It may set a minimum threshold for an asset to be capitalised. Any asset below that limit will be recognised as an expense immediately in the statement of profit or loss instead of recognising as an asset in the statement of financial position. This is to avoid burden and expenditure in tracking small value assets as the cost of doing this may outweigh the benefits it may give. For example, a calculator may have more than one year of useful life. But, due to the small value of the item, this can be recognised as an expense in the statement of profit or loss immediately at the time of its purchase.

The takaful operators commonly report the following property, plant and equipment.

i. **Land and buildings:** These are land and buildings held by the takaful operator to be used for its own administrative purposes or for providing services to the customers. The takaful operator may have legal ownership of these assets or hold it under a finance lease agreement.

   In the former case, the takaful operator may or may not use the term freehold property, but in the latter case, the assets are referred to as leasehold property. A takaful operator may report land and buildings together or separately in the financial statements, and simply refer them as properties. However, this is not the same for an investment property, which is discussed later.

ii. **Computer equipment:** The computer equipment used by the takaful operator or allotted to its employees are included in this cluster. Common examples are desktop or laptop computers given to the employees for use in the takaful operator's business or in providing services, the IT servers for data storage and management, and other computer hardware and peripherals used for the business. The takaful operator generally has legal ownership of these assets.

iii. **Office equipment:** With the advancement of technologies and more sophisticated equipment coming to the market, sometimes there is a thin line between a computer equipment and an office equipment. Nevertheless, printers, scanners, copiers, shredders, communication equipment, and video surveillance equipment are common examples of office equipment. Like computer equipment, the takaful operator generally owns these assets.

iv. **Furniture, fixture and fittings:** A wide range of assets can be combined and reported as furniture, fixture and fittings. These may include the furniture used in the offices of the takaful operator, the office cubicles and desks used by the staff, the office interiors, paintings, the wall and roof fittings and partitions etc. These assets are also generally owned by the takaful operators.

v. **Renovation**: The office spaces of takaful operator may go under major renovation after every few years. This may involve redesigning, repainting, and replacing the interior. The costs incurred for the materials as well as for the professionals involved (e.g. architect and interior designer) are capitalised as renovation costs.

vi. **Motor vehicles**: These are the vehicles used by the employees of the takaful operator or for any purpose as determined by its management. The takaful operator may have legal ownership of these assets or leased under a finance lease.

vii. **Work-in-progress**: The assets that are yet to be available for use are reported as work-in-progress assets. This may also be referred to as assets under construction. This is a temporary account or a parking account. The assets that are under construction or are yet to be available for use are parked in this account until the construction is complete and the asset is ready to use. Once the asset is available for use, it is moved to its appropriate category. Generally, buildings under construction and renovation work-in-progress fall into this asset cluster.

Property, plant and equipment represent a very small share of total assets of the takaful operators. Figure 3 shows the share of these assets in total assets of the takaful operators.

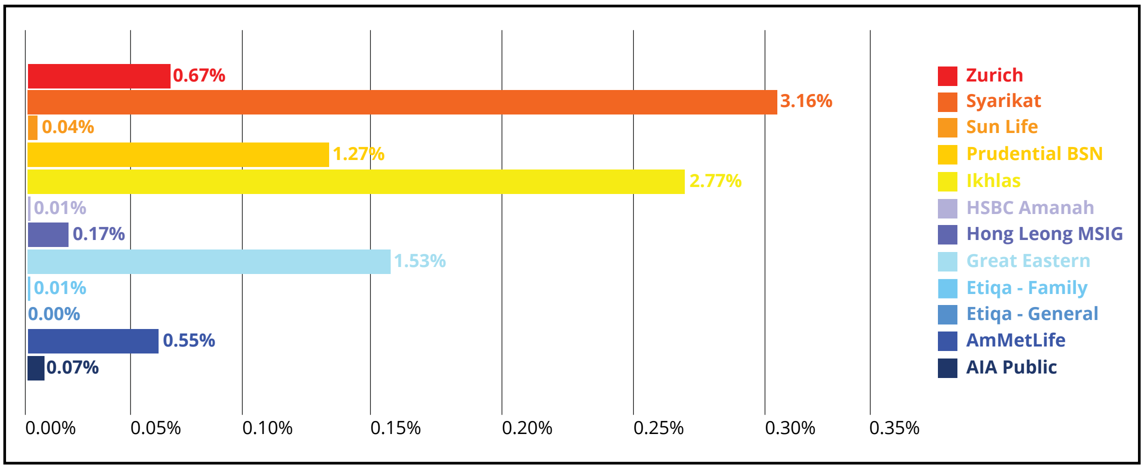

Figure 3: Share of Property, Plant and Equipment in Total Assets

2.2 Recognition And Measurement

Initial costs

An item of property, plant and equipment is measured at cost at initial recognition[6]. This cost comprises the purchase price, any import duties and non-refundable purchase taxes, and any other directly attributable costs incurred for the asset before it has become available for use[7].

[6] *Paragraph 15 of MFRS 116.*
[7] *Paragraph 16-17 of MFRS 116.*

Subsequent costs

Any day-to-day repairs and maintenance costs incurred after the asset become available for use are recognised as an expense in the statement of profit or loss[8]. For example, costs incurred to fix a malfunctioning toner problem of an office photocopier.

If a part of the asset is replaced after the asset becomes available for use, the old part must be written off as an expense in the statement of profit or loss, and the new part will be added to the carrying value of the asset[9].

Subsequent measurement

The takaful operators in Malaysia apply historical cost method of accounting for property, plant and equipment. These are reported at cost less accumulated depreciation and accumulated impairment losses, i.e. carrying value = cost – accumulated depreciation – accumulated impairment losses).

Depreciation

The depreciation of property, plant and equipment begin only when the asset is available for use, i.e. when the asset is in the location and condition necessary for it to be capable of operating in the manner intended by management[10]. The depreciation policies adopted by the takaful operators are subject to the management's judgement based on the expected pattern of usage[11] and an estimated of the useful lives of the assets[12].

The depreciation policies applied by the takaful operators in Malaysia are very similar. All of them apply the straight-line method in depreciating their property, plant and equipment and the estimated useful lives are also not very far from one takaful operator to another. Table 4 identifies the estimated useful lives of property, plant and equipment of takaful operators in Malaysia.

No.	Takaful Operators in Malaysia	Buildings	Leasehold Land	Computer Equipment	Office Equipment	Furniture, fixture and fittings	Renovation	Motor Vechicles
1	AIA Public	—	—	**25%**	20%	**20%**	20%	**25%**
2	AmMetLife	—	—	**20%**	20%	**20%**	20%	**20%**
3	Etiqa - Family[13]	—	—	14%-25%	20%	**20%**	20%	**25%**
4	Great Eastern	—	—	**20%-33%**	10%	**10%-20%**	—	**20%**
5	Hong Leong MSIG	—	—	**20%**	20%	**20%**	20%	**25%**
6	HSBC Amanah	—	—	**33.33%**	10%-20%	**10%-20%**	—	**20%**
7	Ikhlas	**2%-3%**	—	**33.3%**	15%	**15%**	—	**20%**
8	Prudential BSN	**2%**	1.01%	**33.33%**	10%	**10%**	10%	**20%**
9	Sun Life	**2%**	—	**33.33%**	20%	**10%**	10%	**33.33%**
10	Syarikat	**2%**	—	**20%-33.3%**	—	**16.7%-20%**	16.70%	**20%**
11	Zurich	—	—	**20%**	10%	**10%**	10%	**10%**

Table 2: Depreciation Policies for Property, Plant and Equipment of the Takaful Operators in Malaysia

[8]*Paragraph 12 of MFRS 116.*
[9]*Paragraph 13 of MFRS 116.*
[10]*Paragraph 55 of MFRS 116.*
[11]*Paragraph 60 of MFRS 116.*
[12]*Paragraph 50 of MFRS 116.*
[13]*Depreciation policy of Etiqa - General Takaful was not available at the time of writing this chapter.*

The takaful operators review the residual value, useful life and depreciation method of the property, plant and equipment assets at every reporting period[14]. Any changes in these are reflected in the depreciation calculation on a prospective basis[15].

Impairment

Property, plant and equipment are reviewed for impairment whenever events or changes in circumstances indicate that the carrying amount may not be recoverable. An impairment loss is recognised to the extent that the carrying amount of the asset exceeds its recoverable amount. In other words, the asset's carrying amount is written down to its recoverable amount if the asset's carrying amount is greater than its estimated recoverable amount. Recoverable amount is the higher of the asset's net selling price and value in use. This is estimated on an individual asset basis, or if it is not possible on cash generating units basis.

The impairment loss is recognised as an expense in the statement of profit or loss. Any subsequent increase in the recoverable amount of an asset is treated as a reversal of the previous impairment loss. This is recognised to the extent of the carrying amount of the asset that would have been determined (net of amortisation and depreciation) had no impairment loss been recognised. The reversal is recognised in the statement of profit or loss of the respective funds immediately.

Derecognition

The gain or loss on disposal of an asset is the difference between the net sale proceeds and the carrying amount of the relevant asset at the time of disposal. Any gain or loss is recognised in the statement of profit or loss of the respective funds.

2.3 Presentation And Disclosure

Paragraph 54 of MFRS 101 *Presentation of Financial Statements* requires presentation of property, plant and equipment as a separate line item on the face of the statement of financial position. The takaful operators also present property, plant and equipment on the face of the statement of financial position as a separate line item.

As identified in Table 3, the takaful operators commonly present property, plant and equipment in the shareholders' fund column. This suggests that the shareholders' fund is commonly used to acquire these assets. The differences between the total and company columns will be discussed in the investment properties section.

[14]Paragraph 51 of MFRS 116.
[15]Paragraph 61 of MFRS 116.

No.	Takaful operators in Malaysia	Shareholder's fund	General takaful fund	Family takaful fund	Total	Company	Differences
		(A)	(B)	(C)	(D) = (A+B+C)	(E)	(D-E)
		RM'000	RM'000	RM'000	RM'000	RM'000	RM'000
1	AIA Public	**690**	—	—	690	**690**	—
2	AmMetLife	**1,533**	—	—	1,533	**1,533**	—
3	Etiqa - General	—	—	—	—	—	—
4	Etiqa - Family	**774**	—	—	774	774	—
5	Great Eastern	**11,561**	—	—	11,561	**11,561**	—
6	Hong Leong MSIG	**1,189**	—	—	1,189	**1,189**	—
7	HSBC Amanah	**177**	—	—	177	**177**	—
8	Ikhlas	**1,475**	—	—	1,475	**117,293**	(115,818)
9	Prudential BSN	**40,333**	—	—	40,333	**40,333**	—
10	Sun Life	**585**	—	—	585	**585**	—
11	Syarikat	**42,059**	—	—	42,059	**274,441**	(232,382)
12	Zurich	**5,160**	—	—	5,160	5,160	—

Table 3: Amount Presented as Property, Plant and Equipment by Takaful Operators

The takaful operators maintain separate accounting records for each and every item of property, plant and equipment assets. However, for financial reporting, the assets are combined in only a few clusters based on their nature and use in an entity's operations. The management of the takaful operator decides the appropriate cluster for each item of property, plant and equipment. Hence, some dissimilarities can be observed if property, plant and equipment clusters are compared between one takaful operator to another.

For example, separate clusters can be found for computer equipment and office equipment in a takaful operator, but in another takaful operator, these can be found in a combined cluster. Materiality also plays an important role in determining whether to separate or combine in financial reporting. If an asset cluster is not material by itself, then it might be combined with another but similar asset cluster.

3.0 INVESTMENT PROPERTIES

3.1 Background

MFRS 140 *Investment Property* applies for recognition, measurement and disclosure of investment properties. Paragraph 5 of MFRS 140 defines an investment property as a property (land or a building—or part of a building—or both) that is held (by the owner of the property or by the lessee of the property under a finance lease) to earn rentals or for capital appreciation or both. A property that is held for use in the production or supply of goods or services, or for administrative purposes, or for sale in the ordinary course of business, is not an investment property.

The following key points can be derived from the above definition of an investment property:

i. It is a land or a building, or both
ii. It can be part of a building
iii. The takaful operator can be an owner of the property or a lessee of the property under a finance lease
iv. The takaful operator hold the property to earn rentals or for capital appreciation or both
v. The purpose of the property is not to be used in the production or supply of goods or services, or for administrative purposes, or for sale in the ordinary course of business

This is not always straightforward to decide whether a property is an investment property or not. A property may comprise:

- a portion that is held for the takaful operator's own use (e.g. for administrative purposes or to provide services to the customers), and
- another portion that is held to earn rentals or for capital appreciation.

If the takaful operator can sell these portions separately (or lease out separately under a finance lease), it would account for the portions separately (Paragraph 10 of MFRS 140). That means the accounting will be applying MFRS 116 for the portion that is held for own use, and the accounting will be applying MFRS 140 for the portion that is held for rental or capital appreciation.

If these portions cannot be sold or leased separately, the takaful operator needs to apply its judgement based on the significance of the portions. That means the property is an investment property only if an insignificant portion is held for its own use (Paragraph 10 of MFRS 140). If the case is otherwise, i.e. a significant portion of the asset is held for own use, then the accounting of the asset will be applying MFRS 116. The judgement is made on an individual property basis to determine whether ancillary services are so significant that a property does not qualify as an investment property (Paragraph 11 of MFRS 140).

The takaful funds may own properties and rent out those to the takaful operator. As a result, these properties may be reported as investment property in the takaful fund column. However, in the company column, the same properties will be reported under property, plant and equipment instead of investment properties. This is due to the cancelling of inter-fund transactions in consolidation. From the company's perspective, these assets are owned and used within the company. This is illustrated in the presentation and disclosure section.

3.2 Recognition and Measurement

Initial recognition

Investment properties are measured initially at their purchase price including any directly attributable expenditure and transaction costs (Paragraph 20-21 of MFRS 140).

Subsequent measurement

A takaful operator may apply the fair value model or the cost model for subsequent measurement of their investment properties (Paragraph 30 of MFRS 140). The takaful operators in Malaysia–namely, Ikhlas and Syarikat–apply the fair value model for subsequent measurement of their investment properties.

Any gains or losses arising from changes in fair value of investment properties are recognised in the statement of profit or loss. For example, Ikhlas reported RM115,658,000 as investment properties on 31 March 2016 in the family fund column of its statement of financial position. The fair value of the same investment properties was determined as RM115,778,000 on 31 March 2017. Therefore, there was a gain of RM120,000, which was reported as income in the family fund column of its statement of profit or loss.

Derecognition

Investment properties are derecognised when either they have been disposed of or when they are permanently withdrawn from use and no future economic benefit is expected from their disposal. Any gains or losses on the retirement or disposal of an investment property is recognised in the statement of profit or loss in the year in which they arise.

3.3 Presentation and Disclosure

Only two takaful operators are identified as reporting investment properties in their statement of financial position. These operators are Ikhlas and Syarikat.

Syarikat reported investment properties in each of the three columns, namely shareholder's fund, general takaful fund and family takaful fund columns. However, the amount presented in the company column is significantly lower than the total of those three individual columns. In the case of Ikhlas, it reported investment properties only in the family fund column. However, the amount reported in the company column is nil. Two important points can be noted from these:

i. The amounts presented in the individual columns denotes that the funds individually own properties that meet the investment property definition under MFRS 140 at the individual fund level.

ii. The difference between the total of amounts in the individual fund columns and the amount reported in the company column denotes that the investment properties owned by the funds are rented out to the takaful operator. Therefore, even though at the fund level that is an investment property under MFRS 140, but at the company level it is part of the property, plant and equipment under MFRS 116.

    For example, a property is acquired by using the general takaful fund, e.g. RM 1,000,000. The asset is fully rented out to the takaful operator, hence will be reported as an investment property in general takaful fund column. However, in consolidation, the asset will be reported as property, plant and equipment as it is not an investment property at the takaful operator's company level.

    This will result in an equal difference in investment property and property, plant and equipment rows. In investment property row, this results in a significantly lower amount reported in the company column than the total of individual columns. Whereas, in property, plant and equipment row, this results in a significantly higher amount reported in the company column than the total of individual columns. The differences between lower and higher amounts will be equal.

Accordingly, Table 4 shows that the difference in property, plant and equipment (PPE) row and in investment property (IP) row, and reconciliation between those differences (i.e. the difference in the rows are same).

Takaful operators	Assest	Shareholder's fund	General takaful fund	Family takaful fund	Total	Company	Differences
		(A)	(B)	(C)	(D) = (A+B+C)	(E)	(D-E)
Ikhlas	PPE	**1,475**	—	—	1,475	**117,293**	(115,818)
	IP	—	—	**115,818**	115,818	—	115,818
Syarikat	PPE	**42,059**	—	—	42,059	**274,441**	(232,382)
	IP	**11,275**	10,540	**246,536**	268,351	**35,969**	232,382

Table 4: Equal Difference in PPE and IP Amounts

4.0 INTANGIBLE ASSESTS

4.1 Background

MFRS 138 defines an intangible asset as an identifiable non-monetary asset without physical substance. In other words, the intangible assets:

- do not have a physical substance (i.e. these are not like property, plant and equipment or investment property assets), and
- these are not monetary assets (i.e. these are not financial assets like receivables, investments, so on).

An intangible asset may be acquired from a third party or may be internally generated. The examples of intangibles might include computer software, patents, copyrights, motion picture films, customer lists, mortgage servicing rights, fishing licences, import quotas, franchises, customer or supplier relationships, customer loyalty, market share and marketing rights. In any case, to be recognised as an asset in the statement of financial position, an intangible asset must meet the recognition criteria set in MFRS 138. These criteria are:

i. **Identifiability:** An intangible asset must have the quality to be separable from the entity, i.e. it can be sold, transferred, licensed, rented or exchanged, regardless of whether the entity intends to do so; or it must arise from contractual or other legal rights, regardless of whether these rights are transferrable or separable from the entity or from other rights and obligations.

ii. **Control:** The entity recognising the intangible asset must have the power to obtain any future economic benefits flowing from the intangible asset and to restrict the access of others to those benefits.

iii. **Existence of future economic benefits:** There must be economic benefits from the intangible assets, which might be in the form of cost savings or other benefits resulting from the use of the asset.

Only three types of intangible assets are identified from the financial statements of the takaful operators in Malaysia. These are elaborated below.

i. **Preferred partnership fee:** This represents the preferred partnership agreement fee paid by the takaful operator upfront to a third-party Islamic bank. This is in relation to a *bancatakaful* arrangement between the takaful operator and a third-party Islamic bank. This is a strategic alliance between these two parties where the bank markets the takaful products underwritten by the takaful operator. This allows the takaful operator to use relatively more established Islamic banking channels in marketing their products. Even though not all takaful operators are picking up this technique, this is considered as a cost-effective technique to market takaful products.

A *bancatakaful* arrangement offers benefits to the takaful operator, Islamic bank and its customers. The benefit of the takaful operator is the access to the Islamic bank's ready customer database and strong brand identity. For the Islamic bank, it offers an additional source of funds. For the customers, it allows access to integrated financial services in one place.

Among the takaful operators in Malaysia, Great Eastern, Ikhlas and Syarikat are identified to be involved in *bancatakaful* arrangements. The contracts are generally for five years.

ii. **Software and licenses:** This may include computer software for takaful administration system and distribution channel management system. These may have been acquired or licensed from third parties, or are internally generated, i.e. capitalised after successful completion of the development process.

iii. **Software development in progress:** A takaful operator may invest in the development of its own software. The development costs that meet MFRS 138 recognition criteria are recognised as software development in progress. These assets are moved to their appropriate category once available for use. This is like work-in-progress assets as explained in property, plant and equipment section of this chapter.

Intangible assets represent a very small share of total assets of the takaful operators in Malaysia. Figure 4 shows the share of intangible assets in total assets.

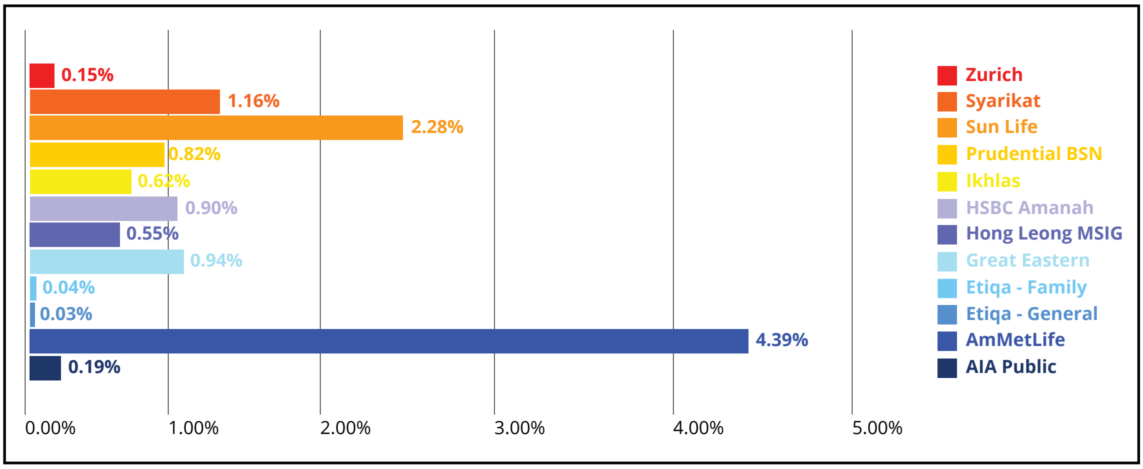

Figure 4: Share of Intangible Assets in Total Assets

4.2 Recognition and Measurement

Initial recognition

The intangible assets are measured initially at cost. This includes expenditures that are directly attributable to the acquisition of the asset if it is acquired from a third party. If the asset is internally generated, then this includes costs incurred at the development phase of the asset.

Subsequent measurement

The takaful operators apply the cost model in subsequent accounting and reporting of their intangible assets. This means that the intangible assets are measured at their cost less accumulated amortisation and any accumulated impairment losses (i.e. Carrying value = Cost – Accumulated amortisation – Accumulated impairment losses).

Amortisation of *intangible assets*

The amortisation of intangible assets depends on identifying their estimated useful lives, which can be either finite or indefinite.

- **Finite useful lives:** Intangible assets with finite lives are amortised over their estimated economic useful lives. The amortisation period and the amortisation method for an intangible asset with a finite useful life are reviewed at least at the end of each reporting period. Changes in the expected useful life or the expected pattern of consumption of future economic benefits embodied in the asset is accounted for by changing the amortisation period or method, as appropriate, and are treated as changes in accounting estimates. The amortised amount is charged to the statement of profit or loss of the takaful operator as an expense.

- **Indefinite useful lives:** Intangible assets with indefinite useful lives are not amortised. These assets are tested for impairment annually or more frequently if events or changes in circumstances indicate that the carrying amount may be impaired either individually or at the cash generating unit level. The useful life of an intangible asset with an indefinite life is also reviewed annually to determine whether the indefinite useful lives assessment continues to be supportable.

The amortisation practice of the takaful operators in Malaysia is provided below.

i. **Preferred partnership fee:** Following the initial recognition of the cost of preferred partnership fee, the fee is amortised based on the actual contribution received over the total committed contribution, until the expiry of the contract, which normally is within five years. Upon the expiry of the contract, if the total projected production is not met, the contract may be renewed for another year or the bank will compensate the takaful operator on a prorated basis on the balance of the 'unamortised' fee.

ii. **Software and licenses:** The useful lives of these assets are generally finite as these are susceptible to technological obsolescence and might be subject to the license period. Therefore, these assets are amortised over their useful lives.

iii. **Software development in progress:** The amortisation of these assets begins only when the development is complete, and the asset is available for use. This is like work-in-progress assets as explained in property, plant and equipment section of this chapter.

Impairment *of* intangible *assets*

Intangible assets with finite and indefinite useful lives are assessed for impairment whenever there is an indication that the intangible asset may be impaired. Any impairment loss is recognised as an expense in the statement of profit or loss of the takaful operator.

Derecognition

On disposal of intangible assets, the difference between net proceeds and the carrying amount is recognised in the statement of profit or loss, and the asset is derecognised from the statement of financial position.

4.3 Presentation and Disclosure

Intangible assets are commonly reported in the shareholders' fund column, i.e. none in the general or family takaful fund column. This implies that only the shareholders' fund is used in acquiring or internally generating the intangible assets. There is also no difference between the total and company columns, which means that there are no inter-fund transactions for the intangible assets. Table 5 shows the amounts presented by the takaful operators as intangible assets in their latest available financial statements.

No.	Takaful operators in Malaysia	Shareholder's fund	General takaful fund	Family takaful fund	Total	Company	Differences
		(A)	(B)	(C)	(D) = (A+B+C)	(E)	(D-E)
		RM'000	RM'000	RM'000	RM'000	RM'000	RM'000
1	AIA Public	2,024	—	—	2,024	2,024	—
2	AmMetLife	12,140	—	—	12,140	12,140	—
3	Etiqa - General	1,074	—	—	1,074	1,074	—
4	Etiqa - Family	4,568	—	—	4,568	4,568	—
5	Great Eastern	7,074	—	—	7,074	7,074	—
6	Hong Leong MSIG	3,781	—	—	3,781	3,781	—
7	HSBC Amanah	13,480	—	—	13,480	13,480	—
8	Ikhlas	26,105	—	—	26,105	26,105	—
9	Prudential BSN	25,942	—	—	25,942	25,942	—
10	Sun Life	35,452	—	—	35,452	35,452	—
11	Syarikat	100,684	—	—	100,684	100,684	—
12	Zurich	1,131	—	—	1,131	1,131	—

Table 5: Amounts Presented as Intangible Assets by the Takaful Operators

5.0 INVESTMENTS

5.1 Background

Instead of keeping the funds idle and to generate income, the takaful operators invest funds in different types of Islamic financial instruments. These instruments may include but not limited to the following:

- Government investment issues (GII)
- Government guaranteed sukuk
- Quoted Shariah approved equities in Malaysia
- Islamic deposit accounts
- Islamic investment accounts
- Unit and property trust fund
- Units held in investment-linked funds
- Negotiable Islamic certificates of deposit (NICD)

As a financial institution, takaful operators are financial instrument intensive entities. Figure 5 shows that a major share of their assets are investments in financial instruments. Chapter 13 will show that the income of takaful operators are also greatly generated from these investments.

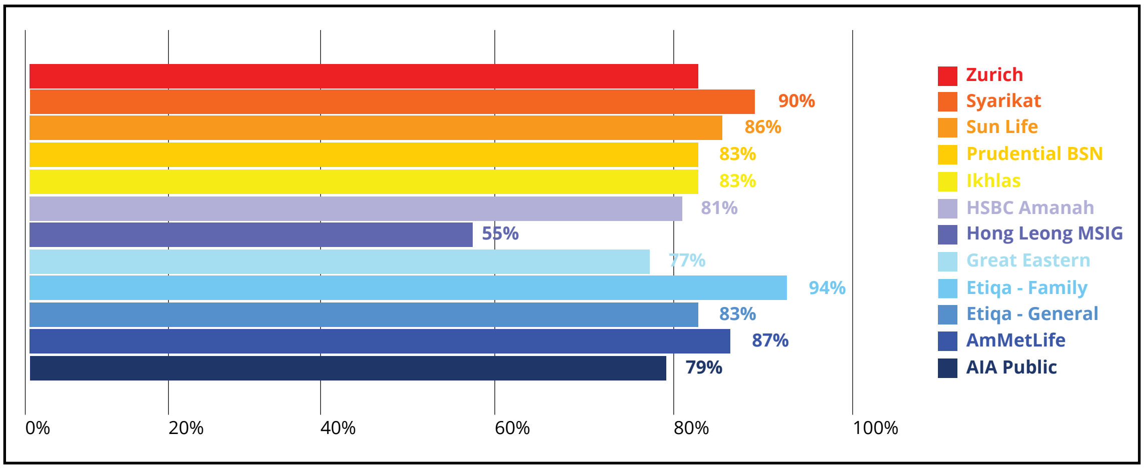

Figure 5: Share of Investments in Total Assets

From 1 January 2018, MFRS 9 Financial Instruments replaces MFRS 139 *Financial Instruments: Recognition and Measurement* for the accounting of financial instruments. The changes brought by the new standard include classification and measurement of financial assets and their impairment. The new standard nevertheless retains certain principles in MFRS 139. For example, the requirements on the derecognition of financial assets.

Nonetheless, the Malaysian Accounting Standards Board (MASB) issued MFRS 4 *Insurance Contracts* that allow two alternative options to the takaful operators in the implementation of MFRS 9.

i. **Temporary exemption:** The takaful operators can opt for a temporary exemption andcommence implementation of MFRS 9 from 1 January 2021. An entity may apply this option if its activities are predominantly connected with insurance[16].

ii. **Overlay approach:** The takaful operators can apply an overlay approach, which allows them to reclassify between profit or loss and other comprehensive income to an amount that results in the profit or loss at the end of the reporting period for the designated financial assests beingthe same as if the entity had applied MFRS 139 to these designated financial assests. In otherwords, this approach allows a takaful operator to adjust profit or loss for eligible financial assestsby removing any accounting volatility to other comprehensive income that may arise from applying MFRS 9. A takaful operator may start applying the overlay approach when it applies MFRS 9 for the first time[17].

The financial statements used for this chapter shows that five takaful operators (out of twelve) commenced implementation of MFRS 9 for classification and measurement of their investment assets. They are Etiqa - General, Etiqa - Family, Great Eastern, Ikhlas and Syarikat.

A mixed approach is observed in the presentation of investments by the takaful operators. Some present aggregate amount on the face of the statement of financial position and provide the breakdown in the notes. Whereas, some others present the investments according to their classification on the face of the statement of financial position. Nonetheless, the financial reporting of investments applying MFRS 139 and MFRS 9 are discussed below.

[16] *Paragraph 20A of MFRS 4.*
[17] *Paragraph 35B of MFRS 4.*

5.2 Financial Reporting Applying MFRS 139

Financial assets are recognised in the statement of financial position when, and only when, the takaful operator or the fund become a party to the contractual provisions of the financial instruments (Paragraph 14 of MFRS 139). Under MFRS 139 the financial assets are classified in one of the following categories: financial assets at fair value through profit or loss (FVTPL), held-to-maturity (HTM), loans and receivables (LAR), and available-for-sale (AFS) financial assets. The classification of financial assets at initial recognition depends on the purpose for which the financial assets are acquired and/or their cash flow characteristics.

i. Financial assets at fair value through profit or loss (FVTPL)

The financial instruments that the takaful operator holds for trading purposes are classified under this category. These instruments are acquired for the purpose of selling in the near future. These instruments allow the takaful operators to benefit from favourable price movements of the financial assets as well as manoeuvre their liquidity position as needed to meet the participants' claims. Figure 6 shows that the investment strategy greatly varies from one takaful operator to another. Investments classified as FVTPL can be as low as below 10% to as high as above 70% of their total assets. Nonetheless, a takaful operator may also designate an investment in a financial asset as FVTPL if such designation results in a more relevant information by eliminating or significantly reducing an accounting mismatch.

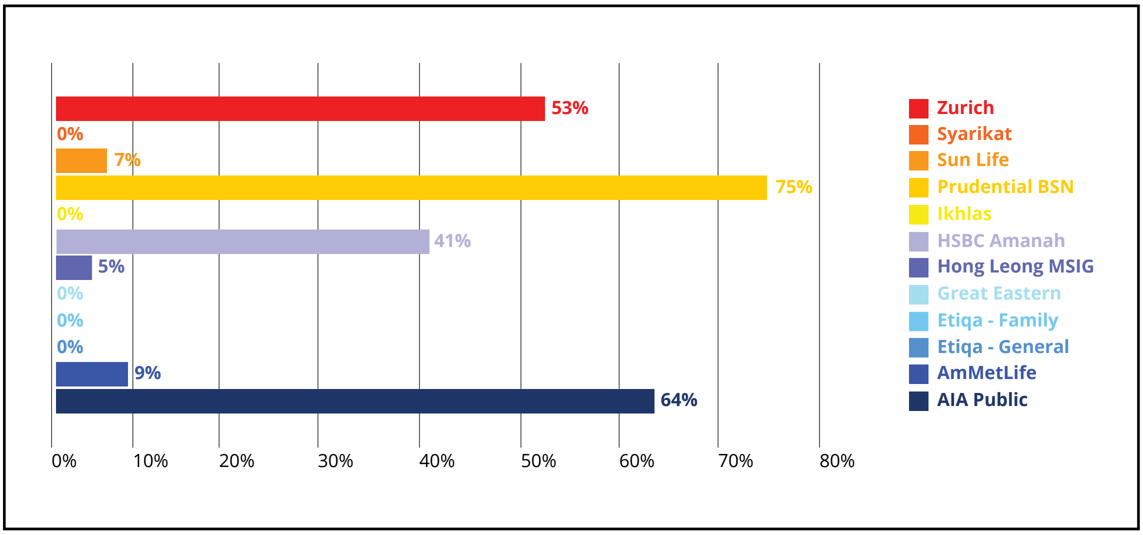

Figure 6: Share of FVTPL (MFRS 139) in Total Assets

Financial assets classified as FVTPL are measured at fair value at initial recognition. These instruments are remeasured to their fair value at each reporting date until the assets are derecognised. Any gains or losses arising from changes in fair value as well as any dividend income are included in the statement of profit or loss in the period in which they occur. Any realised gains or losses arising on the disposal of these financial assets are also recognised in the statement of profit or loss.

Table 6 shows the amounts presented as financial assets at FVTPL (MFRS 139) by the takaful operators.

No.	Takaful operators in Malaysia	Shareholder's fund	General takaful fund	Family takaful fund	Total	Company	Differences
		(A)	(B)	(C)	(D) = (A+B+C)	(E)	(D-E)
		RM'000	RM'000	RM'000	RM'000	RM'000	RM'000
1	AIA Public	7,786	—	660,881	668,667	668,667	—
2	AmMetLife	—	—	24,867	24,867	24,867	—
3	Etiqa - General	—	—	—	—	—	—
4	Etiqa - Family	—	—	—	—	—	—
5	Great Eastern	—	—	—	—	—	—
6	Hong Leong MSIG	—	—	33,211	33,211	33,211	—
7	HSBC Amanah	—	—	617,797	617,797	617,797	—
8	Ikhlas	—	—	—	—	—	—
9	Prudential BSN	195,732	—	2,205,101	2,400,833	2,398,786	2,047
10	Sun Life	11,952	—	93,224	105,176	105,176	—
11	Syarikat	—	—	—	—	—	—
12	Zurich	2,930	—	410,448	413,378	410,448	2,930

Table 6: Amounts Presented as FVTPL Financial Assets (MFRS 139)

ii. Financial assets held-to-maturity (HTM)

As the name suggests, takaful operators invest in these instruments to hold until their maturity. These are debt instruments as equity instruments do not have any maturity date. To be in this category, the instrument must also be quoted in an active market, which distinguishes this category from loans and receivables.

These instruments provide a pre-identified cash flows to the takaful entity. However, from the amounts reported by the takaful operators, it appears that such instruments are not popular among the takaful operators in Malaysia. This also indicates that the takaful operators generally do not hold such investments until their maturity. Nonetheless, none of the takaful operators reported held-to-maturity financial assets.

At initial recognition, financial assets classified as held-to-maturity are measured at fair value plus any directly attributable transaction costs (Paragraph 43 of MFRS 139). These assets are subsequently carried at amortised cost.

iii. Loans and receivables (LAR)

The financial assets that have fixed or determinable payments but are not quoted in an active market are classified as loans and receivables. Figure 7 shows that loans and receivables are generally not a popular class for financial asset designation for takaful operators in Malaysia. A juxtaposition comparison with the assets classified at fair value indicates that the takaful operators are generally not interested to hold assets until their maturity or receive fixed or determinable payments that provide a lower yield. They prefer to gain from fair value movements of their investments.

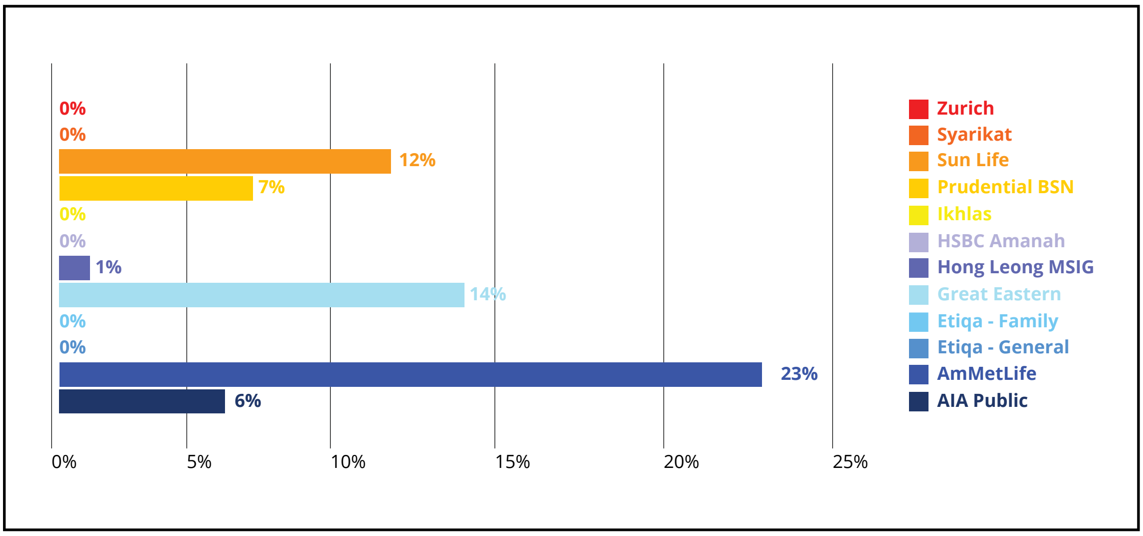

Figure 7: Share of Loans and Receivables (MFRS 139) in Total Assets

At initial recognition, financial assets classified as loans and receivables are measured at fair value plus any directly attributable transaction costs[18]. These assets are subsequently measured at amortised cost. Table 7 shows the amounts presented by the takaful operators under loans and receivables classification.

No.	Takaful operators in Malaysia	Shareholder's fund	General takaful fund	Family takaful fund	Total	Company	Differences
		(A)	(B)	(C)	(D) = (A+B+C)	(E)	(D-E)
		RM'000	RM'000	RM'000	RM'000	RM'000	RM'000
1	AIA Public	4,334	—	57,677	62,011	62,011	—
2	AmMetLife	12,323	—	50,735	63,058	63,058	—
3	Etiqa - General	—	—	—	—	—	—
4	Etiqa - Family	—	—	—	—	—	—
5	Great Eastern	15,500	—	93,500	109,000	109,000	—
6	Hong Leong MSIG	—	—	6,305	6,305	6,305	—
7	HSBC Amanah	—	—	—	—	—	—
8	Ikhlas	—	—	—	—	—	—
9	Prudential BSN	74,495	—	161,590	236,085	236,085	—
10	Sun Life	42,313	—	140,334	182,647	182,647	—
11	Syarikat	—	—	—	—	—	—
12	Zurich	—	—	—	—	—	—

Table 7: Amounts Presented as Loans and Receivables (MFRS 139)

[18] *Paragraph 43 of MFRS 139.*

iv. Financial assets available for sale (AFS)

This is a residual category of financial assets. The financial assets that do not fall into any of the other three categories are included here. For example, a takaful operator may choose to classify some of its investments in debt and equity instruments under this category. However, financial assets that are held for trading cannot be included here.

A financial reporting implication of this will be any unrealised gains or losses from fair value measurement of these investments are recognised in other comprehensive income, hence the effect in the profitability of the takaful operators for fair value remeasurement of these assets is nil until these instruments are sold and gains or losses are realised. Figure 8 presents the share of financial assets classified as available for sale in total assets.

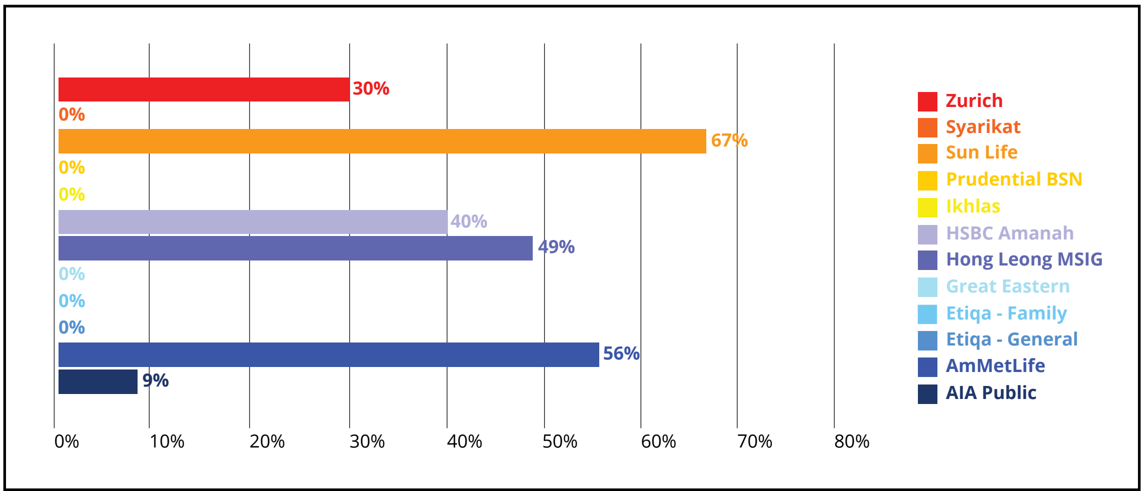

Figure 8: Share of Financial Assets Available for Sale (MFRS 139) in Total Assets

At initial recognition, the available for sale financial assets are measured at fair value plus any directly attributable transaction costs[19]. These assets are subsequently measured at fair value. The unrealised gains or losses arising from fair value measurements are recognised in other comprehensive income. These gains or loss are deferred in reserves until they are realised or impairment occurs. However, any dividend income or impairment losses or certain foreign currency gains and losses are recognised in the statement of profit or loss. Table 8 shows the amounts presented by the takaful operators as available for sale financial assets.

[19] *Paragraph 43 of MFRS 139.*

No.	Takaful operators in Malaysia	Shareholder's fund	General takaful fund	Family takaful fund	Total	Company	Differences
		(A)	(B)	(C)	(D) = (A+B+C)	(E)	(D-E)
		RM'000	RM'000	RM'000	RM'000	RM'000	RM'000
1	AIA Public	**90,518**	—	**5,775**	96,293	**96,293**	—
2	AmMetLife	**42,699**	—	**125,210**	167,909	**154,066**	13,843
3	Etiqa - General	—	—	—	—	—	—
4	Etiqa - Family	—	—	—	—	—	—
5	Great Eastern	—	—	—	—	—	—
6	Hong Leong MSIG	**71,410**	—	**272,802**	344,212	**338,761**	5,451
7	HSBC Amanah	**139,883**	10,020	**452,175**	602,078	**602,078**	—
8	Ikhlas	—	—	—	—	—	—
9	Prudential BSN	—	—	—	—	—	—
10	Sun Life	**292,869**	—	**758,421**	1,051,290	**1,042,681**	8,609
11	Syarikat	—	—	—	—	—	—
12	Zurich	**153,120**	—	**75,735**	228,855	**228,855**	—

Table 8: Amounts Presented as Financial Assets Available for Sale (MFRS 139)

Derecognition

The investments in financial assets are derecognised once the takaful operator and/or the fund is no longer a party to the asset, e.g. by way of disposal, full settlement, or expiry of tenure.

5.3 Financial Reporting Applying MFRS 9

Like MFRS 139, the investments in financial instruments will be recognised in the statement of financial position under MFRS 9 when, and only when, the takaful operator and/or the takaful funds become a party to the contractual provisions of those instruments[20]. However, MFRS 9 establishes fundamentally different criteria than MFRS 139 for determining the classification and measurement of a financial asset. Under MFRS 9, a financial asset will be measured at fair value unless it is measured at amortised cost[21]. The amortised cost classification depends on the following two tests[22]:

i. **Business model test:** The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.

ii. **Solely payment of principal and interest (SPPI) test:** The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding. (In the context of the takaful business, the term “interest” refers to profit or dividend element of the instrument.)

The decision flow for financial asset classification is depicted in Figure 9.

[20]*Paragraph 3.1.1 of MFRS 9.*
[21]*Paragraph 4.1.4 of MFRS 9.*
[22]*Paragraph 4.1.2 of MFRS 9.*

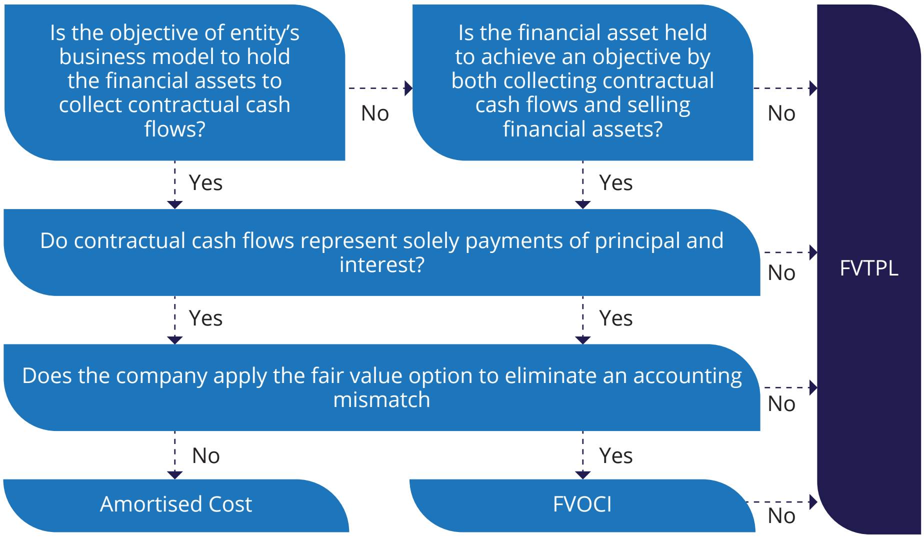

Figure 9: Classification and Measurement Decision Flow of Financial Assets Under MFRS 9

Implementation of MFRS 9 results changes in the classification and measurement of financial assets. The changes from MFRS 139 to MFRS 9 is provided in Table 9.

MFRS 139		MFRS 9
Classification	**Measurement**	**Classification and measurement**
Financial assets at fair value through profit or loss (FVTPL)	FVTPL	FVTPL
Financial assets held-to-maturity (HTM)	Amortised cost	Amortised cost
Loans and receivables (LAR)	Amortised cost	Amortised cost
Financial assets available for sale (AFS)	Fair value through other comprehensive income (FVTOCI)	FVTOCI

Table 9: Changes of Financial Assets Classification and Measurement from MFRS 139 to MFRS 9

i. Financial assets at fair value through profit or loss (FVTPL)

Financial assets classified at FVTPL will be measured at fair value at initial recognition[23]. Changes in fair value in subsequent measurement are recognised in the statement of profit and loss as they arise. Figure 10 shows the share of financial assets at FVTPL in total assets and Table 10 presents the amounts reported by takaful operators under this classification. These confirm the earlier highlighted general preference of the takaful operators for fair value measurement assets than fixed or determinable payment assets.

[23] *Paragraph 5.1.1 of MFRS 9.*

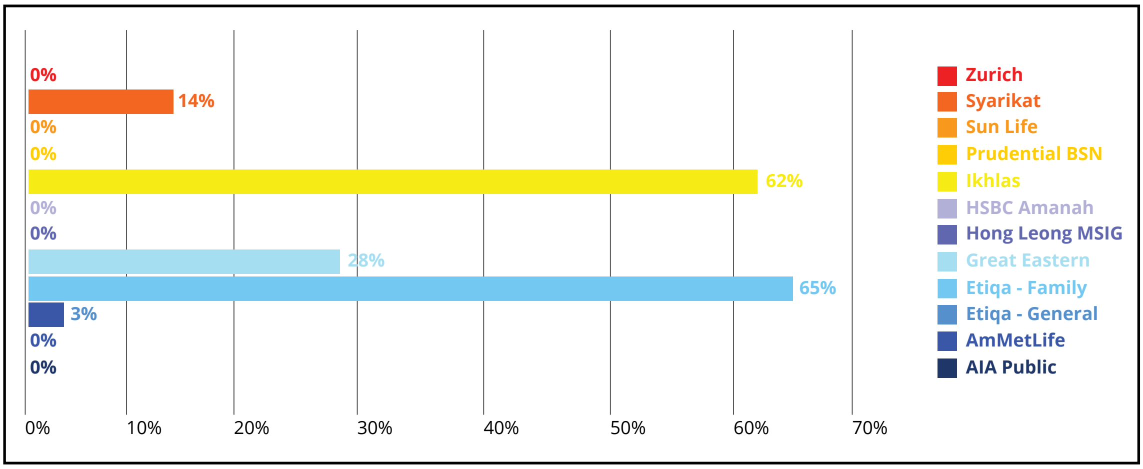

Figure 10: Share of Financial Assets of FVTPL (MFRS 9) in Total Assets

No.	Takaful operators in Malaysia	Shareholder's fund	General takaful fund	Family takaful fund	Total	Company	Differences
		(A)	(B)	(C)	(D) = (A+B+C)	(E)	(D-E)
		RM'000	RM'000	RM'000	RM'000	RM'000	RM'000
1	AIA Public	—	—	—	—	—	—
2	AmMetLife	—	—	—	—	—	—
3	Etiqa - General	**48,610**	62,021	—	110,631	**110,631**	—
4	Etiqa - Family	**1,957,827**	—	**6,165,599**	8,123,426	**8,098,448**	24,978
5	Great Eastern	**68,096**	—	**151,120**	219,216	**213,898**	5,318
6	Hong Leong MSIG	—	—	—	—	—	—
7	HSBC Amanah	—	—	—	—	—	—
8	Ikhlas	**24,869**	8,132	**2,600,875**	2,633,876	**2,612,190**	21,686
9	Prudential BSN	—	—	—	—	—	—
10	Sun Life	—	—	—	—	—	—
11	Syarikat	**167,214**	76,636	**1,038,128**	1,281,978	**1,243,282**	38,696
12	Zurich	—	—	—	—	—	—

Table 10: Amounts Presented as Financial Assets at FVTPL (MFRS 9)

ii. Financial assets at fair value through other comprehensive income (FVTOCI)

Financial assets classified at FVTOCI are measured at fair value plus any directly attributable transaction costs at initial recognition[24].

[24]*Paragraph 5.1.1 of MFRS 9.*

ii. Financial assets at fair value through other comprehensive income (FVTOCI)

Financial assets classified at FVTOCI are measured at fair value plus any directly attributable transaction costs at initial recognition[24].

In subsequent measurement, the changes in fair value of loans and receivables assets are recognised initially in other comprehensive income. When the asset is derecognised or reclassified, changes in fair value previously recognized in other comprehensive income and accumulated in equity are reclassified to profit and loss on a basis that always results in an asset measured at FVTOCI having the same effect on profit and loss as if it were measured at amortized cost.

For investments in equity instruments assets, dividends are recognised when the entity's right to receive payment is established, it is likely the economic benefits will flow to the entity and the amount can be measured reliably. Dividends are recognised in profit and loss unless they clearly represent a recovery of a part of the cost of the investment, in which case they are included in other comprehensive income (OCI). Changes in fair value are recognised in OCI and are never recycled to profit and loss, even if the asset is sold or impaired.

Figure 11 shows the share of financial assets at FVTOCI in total assets and Table 11 presents the amounts reported by takaful operators under this classification.

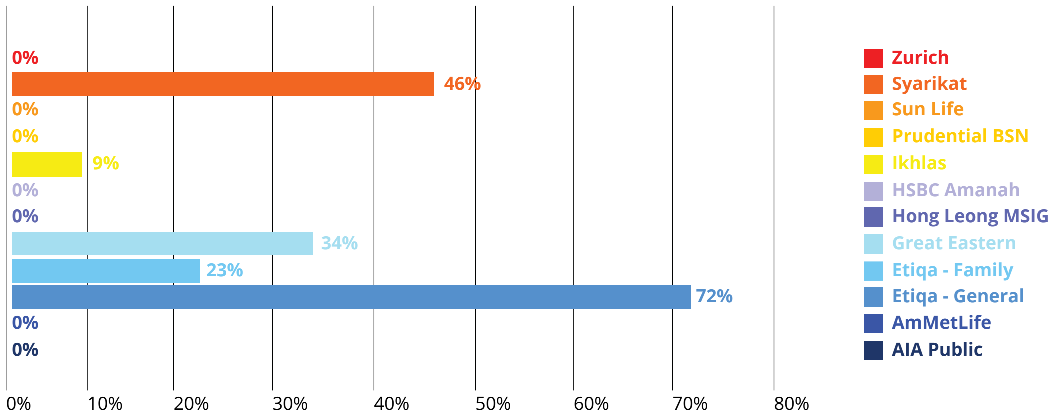

Figure 11: Share of Financial Assets at FVTOCI (MFRS 9) in Total Assets

No.	Takaful operators in Malaysia	Shareholder's fund	General takaful fund	Family takaful fund	Total	Company	Differences
		(A)	(B)	(C)	(D) = (A+B+C)	(E)	(D-E)
		RM'000	RM'000	RM'000	RM'000	RM'000	RM'000
1	AIA Public	—	—	—	—	—	—
2	AmMetLife	—	—	—	—	—	—
3	Etiqa - General	**884,669**	1,411,952	—	2,296,621	**2,296,621**	—
4	Etiqa - Family	—	—	**2,822,015**	2,822,015	**2,822,015**	—
5	Great Eastern	7,096	—	**252,197**	259,293	**259,293**	—
6	Hong Leong MSIG	—	—	—	—	—	—
7	HSBC Amanah	—	—	—	—	—	—
8	Ikhlas	**139,265**	257,872	—	397,137	**397,137**	—
9	Prudential BSN	—	—	—	—	—	—
10	Sun Life	—	—	—	—	—	—
11	Syarikat	**463,943**	364,263	**3,148,248**	3,976,454	**3,976,454**	—
12	Zurich	—	—	—	—	—	—

Table 11: Amounts Presented as Financial Assets at FVTOCI (MFRS 9)

iii. Financial assets at amortised cost

Financial assets at amortised cost are measured at fair value plus any directly attributable transaction costs at initial recognition.[25]

In subsequent measurement, these assets are measured at the amount recognised at initial recognition minus principal repayments, plus or minus the cumulative amortisation of any difference between that initial amount and the maturity amount, and any loss allowance. Any dividend or similar form of income is calculated using the effective profit method and is recognised in profit and loss. Changes in fair value are recognised in profit and loss when the asset is derecognised or reclassified (PwC, 2017).

Figure 12 shows the share of financial assets measured at amortised in total assets and Table 12 presents the amounts reported by takaful operators under this classification.

[25] *Paragraph 5.1.1 of MFRS 9.*

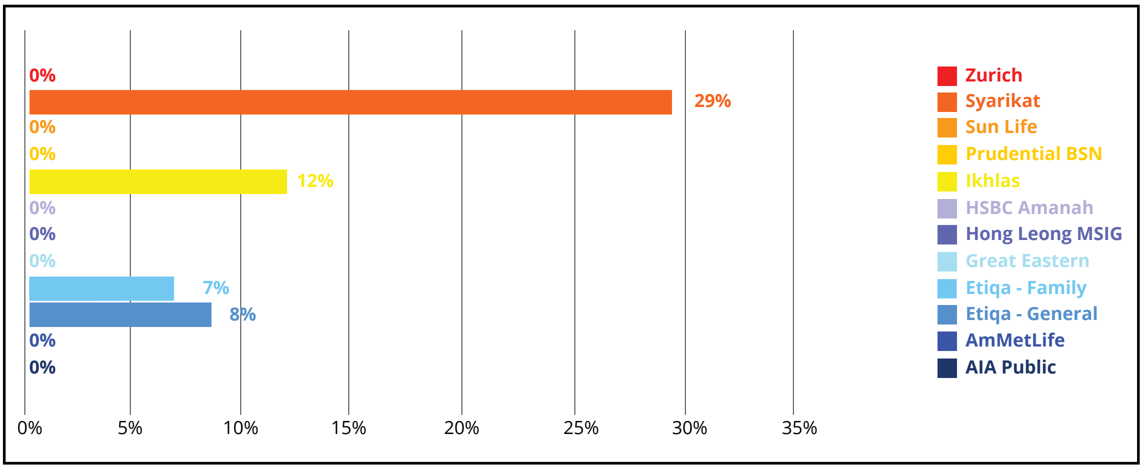

Figure 12: Share of Financial Assets at Amortised Cost (MFRS 9) in Total Assets

No.	Takaful operators in Malaysia	Shareholder's fund	General takaful fund	Family takaful fund	Total	Company	Differences
		(A)	(B)	(C)	(D) = (A+B+C)	(E)	(D-E)
		RM'000	RM'000	RM'000	RM'000	RM'000	RM'000
1	AIA Public	—	—	—	—	—	—
2	AmMetLife	—	—	—	—	—	—
3	Etiqa - General	**121,348**	124,333	—	245,681	**245,681**	—
4	Etiqa - Family	**137,132**	—	**746,077**	883,209	**883,209**	—
5	Great Eastern	—	—	—	—	—	—
6	Hong Leong MSIG	—	—	—	—	—	—
7	HSBC Amanah	—	—	—	—	—	—
8	Ikhlas	**242,562**	161,929	**318,169**	722,660	**516,099**	206,561
9	Prudential BSN	—	—	—	—	—	—
10	Sun Life	—	—	—	—	—	—
11	Syarikat	**490,308**	598,392	**1,531,375**	2,620,075	**2,550,314**	69,761
12	Zurich	—	—	—	—	—	—

Table 12: Amounts Presented as Financial Assets at Amortised Cost (MFRS 9)

Derecognition

Similar to MFRS 139, under MFRS 9, the investments in financial assets are derecognised once the takaful operator and/or the fund are no longer a party to the asset, e.g. by way of disposal, full settlement, or expiry of tenure.

5.4 Impact of MFRS 9 in Financial Assets Impairment

MFRS 9 replaces the incurred loss impairment model of MFRS 139 by introducing a forward-looking expected credit loss model. The new model eliminates the need for a trigger event to occur prior to the recognition of credit losses.

As at the time of writing this book, it is too early to establish the actual impact of MFRS 9 implementation as a complete set of audited financial statements applying this standard yet to be available. Moreover, some takaful operators decided to start applying MFRS 9 whereas some others decided to opt for delayed adoption. Nonetheless, Etiqa elaborated on the impact of MFRS 9 implementation in its unaudited interim financial statements. They have identified that implementation of MFRS 9 will result in higher impairment loss recognition. The disclosures made by Etiqa on impairment is provided in Example 4.

Etiqa Family Takaful Berhad
Notes to the Unaudited Condensed Interim Financial Statements
For the Six Months Ended 30 June 2018

2 **Significant Accounting Policies**

(ii) Impairment

The MFRS 9 impairment requirements are based on an Expected Credit Loss (ECL) model that replaces the Incurred Loss model under the current accounting standard. The ECL model applies to financial assets measured at amortised cost or at FVTOCI, irrevocable loan commitments and financial guarantee contracts, which will include loans, advances and financing and debt instruments held by the Group and the Company. The ECL model also applies to contract assets under MFRS 15 *Revenue from Contracts with Customers* and lease receivables under MFRS 117 *Leases*.

The measurement of expected loss will involve increased complexity and judgement that include:

- **Determining a significant increase in credit risk since initial recognition**

The assessment of significant deterioration since initial recognition is key in establishing the point of switching between the requirement to measure an allowance based on 12-month ECLs and one that is based on lifetime ECLs. The quantitative and qualitative assessments are required to estimate the significant increase in credit risk by comparing the risk of a default occurring on the financial assets as at reporting date with the risk of a default occurring on the financial assets as at the date of initial recognition.

The Company will be generally required to apply a three-stage approach based on the change in credit quality since initial recognition:

3 Stage Approach	Stage 1 Performing	Stage 2 Underperforming	Stage 3 Non-performing
ECL Approach	12-month ECL	Lifetime ECL	Lifetime ECL
Criterion	No significant increase in credit risk	Credit risk increased significantly	Credit-impaired assets
Recognition of interest/ profit income	Gross carrying amount	Gross carrying amount	Net carrying amount

- **ECL Measurement**

There are three main components to measure ECL which are a probability of default model (PD), a loss given default model (LGD) and the exposure at default model (EAD). The model is to leverage as much as possible in accordance with Maybank Group's Basel II models and performed the required adjustments to produce the MFRS 9 compliant model.

MFRS 9 does not distinguish between individual assessment and collective assessment. Therefore, the Company decided to continuously measure the impairment on an individual transaction basis for financial assets that are deemed to be individually significant.

- **Expected Life**

Lifetime expected credit losses must be measured over the expected life. This is restricted to the maximum contractual life and takes into account expected prepayment, extension, call and similar options, except for certain revolvers financial instruments such as credit cards and overdrafts. The expected life for these revolver facilities is expected to be a behavioural life.

- **Forward-looking information**

Expected credit losses are the unbiased probability-weighted credit losses determined by evaluating arrange of possible outcomes and considering future economic conditions. The reasonable and supportable forward-looking information will be based on Maybank's research arm, Maybank Kim Eng (MKE). In addition, the MKE Research's assumptions and analysis would also be based on the collation of macroeconomic data obtained from various sources such as, but not limited to regulators, government and foreign ministries as well as independent research organisations.

Overall, the Company anticipate an impact on the financial statements in the areas of classification and measurement for financial assets and impairment. The classification Company's financial statements whilst the impairment requirements are expected to result in a higher allowance for impairment losses.

Example 4: Impairment Under MFRS 9

6.0 TAKAFUL RECEIVABLES

2.7.1 Background

Takaful receivables are the contributions due from agents and brokers of the takaful operator.

- Islamic Financial Services Act 2013 (IFSA 2013) defines a takaful agent as a person who:
  a. solicits or obtains a proposal for takaful certificate on behalf of a takaful operator;
  b. offers or assumes to act on behalf of a takaful operator in negotiating a takaful certificate; or
  c. does any other act on behalf of a takaful operator in relation to the issuance, renewal, or continuance, of a takaful certificate.

- IFSA 2013 defines a takaful broker as a person who, as an independent contractor, carries on takaful broking business, which is a business of soliciting, negotiating or procuring a takaful certificate with a takaful operator, or the renewal or continuance of the takaful certificate by a person, for a takaful participant other than for himself and includes retakaful broking for a takaful operator.

Takaful certificate is issued upon completion of the underwriting process. This is a contract specifying all the terms and conditions of a takaful cover. In this instance, the agent or broker is assigned with the task of handling or servicing the participant as well as authorised to sign the certificate. Takaful receivables denote the contributions receivable from the agents and brokers that they collected as an intermediary between the takaful operator (which itself is an agent of takaful funds) and participants.

Figure 13 shows that takaful receivables represent only a small share of the total assets of the takaful operators in Malaysia.

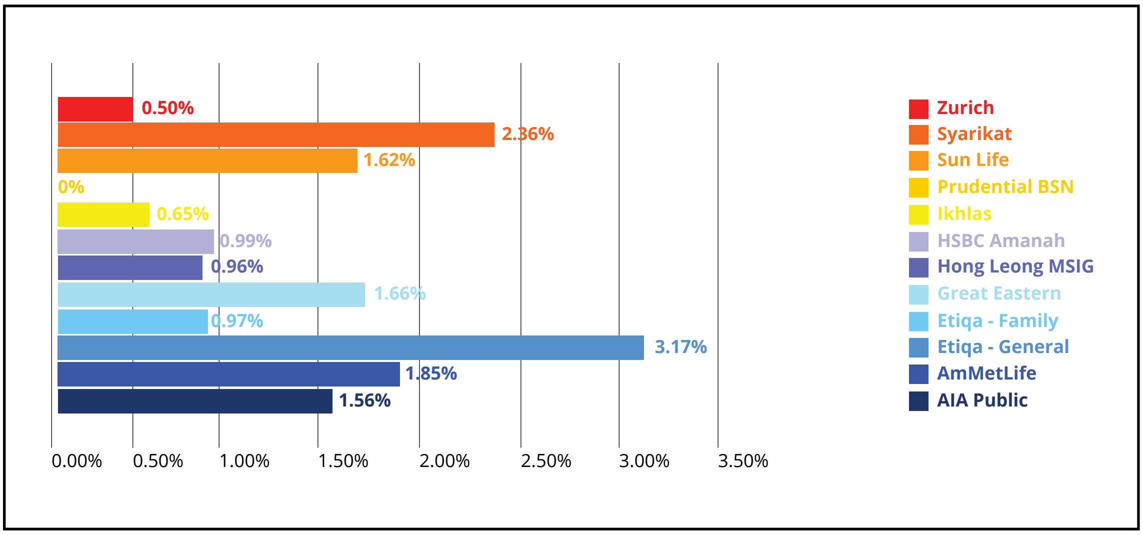

Figure 13: Share of Takaful Receivables in Total Assets

6.2 Recognition and Measurement

Initial recognition

Takaful receivables are recognised when they become due. Takaful receivables classified as loans and receivables under MFRS 139. Under MFRS 9, these are classified as financial asset measured at amortised cost. On initial recognition, the takaful receivables are measured at the fair value of the consideration received or receivable.

Subsequent measurement

In subsequent measurement, takaful receivables are measured at amortised cost using effective yield method. The takaful operator applies the impairment requirements for takaful receivables using the same process adopted for financial assets at amortised cost.

The impairment loss of takaful receivables is calculated under the same method used for financial assets. Nonetheless, Example 5 provides the impairment policy for takaful receivables as applied by Etiqa for the year-ending 31 December 2017 while it applied MFRS 139 requirements.

Etiqa Family Takaful Berhad
Year-Ended 31 December 2017

To determine whether there is objective evidence that an impairment loss on takaful receivables has been incurred, the Company considers factors such as the probability of insolvency or significant financial difficulties of the issuer or obligor and default or significant delay in payments.

Takaful receivables are initially assessed individually for those receivables that are deemed to be individually significant. If such evidence exists, the amount of impairment loss is measured as the difference between the asset's carrying amount and the present value of estimated future cash flows discounted at the financial asset's original effective profit rate. The impairment loss is recognised in profit or loss.

Receivables that are not individually significant or that have been individually assessed with no evidence of impairment are grouped together for collective impairment assessment. These receivables are grouped within similar credit risk characteristics for the collective assessment using such data as considered appropriate for purposes of grouping.

Collective loss estimates are based on the historical loss experience of the Company which could include the Company's past experience in collecting payments, an increase in the number of delayed payments in the portfolio past the average credit period and observable changes in national or local economic conditions that correlate with default on receivables. The product of collective loss estimates and grouped receivables represents the expected impairment losses for that portfolio of receivables. The impairment loss is recognised in profit or loss.

The methodology and assumptions used in determining collective loss estimates are reviewed regularly by the Company to reduce any differences between loss estimates and actual loss experience. Impairment losses on takaful receivables are recognised as a reduction against the carrying amount through the use of an allowance account. When a takaful receivable becomes uncollectible, it is written off against the allowance account. Subsequent recoveries of amounts previously written off in the financial statements are recognised in profit or loss.

Subsequent reversals of impairment loss are recognised when the decrease can be related objectively to an event occurring after the impairment was recognised to the extent that the carrying amount of the asset does not exceed its amortised cost had the impairment loss not been recognised. The reversal is recognised in profit or loss.

Example 5: Impairment of Takaful Receivables Applying MFRS 139

Derecognition

Takaful receivables are derecognised when the derecognition criteria for financial assets have been met.

6.3 Presentation and Disclosure

Takaful receivables are the contributions due from other parties to the takaful funds. Therefore, there is no amount reported in the shareholders' fund column as it has nothing to do with takaful receivables. These are only reported in general and family fund columns as identified in Table 13.

No.	Takaful operators in Malaysia	Shareholder's fund	General takaful fund	Family takaful fund	Total	Company	Differences
		(A)	(B)	(C)	(D) = (A+B+C)	(E)	(D-E)
		RM'000	RM'000	RM'000	RM'000	RM'000	RM'000
1	AIA Public	—	—	**16,286**	16,286	**16,286**	—
2	AmMetLife	—	—	**5,122**	5,122	**5,122**	—
3	Etiqa - General	—	100,694	—	100,694	**100,694**	—
4	Etiqa - Family	—	—	**121,129**	121,129	**121,129**	—
5	Great Eastern	—	—	**12,534**	12,534	**12,534**	—
6	Hong Leong MSIG	—	—	**6,597**	6,597	**6,597**	—
7	HSBC Amanah	—	6,075	**8,748**	14,823	**14,823**	—
8	Ikhlas	—	15,398	**27,266**	42,664	**27,266**	15,398
9	Prudential BSN	—	—	—	—	—	—
10	Sun Life	—	—	**25,078**	25,078	**25,078**	—
11	Syarikat	—	70,246	**134,278**	204,524	**204,524**	—
12	Zurich	—	—	**3,875**	3,875	**3,875**	—

Table 13: Amounts Presented as Takaful Receivables by the Takaful Operators

7.0 RETAKAFUL ASSETS

7.1 Background

The takaful operators cede their takaful fund risks to retakaful operators as part of their normal course of business. This is to cover wholly or partly the takaful operator's risks of the takaful fund it administers. Ceded retakaful arrangements do not relieve the takaful operator from its obligations to participants. The retakaful assets reported by the takaful operators in their statement of financial position represent balances receivable and recoverable by them from the retakaful operators.

Amounts recoverable from retakaful operators are estimated in a manner consistent with the outstanding claims provision or settled claims associated with the retakaful's certificates and are in accordance with the related retakaful contracts. As presented in Figure 14, all the takaful operators cede their fund risks to retakaful operators, hence have balances receivable or recoverable from retakaful operators.

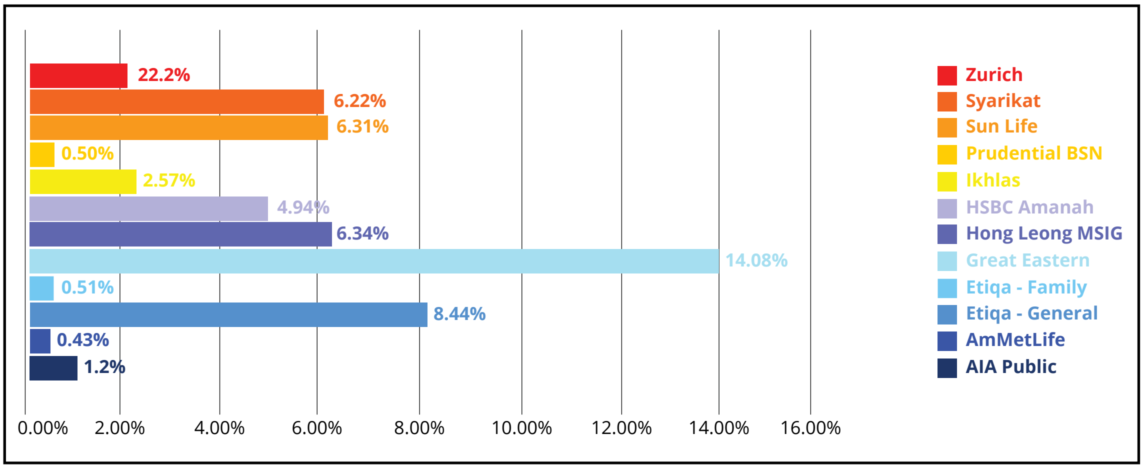

Figure 14: Share of Retakaful Assets in Total Assets

7.2 Recognition and Measurement

Initial recognition

Retakaful assets represent amounts recoverable from retakaful operators for takaful certificate liabilities which have yet to be settled at the reporting date. Amounts recoverable from retakaful operators are measured consistently with the amounts associated with the underlying takaful certificate and the terms of the relevant retakaful arrangement.

The retakaful receivables have fixed or determinable payments but are not quoted in an active market. Hence, they are classified as loans and receivables under MFRS 139. They are measured at amortised cost under MFRS 9 as they meet both of the following requirements:

a. The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.
b. The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding[26].

Subsequent measurement

Retakaful assets are reviewed for impairment at each reporting date or more frequently when an indication of impairment arises during the reporting period. Impairment occurs when there is objective evidence that the general and family takaful fund may not receive all outstanding amounts due from the retakaful operator under the terms of the contract. The impairment loss is recorded in the statement of profit or loss. Example 6 stipulates on impairment of reinsurance assets.

[26] Paragraph 4.1.2 of MFRS 9.

MFRS 4 Insurance Contracts
Impairment of reinsurance assets 20 If a cedant's reinsurance asset is impaired, the cedant shall reduce its carrying amount accordingly and recognise that impairment loss in profit or loss. A reinsurance asset is impaired if, and only if: (a) there is objective evidence, as a result of an event that occurred after the initial recognition of the reinsurance asset, that the cedant may not receive all amounts due to it under the terms of the contract; and (b) that event has a reliably measurable impact on the amounts that the cedant will receive from the reinsurer.

Example 6: MFRS 4 on Impairment of reinsurance assets

Derecognition

Retakaful assets are derecognised when the contractual rights are extinguished or expired or when the contract is transferred to another party.

7.3 Presentation and Disclosure

The takaful operators ceded their fund risks, therefore as shown in Table 14, the retakaful asset amounts are presented only in takaful fund columns, and none in shareholders' fund column. The presentation of retakaful assets under takaful fund columns is in accordance to Section 5(2) of IFSA 2013, which states that "for the purposes of this Act, the retakaful of liabilities under takaful certificates shall be treated as belonging to the same class and description as the takaful certificates issued by the retakaful operator in respect of the retakaful of such liabilities".

No.	Takaful operators in Malaysia	Shareholder's fund	General takaful fund	Family takaful fund	Total	Company	Differences
		(A)	(B)	(C)	(D) = (A+B+C)	(E)	(D-E)
		RM'000	RM'000	RM'000	RM'000	RM'000	RM'000
1	AIA Public	—	—	**12,471**	12,471	**12,471**	—
2	AmMetLife	—	—	**1,201**	1,201	**1,201**	—
3	Etiqa - General	—	268,261	—	268,261	**268,261**	—
4	Etiqa - Family	—	—	**63,915**	63,915	**63,915**	—
5	Great Eastern	—	—	**106,181**	106,181	**106,181**	—
6	Hong Leong MSIG	—	—	**43,446**	43,446	**43,446**	—
7	HSBC Amanah	—	33,038	**41,025**	74,063	**74,063**	—
8	Ikhlas	—	187,056	**108,811**	295,867	**108,811**	187,056
9	Prudential BSN	—	—	**15,765**	15,765	**15,765**	—
10	Sun Life	—	—	**97,866**	97,866	**97,866**	—
11	Syarikat	—	339,216	**199,897**	539,113	**539,113**	—
12	Zurich	—	—	**17,198**	17,198	**17,198**	—

Table 14: Amounts Presented as Retakaful Assets by the Takaful Operators

8.0 QARD RECEIVABLES

8.1 Background

To protect the takaful participants and to maintain public trust on the takaful industry, IFSA 2013 requires the takaful operators to provide qard from shareholders' fund to takaful fund if there is a deficit in the latter. Example 7 provides related excerpt from IFSA 2013.

Islamic Financial Services Act 2013		
Deficiency of takaful funds	**95.**	Where the value of the assets of the takaful fund is less than the value specified under paragraph 92(1)(b), the licensed takaful operator shall provide qard or other forms of financial support to the takaful fund from the shareholders' fund for an amount and on such terms and conditions as may be specified by the Bank.
Priority of payments in winding up of licensed takaful operator	**218.**	(1) In the winding up of a licensed takaful operator, the assets of a takaful fund for any class or description of takaful business established under section 90 shall be applied to meet the liabilities to takaful participants or proper claimants in respect of that takaful fund and such liabilities shall have priority over all unsecured liabilities of that takaful fund including any *qard* or other forms of financial support referred to in section 95, other than any tax set out in paragraph 292(1)(f) of the Companies Act 1965 which is attributable to the takaful fund.

Example 7: IFSA 2013 on Qard

Accordingly, the BNM Guidelines on Takaful Operational Framework dictates that the takaful operator shall rectify any deficit in the participants' risk fund by providing an equal amount as *qard* (i.e. interest-free loan) from the shareholders' fund. This also prevents the moral hazard of a takaful operator, i.e. continuing to enjoy fees irrespective of the health of its participants' funds, whilst an insurance company in a similar situation would bear its policyholders' deficiencies. It is also in the interest of consumer protection that regulatory capital requirements for takaful operators are often similar to those for conventional insurers.

The Malaysian Accounting Standards Board (MASB) in its Discussion Paper *i*-1 Takaful (2011) deliberated on the classification and measurement of qard. It provided a deliberation that *takaful* operators expect qard to be repaid from the fund's eventual surplus (irrespective of the tenure of the *qard*). A strict interpretation of Shariah would dictate that takaful participants should ultimately bear the risks of the fund, and therefore, have a real obligation to repay the *qard*.

In 2013, the Malaysian Institute of Accountants (MIA) issued a guidance on '*qard*' accounting, Guidance on Special Matter No. 2 *Presentation of Financial Statements for Takaful Companies; and Classification and Measurement of Qard* (hereinafter, Guidance). As provided in Example 8, it stipulates on classification and measurement of 'qard' in the statement of financial position of a takaful operator.

Malaysian Institute of Accountants

Guidance on Special Matter No. 2 Presentation of Financial Statements for Takaful Companies; and Classification and Measurement of ***Qard***

4.2 Classification and measurement of ***Qard*** in the statement of financial position of takaful operator

From the takaful operator's perspective, ***qard*** is in substance, an investment by the takaful operator in takaful funds. The ***qard***, although is refundable by the takaful fund when it has surplus assets, carries more features of an equity instrument rather than a debt instrument because:

- Its recoverability is dependent on the performance of the underlying assets and liabilities of the takaful fund;
- It is only provided in specific circumstances i.e. when the takaful fund has a shortfall of assets to cover its obligations;
- It does not have a fixed repayment period;
- It acts as a temporary capital to determine that the takaful fund will be able to continue as a going concern and provides returns to the operator via profit sharing or management fee arrangements;
- As it can only be refunded via surplus assets of the takaful fund, it is subordinated below other liabilities of the takaful fund.

Example 8: *Qard* in the Statement of Financial Position of Takaful Operator

8.2 Recognition and Measurement

Initial recognition

Qard is a benevolent (i.e. interest-free) loan from the takaful operator to the participants' risk fund. The amount shall be repaid from the future surplus of the takaful risk fund. Hence, the amount is accounted for as a receivable in the shareholder's fund column. The same is reported as *qard* payables in the takaful fund column. The amounts will be eliminated against each other in takaful operator's statement of financial position (i.e. in the company column).

According to the BNM Guidelines on Financial Reporting for Takaful Operators, '*qard*' shall be measured at cost at initial recognition. This is equal to the amount of interest-free loan paid as 'qard' by the shareholders' fund to family fund. *Qard* balances are eliminated in preparing the takaful operator's statement of financial position.

Subsequent measurement

According to the MIA *Guidance*, qard receivables are carried at cost less any accumulated impairment losses. At the end of each reporting period, the takaful operator needs to assess whether there is any indication that the qard may be impaired in accordance with MFRS 136 *Impairment of Assets*. The impairment loss of qard shall be recognised when its carrying amount exceeds its recoverable amount (i.e. higher of its fair value less costs of disposal and its value in use).

However, with the implementation of MFRS 9, as discussed before in this chapter, an expected loss model will be applied for an impairment test. MASB in its Discussion Paper *i*-1 anticipates that this will result in accelerate impairment recognition as compared to an incurred loss model.

Derecognition

Qard receivable is derecognised together with the corresponding qard payable if it is repaid by the family fund or otherwise impaired.

8.3 Presentation and Disclosure

Hong Leong MSIG reported *qard* receivable in shareholder's fund column and *qard* payable in family takaful fund column. The amounts offset one another in company level consolidation, hence no amount reported in the company column. Table 15 provides the excerpt from the statement of financial position of Hong Leong MSIG.

Asset/ Liability	Shareholder's fund	General takaful fund	Family takaful fund	Total	Company	Differences
	(A)	(B)	(C)	(D) = (A+B+C)	(E)	(D-E)
***Qard* receivable**	**31**	—	—	31	—	31
***Qard* payable**	—	—	**31**	31	—	31

Table 15: Offset of *Qard* Receivable and Payable: Hong Leon MSIG

Further discussion on qard payable is provided in Chapter 11.

9.0 CURRENT TAX ASSETS

9.1 Background

The takaful operators pay taxes on their taxable profit. Taxable profit is determined by adjusting accounting profit, according to rules established by relevant tax authorities. If the amount of tax already paid by a takaful operator in respect of current and prior periods exceeds the amount due for those periods, then the excess is recognised as an asset. However, any unpaid amount is recognised as a liability.

Normally, the takaful operators pay taxes in advance before finalising their year-end tax accounts. This may result in paying more than what the takaful operator is required to. The excess paid amount is reported as current tax assets or tax recoverable in the statement of financial position of the takaful operator. This excess paid amount can be reimbursed to the takaful operator or can be adjusted with its future tax liabilities.

As identified in Figure 15, current tax assets or tax recoverable represent a very small share of the total assets of the takaful operators in Malaysia. Nevertheless, this being a transaction with a regulatory entity, the nature of this amount entails high importance in the financial statements.

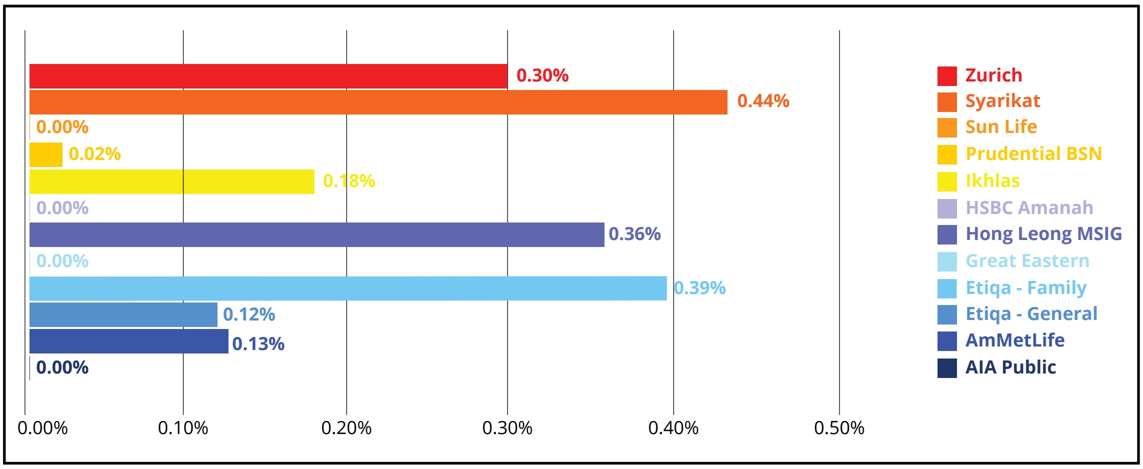

Figure 15: Share of Current Tax Assets in Total Assets

9.2 Recognition and Measurement

Current tax assets for the current and prior periods are measured at the amount expected to be recovered from the taxation authorities, using the tax rates (and tax laws) that have been enacted or substantively enacted by the end of the reporting period[27].

9.3 Presentation and Disclosure

Table 16 presents the balances reported by the takaful operators as current tax assets or tax recoverable. The total of individual columns is generally equal to the amount reported in the company column, except for Great Eastern and HSBC Amanah.

No.	Takaful operators in Malaysia	Shareholder's fund	General takaful fund	Family takaful fund	Total	Company	Differences
		(A)	(B)	(C)	(D) = (A+B+C)	(E)	(D-E)
		RM'000	RM'000	RM'000	RM'000	RM'000	RM'000
1	AIA Public	—	—	—	—	—	—
2	AmMetLife	**347**	—	—	347	**347**	—
3	Etiqa - General	—	3,883	**20,213**	3,883	**3,883**	—
4	Etiqa - Family	**29,296**	—	—	49,509	**49,509**	—
5	Great Eastern	**1,003**	—	—	1,003	—	1,003
6	Hong Leong MSIG	**2,455**	—	**42**	2,455	**2,455**	—
7	HSBC Amanah	**3,935**	—	—	3,977	—	3,977
8	Ikhlas	**7,729**	—	—	7,729	**7,729**	—
9	Prudential BSN	**605**	—	—	605	**605**	—
10	Sun Life	—	—	—	—	—	—
11	Syarikat	**38,104**	—	—	38,104	**38,104**	—
12	Zurich	—	—	**2,321**	2,321	**2,321**	—

Table 16: Amounts Presented as Current Tax Assets/Tax Recoverable by the Takaful Operators

[27]*Paragraph 46 of MFRS 112 Income Taxes.*

As depicted in Table 17, the reason for the difference is that the same difference is present in their current tax liabilities. The separate presentation in assets and liabilities is due to not fulfilling the offset criteria as provided in Paragraph 71 of MFRS 112 which states that "an entity shall offset current tax assets and current tax liabilities if, and only if, the entity: (a) has a legally enforceable right to set off the recognised amounts; and (b) intends either to settle on a net basis, or to realise the asset and settle the liability simultaneously".

No.	Takaful operators in Malaysia	Shareholder's fund	General takaful fund	Family takaful fund	Total	Company	Differences
		(A)	(B)	(C)	(D) = (A+B+C)	(E)	(D-E)
		RM'000	RM'000	RM'000	RM'000	RM'000	RM'000
1	Great Eastern	—	—	**1,286**	1,286	**283**	1,003
2	HSBC Amanah	—	4,716	**1,059**	5,775	**1,798**	3,977

Table 17: Amounts Presented as Current Tax Liabilities by the Takaful Operators

10.0 DEFERRED TAX ASSETS (DTA)

10.1 Background

Deferred tax is an accounting measure rather than a tax levied by the government. It represents tax payable or recoverable in future accounting periods in relation to transactions which have already taken place. An entity may present only DTA or only deferred tax liabilities (DTL) or both in its statement of financial position.

An entity presents both the DTA and DTL if requirements of Paragraph 74 of MFRS 112 are not fulfilled. It states that an entity shall offset DTA and DTL if, and only if:

a. the entity has a legally enforceable right to set off current tax assets against current tax liabilities; and

b. the DTA and the DTL relate to income taxes levied by the same taxation authority on either:
   i. the same taxable entity; or
   ii. different taxable entities which intend either to settle current tax liabilities and assets on a net basis or to realise the assets and settle the liabilities simultaneously, in each future period in which significant amounts of DTL or assets are expected to be settled or recovered.

As presented in Figure 16, the DTA represent a very small share of the total assets of the takaful operators in Malaysia.

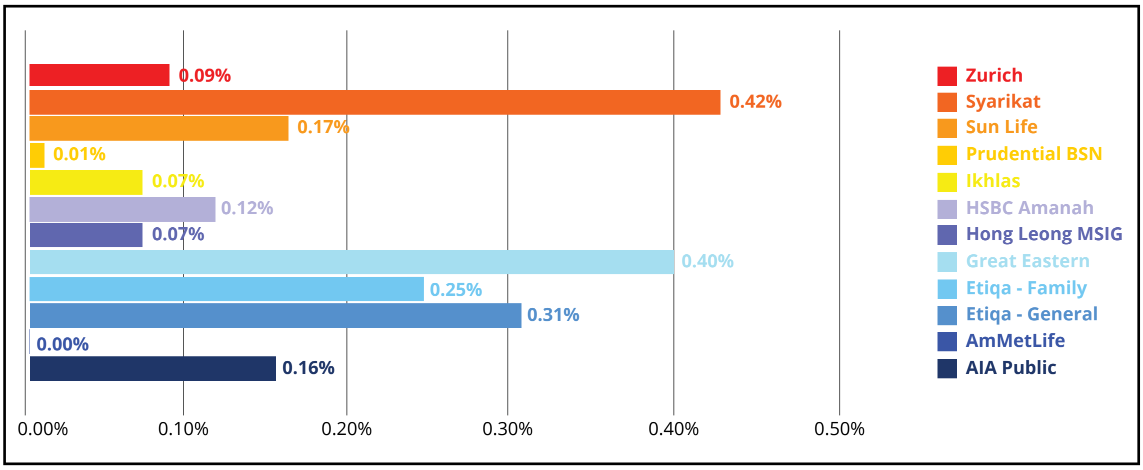

Figure 16: Share of DTA in Total Assets

10.2 Recognition and Measurement

DTA are the amounts of income taxes recoverable in future periods in respect of deductible temporary differences (and in respect of the carry forward of unused tax losses or tax credits). DTL are the amounts of income taxes payable in future periods in respect of taxable temporary differences.

Therefore, determining DTA and DTL depends on the temporary differences calculated. Temporary differences are the differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. This can either be taxable or deductible. Based on these, DTA and DTL are calculated. The process of identifying taxable and deductible temporary differences which result in either deferred tax liability or asset is summarised in Figure 17.

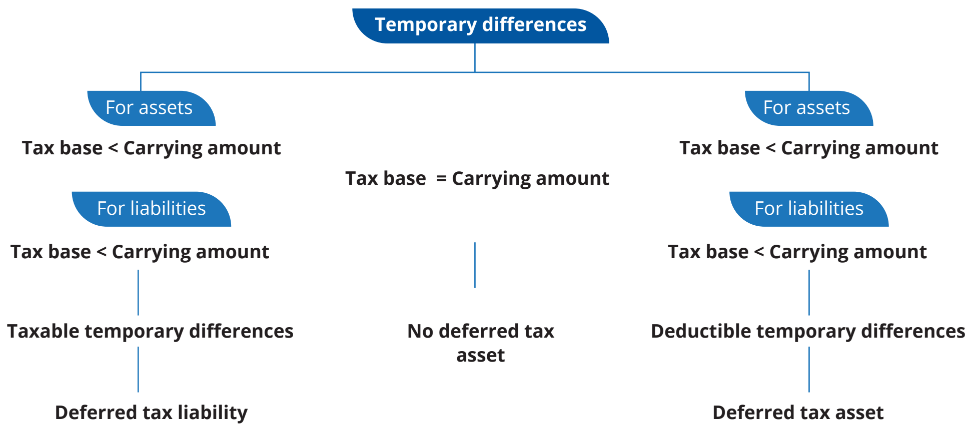

Figure 17: Identifying Temporary Differences and Deferred Tax Amounts

The steps in determining deferred tax balances are further elaborated below:

- **Step 1: Determine the item's carrying amount and its tax base**
  The entity should determine the carrying amounts of its assets and liabilities in its statement of financial position and their tax base values as determined for tax purposes.

- **Step 2: Calculate the temporary difference**
  Temporary differences are differences between the carrying amount of an asset or liability in the statement of financial position and its tax base. If there is a difference between the two amounts, then the entity needs to recognise a deferred tax asset or liability.

- **Step 3: Determine the deferred tax**
  A deferred tax asset or liability is calculated by multiplying the temporary difference by the relevant tax rate. The tax rate to be used in the calculation for determining a deferred tax asset or liability is the rate that is expected to apply when the asset is realised, or the liability is settled. These rates should be based on tax laws that have already been enacted or substantively enacted by the end of the reporting period.

DTA and DTL are calculated at the end of each reporting period. Depending on the movement in the balance, there will be either a debit entry or a credit entry of tax charges in the statement of profit or loss. But there can be exceptions including:

- Deferred tax relating to items dealt with in other comprehensive income (such as revaluation) are recognised as tax relating to other comprehensive income.

- Deferred tax relating to items dealt with directly in equity (such as the correction of an error or retrospective application of a change in accounting policy) are recognised directly in equity.

- Deferred tax resulting from a business combination is included in the initial calculation of goodwill.

10.3 Presentation and Disclosure

Table 18 presents the manner of DTA and DTL presentation by the takaful operators in Malaysia. The takaful operators that have presented DTL had taxable temporary difference and those presented DTA had a deductible temporary difference.

No.	Takaful operators in Malaysia	Shareholder's fund	General takaful fund	Family takaful fund	Company
1	AIA Public	**DTL**	—	**DTA**	DTA
2	AmMetLife	**DTL**	—	**DTL**	DTL
3	Etiqa - General	**DTA**	DTA	—	DTA
4	Etiqa - Family	**DTA**	—	**DTA**	DTA
5	Great Eastern	**DTA**	—	**DTA**	DTA
6	Hong Leong MSIG	**DTA**	—	**DTL**	DTA & DTL
7	HSBC Amanah	**DTA**	DTA	**DTL**	DTA
8	Ikhlas	**DTA**	DTA	**DTL**	DTA
9	Prudential BSN	**DTA**	—	**DTA & DTL**	DTA & DTL
10	Sun Life	**DTA**	—	**DTA**	DTA
11	Syarikat	**DTA**	—	—	DTA
12	Zurich	**DTL**	—	**DTA & DTL**	DTA & DTL

Table 18: DTA and DTL Presented by the Takaful Operators

The peculiarity can be observed from Table 18 which includes:

- AIA Public, HSBC Amanah and Ikhlas had a mix of DTA and DTL in the individual fund columns. However, in the company column, they have reported DTA. This implies that they have offset their deferred tax asset and liability balances applying Paragraph 74 of MFRS 112 as discussed earlier in this section.

- Hong Leong MSIG, Prudential BSN and Zurich have provided both DTA and DTL separately in the company column of their statement of financial position. This implies that all their DTA and DTL balances could not be offset as they have not fulfilled the requirements of Paragraph 74 of MFRS 112.

11.0 CASH AND CASH EQUIVALENTS

11.1 Background

Cash and cash equivalents consist of cash in hand, balances and deposits with banks and highly liquid investments. These deposits and investments have maturities of three months or less and have an insignificant risk of changes in fair value. These are used by the takaful operators in the management of their short-term commitments, e.g. paying takaful claims. Holding too much cash and cash equivalents may not be profitable for a takaful operator as they yield a very small return. Nonetheless, Figure 18 shows the share of cash and cash equivalents in total assets of the takaful operators.

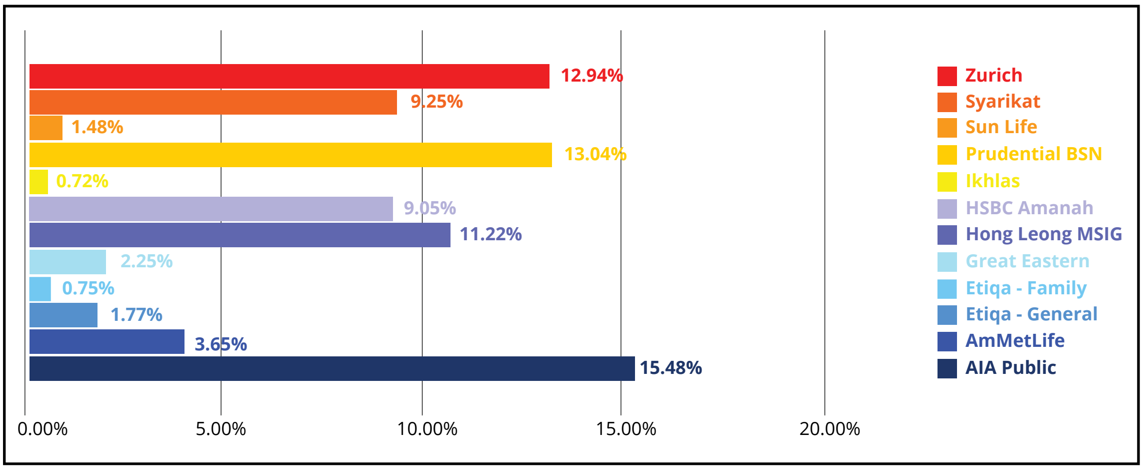

Figure 18: Share of Cash and Cash Equivalents in Total Assets

11.2 Recognition and Measurement

Initial recognition

If cash and cash equivalents are in local currency (i.e. in ringgit) then these are recorded at their par value. However, if the cash and cash equivalents are in foreign currency (e.g. dollar or euro) then these are recorded at their translated amount applying the spot exchange rate as of the date of initial recognition.

Subsequent measurement

If the cash and cash equivalents are in foreign currency, these are translated at the reported date, and any gain or loss arising from the translation is recognised in the statement of profit or loss of the takaful operator.

Cash equivalents are not amortised due to their short-term nature. Any income generated from these is recognised in the statement of profit or loss once the income is earned.

Derecognition

Cash and cash equivalents are derecognised when they are spent to serve any activities of the takaful operator.

11.3 Presentation and Disclosure

Shareholder's fund, as well as takaful funds, present cash and cash equivalents in their individual columns. This shows the cash generated by each individual fund (e.g. takaful contributions received by the takaful funds). The cash and cash equivalents are used to pay out claims to the takaful participants of the respective funds. Table 19 shows the cash and cash equivalents balances presented by the takaful operators in their statement of financial position.

No.	Takaful operators in Malaysia	Shareholder's fund	General takaful fund	Family takaful fund	Total	Company	Differences
		(A)	(B)	(C)	(D) = (A+B+C)	(E)	(D-E)
		RM'000	RM'000	RM'000	RM'000	RM'000	RM'000
1	AIA Public	9,993	—	151,279	161,272	161,272	—
2	AmMetLife	2,658	—	7,448	10,106	10,106	—
3	Etiqa - General	7,474	48,732	—	56,206	56,206	—
4	Etiqa - Family	16,852	—	77,608	94,460	94,460	—
5	Great Eastern	6,760	—	10,217	16,977	16,977	—
6	Hong Leong MSIG	7,429	—	69,544	76,973	76,973	—
7	HSBC Amanah	11,124	46,290	78,387	135,801	135,801	—
8	Ikhlas	13,344	5,129	17,274	35,747	30,618	5,129
9	Prudential BSN	88,197	22,113	304,852	415,162	415,162	—
10	Sun Life	6,767	—	16,125	22,892	22,892	—
11	Syarikat	120,901	129,349	552,145	802,395	802,395	—
12	Zurich	20,304	—	79,771	100,075	100,075	—

* The amount of the general takaful fund is considered as an asset of the discontinuing operations and hence have been excluded from cash and cash equivalent of the company.

Table 19: Amounts Presented as Cash and Cash Balances by the Takaful Operators

SUMMARY

- The columnar presentation of shareholders' fund and takaful funds as separate entities and their consolidation as a single entity is a unique practice that aims to provide better information to the users of takaful financial statements while ensuring compliance with the Shariah.
- This also provides better information regarding the net asset position of the individual funds and whether they are performing better or worse than earlier periods or other competitors.
- Nonetheless, at the time of writing this chapter, the takaful operators in Malaysia were undergoing through changes in their business model and financial reporting.
- A single takaful operator is no longer allowed to offer both general and family takaful products. Furthermore, the transition from MFRS 139 to MFRS 9 likely to have a significant impact on the classification and measurement of financial assets, which comprises the largest portion of the takaful operators' assets. However, the actual impact yet to be known.
- Thus far five out of twelve takaful operators started the implementation of MFRS 9 and the others opted for temporary exemption. Implementation of MFRS 9 will be mandatory for all from 1 January 2021.
- Moreover, with the implementation of MFRS 17 *Insurance Contracts*, the financial reporting of the takaful operators may change significantly. However, this is still under discussion among the concerned parties.
- The adoption style of MFRS 17 and their impact in financial reporting of takaful operators yet to be seen. The standard is applicable from annual reporting periods beginning on or after 1 January 2021.

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CHAPTER 11

FINANCIAL REPORTING OF LIABILITIES BY TAKAFUL OPERATOR

FINANCIAL REPORTING OF LIABILITIES BY TAKAFUL OPERATOR

LEARNING OBJECTIVES

The chapter aims to:

i. discuss the nature of liabilities, contractual and provisional, in takaful operator's financial statements.
ii. explain the accounting treatment, i.e. recognition principle, measurement and disclosure of each of the liabilities with reference to the relevant MFRSs or BNM guidelines.
iii. explain the accounting treatment of discretionary participation feature in takaful contracts.
iv. provide understanding of the accounting treatment of liabilities not related directly to takaful contracts such as subordinated obligation and tax payable.

1.0 INTRODUCTION

1.1 Liabilities of takaful business in general

According to the Conceptual Framework for Financial Reporting, hereafter referred to as CFFR, liabilities are present obligations of a takaful operator which are enforceable legally, contractually or constructively through normal business practice. Under the IFSA 2013, the takaful contractual obligations of a takaful operator are provided in a takaful certificate (for general or family takaful).

Paragraph 2 of IFSA 2013 provides that 'a takaful certificate of a takaful operator includes a takaful certificate in respect of which the takaful operator is under any liability, whether the takaful certificate was issued by the takaful operator or the liability was transferred to the takaful operator from another takaful operator'. A takaful certificate defines the takaful benefits payable and the payments that participants have to make. A takaful participant is a person who has legal title to the takaful certificate.

Further, "takaful claim" means a demand for payment of an amount due under a takaful certificate, whilst "takaful contribution" means the amount payable by a takaful participant to a takaful operator under a takaful certificate and includes any remuneration for the functions and duties assumed by the takaful operator. Thus, the main liabilities arising from takaful certificates are those related to claims and contributions proportionate to the unexpired period of the certificate.

The IFSA 2013 also requires the assets and liabilities of takaful funds to be segregated from those of the takaful operator. Thus, in the statement of financial position of a takaful operator, liabilities of the takaful funds (family and general) are distinguished from those of the shareholder's fund and disclosed in separate columns in the same manner as assets (see Chapter 10). As shown in Table 1, examples of such liabilities are takaful certificate liabilities and takaful payables.

The shareholders do not own the takaful or participants' funds although the role of the takaful operator is not limited to just managing them[1]. They are required to provide financial assistance by providing qard from the shareholder's fund in the event the participants' risk funds liabilities exceed the funds' assets[2].

[1]*Paragraph 10.6-10.8 of the Guideline on Takaful Operational Framework, Discussion Paper i-1- Takaful (MASB.*
[2]*Paragraph 14.2 of the Guideline on Takaful Operational Framework.*

Thus, the shareholders' fund is exposed to the participants' fund's risk or the variability of the participants' fund's future cash flows. By virtue of this risk exposure faced by the takaful operator and its control (as defined in MFRS 10 *Consolidated Financial Statements*) over the participants' funds, the participants' funds liabilities as well as assets are consolidated with the shareholders' assets and liabilities. The participants' funds are classified as liabilities in the company's statement of financial position.

In valuing the takaful funds' liabilities, provisions are necessarily made as a prudential measure. A significant portion of the liabilities in the financial statements of a takaful operator is estimated using actuarial methods. It is not uncommon for the liabilities such as claim liabilities to be termed as 'claims reserves' or 'loss reserves'.

The Shariah Advisory Council of BNM resolved that the setting up of provision for liabilities of takaful business is permissible as this ensures the ability of takaful fund to meet its obligation[3]. However, paragraph 14(a) of MFRS 4 *Insurance Contracts* requires takaful operators to recognise as liability provisions for future claims related to takaful contracts in existence at the end of the reporting period. This requirement prohibits catastrophe and equalisation provisions.

Takaful contract liabilities comprise participants' funds, takaful certificate liabilities, expense liabilities and takaful payables. Figure 1 provides a summary of what these liabilities are and the sections of this chapter in which they are discussed. The following sections discuss how the related financial reporting standards especially, MFRS 4 and MFRS 9 *Financial Instruments*, and the relevant BNM guidelines are applied in the accounting treatment of takaful liabilities. As it is important for the takaful operator to adequately provide for these liabilities at the reporting date, the amount to be reported is highly regulated by BNM.

Paragraph 15 of MFRS 4 requires takaful operators to assess whether the takaful liabilities recognised at the end of the reporting period is adequate to meet all future obligations related to the takaful contracts based on current estimates of future cash flows. Valuation of liabilities based on the BNM guidelines as discussed in the following respective sections satisfies this 'liability adequacy test' of MFRS 4.

Apart from the takaful contract related liabilities, there are other business-related liabilities such as loan/obligation and tax liabilities as shown in Table 1. These liabilities arise from normal business operation similar to non-takaful business. For instance, like any other business, a takaful operator needs additional funding in the form of loans or sukuk (Islamic bond). A takaful operator has tax obligations under the taxation law. The following sections will also discuss the accounting treatment of such liabilities. The various relevant excerpts from financial statements as at 31 December 2016 are prepared prior to the licensing split regulation that was effective on 1 January 2018.

[3]*(Guidelines on Valuation Basis of Liabilities for General Takaful Business and Guidelines on Valuation Basis of Liabilities for Family Takaful Business).*

TAKAFUL CERTIFICATE

Determines:

i. Participants
- contribution and other payments e.g. *wakalah* fees

ii. Takaful operators
- obligation to provide benefits
- investment

PARTICIPANTS' FUNDS

- Surplus from underwriting activities (earned contribution/other fees less expenses/claims/ benefits incurred)
- Surplus from investment activities (investment income, fair value gains and losses)

SECTION 2
(Further detailed discussion in Chapter 12)

TAKAFUL CERTIFICATE LIABILITIES

- Claim liabilities (claims incurred, incurred but not reported, etc)
- Unearned contributions (a measure of obligations in the unexpired period of takaful certificate)
- Net asset value attributable to participants (Part of contribution invested)
- Actuarial liabilities (Future obligations estimated actuarially)

SECTIONS 3 AND 4

EXPENSE LIABILITIES

- Unearned *wakalah* fees
- (a measure of future obligations to manage takaful funds)

SECTION 6

TAKAFUL PAYABLES

- Obligation to various parties involved in the inception and execution of certificates

SECTION 7

Figure 1: A summary of takaful operator's obligations arising from takaful certificates and the section in the chapter in which it is discussed

Liabilities and Participants' Funds	Notes	Shareholder's Fund	General Takaful Fund	Family Takaful Fund	Company
		RM'000	RM'000	RM'000	RM'000
Participants' funds	12	—	155,321	2,824,275	2,979,596
Takaful certificate liabilities	13	—	1,559,724	6,341,039	7,879,763
Qard payable*		—	—	—	—
Subordinated obligation	14	300,000	—	—	300,000
Expense liabilities	15	526,588	—	—	526,588
Deferred tax liabilities	16	—	—	514	
Takaful payables	17	7,762	61,776	38,213	107,751
Other payables	18	135,939	386,735	341,124	595,700
Profit payable on subordinated obligation	14	1,189	—	—	1,189
Current tax liabilities		6,317	—	—	6,317
Total liabilities and participants' funds		977,795	2,163,556	9,545,165	12,396,904

* During the financial year, the outstanding *Qard* was repaid to Shareholder's Fund.

Table 1: Excerpt from Etiqa Takaful Berhad Statement of Financial Position as at 31 December 2016

2.0 PARTICIPANTS' FUNDS

2.1 Nature/definition

Participants' funds comprise largely of surplus from underwriting operations and from investment activities. As shown in Note 12 (a) in Table 2A, the general takaful participants' funds are accumulated surplus related to underwriting and investment activities and reserves related to fair value adjustments of assets classed as available for sales (AFS) under MFRS 139 (as this statement is prepared before MFRS 9 became effective). After 1 January 2018, the surplus resulting from fair value changes is in accordance with MFRS 9.

Similarly, as shown in Note 12 (b) in Table 2A, the family takaful participants' funds consist of accumulated surplus and AFS reserves. In addition, Etiqa Takaful Berhad maintains separately an accumulated surplus attributed to participants. The accumulated surplus is derived from profit/loss recognised in the income statement whilst the AFS reserves are derived from gains/losses recognised in other comprehensive income statements.

2.2 Recognition and measurement

- **General takaful participants' fund**

The annual surplus or deficit is transferred from the general takaful part of the income statement. Chapter 12 discusses further the recognition and measurement principles of the income and expense items individually. In summary, the surplus consists of operating revenues such as gross earned contribution, fee, commission, and income and gains from investment recognised in the income statement as prescribed by MFRS 139 (as it is prior to the implementation of MFRS 9), after taking into account operating expenses and changes in takaful contract liabilities. The amount accumulated in the general takaful participants' fund is the amount attributable to the participants.

The annual gains or losses from fair value adjustments of AFS financial assets are transferred from the general takaful part of the other comprehensive income statement. The gains or losses transferred are those attributable to the general takaful participants.

- **Family takaful participants' fund**

Similarly, the annual surplus or deficit is transferred from the family takaful part of the income statement. Surplus consists of items similar to those found in the general takaful income statement. Amounts attributable to participants and hibah are deducted from the accumulated surplus in Etiqa Takaful Berhad's fund statement.

As with the general takaful fund, the family takaful participants' fund also consists of gains or losses from fair value adjustments of AFS financial assets which are transferred from the family takaful part of the other comprehensive income statement.

12. PARTICIPANTS' FUND Takaful funds and Company	RM'000
General takaful fund (Note (a))	155,321
Family takaful fund (Note (b))	2,824,275
Company	**2,979,596**
(a) General takaful fund	**RM'000**
Accumulated surplus (Note (i))	175,393
AFS reserves (Note (ii))	-20,072
	155,321
(i) Accumulated surplus	
At 1 January	146,002
Surplus arising during the year	137,240
Hibah paid to participants during the year	-107,849
At 31 December	**175,393**
(ii) AFS reserves	
At 1 January	-29,109
Net gain/(loss) on fair value changes	25,829
Realised gain transferred to income statement (Note 23)	-13,427
Deferred tax on fair value changes (Note 16)	-3,365
At 31 December	**-20,072**
(b) Family takaful fund	**RM'000**
Accumulated surplus (Note (i))	2,738,884
Surplus attributable to participants (Note (ii))	75,582
AFS reserves (Note (iii))	9,809
	2,824,275
(i) Accumulated surplus	
At 1 January	2,451,312
Surplus arising during the year	333,322
Surplus attributable to participants during the year	-25,844
Hibah paid to participants during the year	-19,906
At 31 December	**2,738,884**
(ii) Surplus attributable to participants	
At 1 January	49,738
Surplus attributable to participants during the year	25,844
At 31 December	**75,582**
(iii) AFS reserves	
At 1 January	20,709
Net gain on fair value changes	12,265
Realised gain transferred to income statement (Note 23)	-24,086
Deferred tax on fair value changes (Note 16)	921
At 31 December	**9,809**

Table 2A: Excerpt from Etiqa Takaful Berhad Statement of Financial Position as at 31 Decem-

After 1 January 2018, Etiqa Takaful Berhad no longer exists. Etiqa Family Takaful Berhad and Etiqa General Takaful Berhad are formed in order to comply with the licensing split regulation. However, what constitutes a participants' fund is the same for the years prior to the license split. Table 2B shows excerpts from the unaudited condensed interim financial statements for the six months period ended 30 June 2018 of Etiqa Family Takaful Berhad. Another significant change effective 1 January 2018 is the adoption of MFRS 9. AFS reserves are replaced by fair value to other comprehensive income (FVOCI) reserves. This is the result of adopting MFRS 9 where financial assets such as Malaysian Government Papers and unquoted debt securities in Malaysia (Note 19 (c) of Etiqa Family Takaful Berhad unaudited condensed statement of Financial Position for the six months period ended 30 June 2018) previously under MFRS 139 were classified as AFS are now, under MFRS 9, classified as FVOCI.

15. PARTICIPANTS' FUND **Family takaful fund**	**RM'000**
Accumulated surplus (Note (i))	1,918,076
Surplus attributable to participants (Note (ii))	1,303,437
FVOCI reserves (Note (iii))	-52,105
	3,169,408
(i) Accumulated surplus	
At 1 January 2018	1,723,241
Effect of adopting MFRS 9	-6,288
At 1 January 2018 (restated)	**1,716,953**
Surplus arising during the period	210,432
Surplus attributable to participants during the period	—
Hibah paid to participants during the period	-9,309
At 30 June 2018	**1,918,076**
(ii) Surplus attributable to participants	
At 1 January 2018	1,303,437
Surplus attributable to participants during the period	—
At 30 June 2018	**1,303,437**
(iii) FVOCI reserves	
At 1 January 2018	-28,401
Effect of adopting MFRS 9	3,711
At 1 January 2018 (restated)	**-24,690**
Net gain on fair value changes	-90,134
Realised gain transferred to income statement	60,733
Deferred tax on fair value changes	1,986
At 30 June 2018	**-52,105**

Table 2B: Excerpt from Etiqa Family Takaful Berhad unaudited condensed statement of Financial Position for the six months period ended 30 June 2018 - Note 15

2.3 Presentation and disclosure

In general, paragraph 36 of MFRS 4 requires takaful operators to disclose information that identifies and explains the recognised amounts. This requires disclosure of accounting policies, assumptions used in valuation, the effect of changes in the assumptions and reconciliation of changes in the takaful liabilities and retakaful assets.

The takaful operator is also required to 'disclose information that enables users to evaluate the nature and extent of risks arising' from the takaful contract. Thus, disclosure of the takaful operator's risk management objectives, policies and methods are crucial.

With regards to participants' funds, the detailed disclosure of income, expenses, gains and losses are discussed in Chapter 12. Tables 2A and 2B disclose the movement in the participants' funds to enable users to reconcile the beginning, current and end of the period amounts.

3.0 GENERAL TAKAFUL CERTIFICATE LIABILITIES

3.1 Nature/definition

The Guidelines on Valuation Basis of Liabilities for General Takaful Business defines liabilities of general takaful fund as 'the obligation of the general takaful fund to meet takaful benefits stipulated in takaful certificates and expenses payable from takaful fund'. Expense liabilities incurred in managing the general takaful but are payable from the shareholders' fund are discussed in section 6.3 below. The general takaful fund's liabilities are mainly claimed liabilities and contribution liabilities. Paragraph 11.4 of Guidelines on Takaful Operational Framework stipulates that expenses payable from takaful funds are those related to claims and investment that are approved by the Shariah Board and are not already factored into any form of remuneration received by takaful operators such as upfront fees or *wakalah* fees.

Table 3 shows the total gross and net takaful certificate liabilities after taking into account retakaful. The deduction of seed money from the gross amount is an inter-fund elimination. Seed money is an amount advanced by takaful operator to takaful fund in order to finance, for example, a new investment-linked takaful product. This seed money is used to start the fund related to the new product and thus is used to purchase investment assets such as equity or bond. Table 5 shows the general takaful fund's claim and contribution liabilities for Etiqa Takaful Berhad as at 31 December 2016.

In simple terms, claims liabilities are obligations of the takaful operator to pay participants as agreed in the takaful contracts. As a prudential measure, these liabilities consist of not only obligations arising from the actual occurrences of events as agreed in the takaful contracts, but also estimation of liabilities for future payments or obligations in relation to such claims.

Contribution liabilities are estimates of the takaful operator's future obligations which correspond with the unexpired period of the takaful contracts at the reporting date. Throughout the takaful contract, contributions paid by participants are recognised as earned through the passage of time. Thus, contribution liabilities represent the unrecognised portion for the unexpired period, thus the unexpired risk. It is also an estimate of the future obligations of takaful operators.

Contributions for general takaful such as motor, medical and fire typically cover potential loss and claimable in one calendar year. In many cases, the one-year period straddles across two accounting periods. The challenge in determining claims and contribution liabilities is in estimating what portion of the contribution is recognised as earned or unearned, as well as future obligations with regards to the unexpired period.

13. TAKAFUL CERTIFICATE LIABILITIES	Gross RM'000	Retakaful RM'000	Net RM'000
General takaful fund (Note (a))	1,559,724	-242,173	1,317,551
Family takaful fund (Note (b))	6,341,039	-49,675	6,291,364
	7,900,763	**-291,848**	**7,608,915**
Less: Seed money elimination *	-21,000	—	-21,000
	7,879,763	**-291,848**	**7,587,915**

Table 3: Excerpt from Etiqa Takaful Berhad Statement of Financial Position as at 31 December 2016 – Note 13

As discussed earlier, after the license split regulation became effective on 1 January 2018, takaful certificate liabilities for general takaful fund and family takaful fund are presented in the respective takaful companies' financial statements.

3.2 Recognition

The Guidelines on Valuation Basis of Liabilities for General Takaful Business requires takaful operators to value the liabilities of their general takaful fund at the end of each reporting period as specified in the guideline. The valuation is conducted for each homogenous class of business (for example aviation, cargo, personal accident, etc). The changes in the value of the liabilities between two reporting dates are recognised in the income statement.

3.3 Measurement

3.3.1 Measurement of claim abilities

The guideline specifies that an appointed actuary is responsible for the valuation (i.e. to ensure that the valuation meets the requirement of the guideline). At the end of the reporting date, claim liabilities are measured based on the best estimate value and the provision of risk margin for adverse deviation (PRAD), calculated at the fund level.

The Guidelines on Valuation Basis of Liabilities for General Takaful Business defines the best estimate value as the statistical central estimate value of the liabilities concerned and PRAD as the 'component of the value of liabilities that relates to the uncertainty inherent in the best estimate'. The estimation process entails the employment of a standard loss reserving methods such as the link ratio method, the Bornheutter Ferguson Method, Incurred Chain Ladder, Paid Chain Ladder and a number of other methods that are commonly used by the actuaries in the insurance industry.

In estimating the claim liabilities, the appointed actuary considers all obligations of the takaful fund, whether contractual or otherwise, to make future payments in relation to all claims that have been incurred as at the valuation date. These include:

a. provision for claims reported
   Claims reported are actual claims made by participants on the occurrence of events as agreed in takaful contracts.

b. claims incurred but not reported (IBNR).
   IBNR are estimated claims since takaful operators could not have known how many claims have incurred since they have not been reported. But there are indications to show they exist. For example, it is usual for a takaful operator to receive 1,000 claims related to motor takaful a month. To date, it has only received 700 claims. The balance 300 could possibly be incurred but the participants involved in the accidents have not made any report. Provision should, therefore, be made for such possible claims. Another indicator could be an occurrence of a natural disaster such as flooding. The takaful operators who have issued takaful contracts that cover damage from flooding in the affected areas for various assets should expect claims to be made sometime in the future.

c. claims incurred but not enough reserved (IBNER)
IBNER are claims that have been incurred and reported but the total amount of damages later turned out to be more than initially provided. A reason for this is that the amount initially claimed is understated.

d. claims-related expenses that are borne by the takaful fund' (Guidelines on Valuation Basis of Liabilities for General Takaful Business).

Examples of 'claims-related expenses that are borne by the takaful fund' are professionals services fees and other expenses incurred in settling claims such as adjustor's and legal fees.

The actual amount of claim paid is deducted from this claim liabilities. It is common to call claim liabilities or provision as claim reserves. In other words, the actual claim is paid out of claim reserves. For the year ended 31 December 2016, Etiqa Takaful Berhad paid out a total of RM610,410,000 in claims as shown in Table 5.

3.3.2 Measurement of contribution liabilities

As prescribed by the Guidelines on Valuation Basis of Liabilities for General Takaful Business, contribution liabilities are estimated based on the higher of:

a. the aggregate of the provision for Unearned Contribution Reserve (UCR); and
b. the best estimate value of the provision for Unexpired Risk Reserve (URR) at the valuation date and the PRAD calculated at the total fund level.

BNM provides guidance on the limits (maximum or minimum) of UCR (6). As an example, for unearned contribution related to marine cargo and aviation cargo, UCR calculated should not be less than 25%. Refer to Table 4 for other examples.

(a) Unearned contribution reserves

UCR represents the portion of the contributions of takaful certificates written, net of the related retakaful contributions ceded to qualified retakaful operators, that relate to the unexpired periods of the certificates at the reporting date.

In determining UCR at the reporting date, the method that most accurately reflects the actual unearned contribution is used as follows:

- 25% method for marine cargo and aviation cargo, and transit business;
  and
- all other classes of general business, using time-apportionment basis over the period of the risks, reduced by the corresponding percentage of accounted gross direct business commissions to the corresponding contributions, not exceeding limits specified by BNM as follows:

Motor and bond	10%
Fire, engineering, aviation and marine hull	15%
Workmen compensation and employers' liability:	
- Foreign workers	10%
- Others	25%
Other classes	25%

Table 4: Excerpt from Etiqa Takaful Berhad significant accounting policies – Note 2.2 (j)(ii)

Takaful operators may use a number of methods such as the 1/24th or 1/365th method in estimating the unearned portion of the contribution. As an example, say a takaful operator collected every month throughout the year (January-December), a total of RM240,000 contribution from a number of policies or certificates. Under the 1/24th method, the contribution is assumed to be collected on the 15th of each month i.e the middle of the month. Thus the unearned portion of the contribution as at the end of 12 months is calculated as follows:

MONTH	CONTRIBUTION WRITTEN/COLLECTED	UNEARNED CONTRIBUTION RESERVES AS AT 31 DECEMBER
January	240,000	240,000 X 1/24
February	240,000	240,000 X 3/24
March	240,000	240,000 X 5/24
—	—	—
—	—	—
—	—	—
November	240,000	240,000 X 21/24
December	240,000	240,000 X 23/24

The UCR calculated is on a gross basis and retakaful cessions can be deducted from it under certain conditions. Examples of those conditions include retakaful arrangement achieves effective risk mitigation or there is no obligation on the part of the ceding takaful fund to repay any amount to the retakaful operator.

URR is effectively an additional reserve to make up for any expected insufficiency in UCR to meet future claims and expenses. Thus, accounting for all expected future losses prevents the premature distribution of surplus. URR is estimated from an actuarial valuation. The Takaful Operators Statistical System Guidance Notes provides that the estimation includes expected future payments, allowance for expenses expected to be borne by the takaful fund such as cost of retakaful, and the expected future contribution refunds. This valuation is conducted by an appointed actuary.

3.4 Presentation and disclosure

The general disclosure requirement of MFRS 4 as discussed in Section 2.4 applies for the general takaful fund's liabilities. Table 3 shows the gross amount of general takaful liabilities less the amount reinsured, retakaful. This disclosure enhances users' understanding of how Etiqa Takaful Berhad manages the risk arising from the takaful certificate and thus reduces the liabilities. In other words, liabilities are disclosed before and after the risk mitigating action of retakaful.

Table 5 shows reconciliations of beginning, current and end of period amounts for both claims and contributions liabilities. In addition, MFRS 4 specifically requires disclosure of concentration of insurance risk based on types of event, geographical area or currency. In note 40 of Etiqa Takaful Berhad's financial statements which are not reproduced here, the takaful operator discloses contribution written, by breaking down into the type of insured events - motor, fire, marine and others. Note 40 also shows sensitivity analysis of how changes in key assumptions used in valuing liabilities affect gross and net liabilities. In particular, note 40 shows how a +5%/-5% change in incurred claims ratio - a key assumption, impact gross and net liabilities.

(a) General takaful fund	Gross RM'000	Retakaful RM'000	Net RM'000
Claims liabilities (Note (i))	978,209	-215,514	762,695
Contribution liabilities (Note (ii))	581,515	-26,659	554,856
	1,559,724	**-242,173**	**1,317,551**
(i) Claims liabilities			
At 1 January	925,935	-185,579	740,356
Claims incurred in the current accident year	772,249	-75,243	697,006
Movement in claims incurred in prior accident years	-29,723	4,821	-24,902
Claims paid during the year	-610,410	29,524	-580,886
Movements in PRAD	-79,842	10,963	-68,879
At 31 December	**978,209**	**-215,514**	**762,695**
(ii) Contribution liabilities			
At 1 January	579,968	-17,821	562,147
Contributions written during the year	1,181,642	-103,743	1,077,899
Contributions earned during the year	-1,180,095	94,905	-1,085,190
At 31 December	**581,515**	**26,659**	**554,856**

Table 5: Excerpt from Etiqa Takaful Berhad Statement of Financial Position as at 31 December 2016 – Note 13(a)

4.0 FAMILY TAKAFUL CERTIFICATE LIABILITIES

4.1 Nature/definition

BNM's Guidelines on Valuation Basis of Liabilities for Family Takaful Business states that 'liabilities of family takaful fund refers to the obligation of the family takaful fund to meet takaful benefits stipulated in takaful certificates and expenses payable from takaful fund'. Expense liabilities incurred in managing the family takaful but are payable from shareholders' fund are discussed in section 6.1 below. As described in section 6.3, expenses payable from takaful fund are those related to claims and investment as stipulated in paragraph 11.4 of Guidelines on Takaful Operational Framework.

Unlike a general takaful contract, a family takaful contract is typically a contract that covers potential loss and claims in more than one year. Thus, the challenge in determining the certificate liabilities is in estimating the potential obligation and related cash flows for a relatively long period of time in the future.

(b) Family takaful fund

(i) The family takaful certificate liabilities and its movements are further analysed as follows:

	Gross RM'000	Retakaful RM'000	Net RM'000
Claims liabilities (Note (ii))	152,003	-9,356	142,647
Actuarial liabilities (Note (ii))	6,158,453	-40,319	6,118,134
NAV attributable to unit holders (Note (ii))	30,583	—	30,583
	6,341,039	**-49,675**	**6,291,364**

Table 6: Excerpt from Etiqa Takaful Berhad Statement of Financial Position as at 31 December

A takaful operator is required to maintain a Participants' Risk Fund (PRF)[4] for all products. PRF is the pool of contributions paid by participants on the basis of tabarru' (donation). This tabaru' is used to meet claims on the occurrence of events as agreed in the takaful contracts. For annuity products, the PRF is the pool of tabarru' contributions for the purpose of making payments during the annuity period.

In addition, a takaful operator maintains a Participants' Investment Fund (PIF) which is a fund in which a portion of the contributions paid by takaful participants for a takaful product is allocated for the purpose of savings and/or investment. This requirement is in line with the provision of MFRS 4. MFRS 4 requires an insurer to unbundle insurance and deposit components where the insurer can measure the deposit component and the insurer's accounting policies do not require it to recognise obligations and rights arising from the deposit component. MFRS 4 prohibits unbundling of insurance and deposit components in situations where the insurer cannot measure separately the deposit component.

Although it is not apparent from the financial statements of takaful operators such as Etiqa Takaful Berhad (given in Table 3), the amount shown as the general takaful fund's certificate liabilities is PRF. The family takaful fund's certificate liabilities comprise of PRF and PIF.

4.2 Recognition

The Guidelines on Valuation Basis of Liabilities for Family Takaful Business requires takaful operators to value the liabilities of their family takaful business at the end of each financial year in accordance to the requirements of the guideline.

[4] *Guidelines on Takaful Operational Framework.*

4.3 Measurement

Unlike the measurement of general takaful liabilities, the measurement of family takaful liabilities is not so straightforward even though the purpose of the provision is the same and that is to provide for the takaful operator's future obligation towards meeting all takaful benefits and related expenses. As for general takaful liabilities, a significant portion of family takaful liabilities consists of claims liabilities. Recall that the way to account for future obligations of general takaful is to estimate UCR. The earned contribution is recognised in the income statement.

However, for family takaful, the gross contribution is recognised in the income statement on due dates, without apportioning earned and unearned. The liabilities, the future obligations, of family takaful fund is measured as the present value of future benefits plus any present value of expected future expenses payable from the takaful funds less the present value of future gross tabarru' arising from the certificate. The valuation is conducted for each takaful certificate. Part of the contribution related to the investment-linked product where participants are assigned units is invested accordingly and accounted for separately.

The present values are calculated based on a risk-appropriate discount rate as prescribed by the guideline. The guideline also requires the appointed actuary to consider appropriately the assumptions underlying the calculation of present values. These assumptions include expenses (of both takaful and shareholders' funds), mortality and morbidity, persistence and growth rate of PIF. The retakaful cessions may be deducted from the gross value of the family takaful fund's liabilities if certain conditions are met such as the retakaful arrangement is effective in mitigating risk.

Table 6 shows the main components of family takaful certificate liabilities for Etiqa Takaful Berhad as at 31 December 2016. They are claims liabilities, actuarial liabilities and the net asset value (NAV) attributable to unit holders. As shown in Table 7, under claim liabilities column, in the same manner as to claim liabilities of general takaful, claims paid during the year is deducted from the claim liabilities.

The actuarial liabilities column shows the movement of the estimated liabilities based on present value calculation which is a provision for future obligations. NAV attributable to unitholders refers to the PIF component for investment-linked products. For non-unit investment-linked products, the related PIF is part of the actuarial liabilities. To understand further, the measurement of NAV considers the following simple example.

Suppose a takaful operator offers a new investment-linked family takaful. At the inception of the fund, the shareholders' fund provides RM10,000,000 as seed money to purchase 10,000,000 units. Throughout the year RM1,000,000 contribution money is received of which RM900,000 is used to purchase 900,000 units. RM100,000 of the participants' contribution is tabarru' payment into PRF. Investment income received for the year amounts to RM545,000. The NAV of the fund at the end of the first year of operation is as follows:

					NAV
	CONTRIBUTION RM'000	RM'000	UNIT	PRICE/UNIT	PRF
Shareholders' fund (seed money)	10,000	10,000	10,000	1.00	—
Participants	1,000	900	900	1.00	100
Investment income		545		1.06	
TOTAL		**11,445**	**10,900**		

Thus, the reported NAV for the year-end is RM11,445,000.

4.4 Presentation and disclosure

The disclosure principles discussed in section 3.4 for the general takaful certificate liabilities also applies to the family takaful certificate. Table 7 shows how each of the family takaful certificate liabilities is further broken down in detail to comply with those disclosure principles.

The movement in the claim liabilities consists of outstanding claims intimated for the year which is the actual claims intimated (for example, on the death of the person insured) less claims paid during the year.

The actual claim intimated for the year reduces the opening value of the actuarial liabilities. This net figure is reconciled with the year-end value estimated from the actuarial process by an adjustment, an increase in certificate reserves.

The movements of the NAV of the unitholders, which is a PIF, consist of additional earned contribution plus other revenue and less claims paid and expenses.

In terms of providing information to enable users to understand the 'nature and extent' of risk, the takaful operator is required to disclose a sensitivity analysis of key assumptions used in the valuation, concentration of the takaful risk (such as by type or geographical area) and claim developments (that is a comparison of actual and previous estimates).

For example, Etiqa Takaful Berhad discloses a breakdown of the concentration of family takaful actuarial liabilities into endowment, mortgage, term assurances, annuity and others (note 40 of the financial statements). For the sensitivity analysis, note 40 of the financial statements shows how a negative change in the discount rate (used in the calculation of the present value) affect gross and net liabilities. Similarly, the effect of each of the percentage change in mortality and morbidity rates, lapse and surrender rates, and estimated expenses on the gross and net liabilities are shown in note 40.

	Claims Liabilities RM'000	Actuarial Liabilities RM'000	NAV Attributable to Unit holders RM'000	Gross Liabilities RM'000	Retakaful Assets RM'000	Net Liabilities RM'000
At 1 January	121,506	5,987,224	26,351	6,135,081	-36,129	6,098,952
Net earned contribution	—	—	10,421	10,421	-52,658	-42,237
Other revenue	—	—	1,799	1,799	—	1,799
Experience/ benefit variation	2,805	—	—	2,805	28,064	30,869
Claims intimated during the year	754,737	-754,737	—	—	532	532
Claims paid during the year	-727,045	—	-7,533	-734,578	24,595	-709,983
Other expenses	—	—	-352	-352	—	-352
Taxation	—	—	-103	-103	—	-103
Increase in certificate reserves	—	925,966	—	925,966	-14,079	911,887
At 31 December	**152,003**	**6,158,453**	**30,583**	**6,341,039**	**-49,675**	**6,291,364**

Table 7: Excerpt from Etiqa Takaful Berhad Statement of Financial Position – Note 13(b)(ii)

5.0 QARD PAYABLE

5.1 Nature/definition

Takaful operators must evaluate deficiency or loss in PRF that is when the assets of PRF (of the general or family takaful fund) is less than the respective PRF liabilities (Guidelines on Takaful Operational Framework). *Qard* payable is an amount due to the shareholders' fund for an amount received from the shareholders' fund to rectify such deficit or loss. Thus, it is a payable recognised in either the general or family takaful fund as the case may be.

The amount is payable in a future period when PRF assets exceed liabilities. In the case of Etiqa Takaful Berhad, the *Qard* is paid during the financial year ending 31 December 2016 (Table 1). Thus, no amount of *Qard* payable is disclosed in the financial statement for that period. If the deficiency or loss in PRF is due to negligence or mismanagement, the shareholders bear the loss through an outright transfer.

Note that shareholders' fund is not required to make good deficiency or loss in PIF except in cases where the deficiency or loss is due to negligence or mismanagement. Under normal circumstances, participants are to bear the losses as the contract underlying the PIF is a *mudharabah* contract. If shareholders bear the losses via *Qard*, this effectively means the takaful operator as *mudharib* guarantees the *mudharabah* capital. This violates the Shariah principles underlying a *mudharabah* contract.

5.2 Recognition

Qard payable in the takaful fund is recognised when the assets of PRF (of the general or family takaful fund) is less than the respective PRF liabilities (Guidelines on Takaful Operational Framework). Based on MIA's Guidance on Special Matter No. 2 *Presentation of Financial Statements for Takaful Companies and Classification and Measurement of Qard*, *qard* payable in the takaful fund's financial statement is classified as a liability.

5.3 Measurement

On initial recognition, *Qard* is recorded at the amount equivalent to the deficit in the takaful fund. In determining such deficit, the Guidelines on Takaful Operational Framework provides that "Assets" refers to the total assets of the PRF, as reported in the balance sheet of the fund; and "Liabilities" refers to the sum of actuarial liabilities and other liabilities of the PRF, as reported in the balance sheet of the fund."

As discussed in MIA's Guidance on Special Matter No. 2, the takaful fund does not have an unconditional right to defer settlement of the liability for at least twelve months after the reporting period.' Further, the fair value of a *qard* payable with a demand feature is not less than the amount payable on demand, discounted from the first date that the amount could be required to be repaid.

5.4 Presentation and disclosure

The takaful operator discloses its accounting policy regarding *Qard*.

6.0 EXPENSE LIABILITIES

6.1 Nature/definition

As defined in the Guidelines on Valuation Basis of Liabilities for General Takaful Business and the Guidelines on Valuation Basis of Liabilities for Family Takaful Business, expense liabilities are anticipated future costs to be incurred in managing the general and takaful contracts that are payable from the shareholder's fund. These expenses are operation and management expenses including commission and underwriting expenses such as surveyors' fees or medical assessment fees. Paragraph 11.4 of Guidelines on Takaful Operational Framework stipulates that these fees are to be borne by the shareholders' fund. The purpose of such provisioning is to ensure the solvency of the takaful operator.

6.2 Recognition

Expense liabilities are valued by an appointed actuary for general and family takaful fund separately. Thus, it is a provision recognised at the end of the reporting period. The expense is recognised in the income statement through the passage of time over the term of the takaful contracts.

6.3 Measurement

- **Expense liabilities for general takaful fund**
  The Guidelines on Valuation Basis of Liabilities for General Takaful Business provides that the expense liabilities of shareholders' fund in managing the general takaful fund is the higher of

  a. the aggregate of the provision for Unearned *Wakalah* Fee (UWF), calculated in a similar manner as the calculation of the Unearned Contribution Reserves (UCR), for all lines of business; and
  b. the best estimate value of the provision for Unexpired Expense Risk (UER) at the valuation date and the PRAD calculated at the total fund level.

UWF is calculated as shown in section 3.3 where an example of the calculation of UCR is discussed. UER is estimated using the actuarial method. As shown in Table 8, the expense liabilities provided for general takaful fund of Etiqa Takaful Berhad as at 31 December 2016 is RM135,813,000. This shows for this accounting year, UWF of Etiqa Takaful Berhad is higher than UER.

To understand the movement of UWF for general takaful as shown in Table 8, the following fictional journal entries based on the figures given in Table 8 are created.

		RM'000	RM'000
Dr	Cash	351,836	
Cr	*Wakalah* Fee (Income Statement) (Received *wakalah* fees upfront)		351,836
Dr	Unearned *wakalah* fees (Income Statement)	19,614	
Cr	Expense liabilities		19,614

(Recognising increase in UWF for general takaful fund)

Thus, an amount of (RM351,836,000 - RM19,614,000) = RM332,222,000 is recognised as earned *wakalah* fees in the income statement.

The balance of the expense liabilities as at 31 December 2016 is:
= Beginning balance + changes in UWF
= RM116,199,000 + RM19,614,000
= RM135,813,000

Suppose UER is estimated to be RM150,813,000. The expense liability of general takaful fund is UER balance. An additional RM15,000,000 is to be provided as follows.

		RM'000	RM'000
Dr	UER	15,000	
Cr	Expense Liability		15,000

- **Expense liabilities for family takaful fund**
  The expense liabilities of the shareholders' fund in managing the family takaful fund is estimated from an actuarial process. In the estimation, the appointed actuary takes into account the present value of expected future expenses payable from shareholders' fund in managing the takaful fund for the full contractual obligation of the takaful certificate.

The cash flows to be considered as shareholders' fund income shall be future *wakalah* fees, remunerations from PIF and any other income that the takaful operator can determine with reasonable certainty.[5]

The accounting treatment for *wakalah* fees mirrors that of contribution. The following journals created below help to understand the accounting treatment.

		RM'000	RM'000
Dr	Cash	260,006	
Cr	*Wakalah* Fee (Income Statement) (Received *wakalah* fees upfront)		260,006
Dr	Unexpired expense risk (UER)	36,443	
Cr	Expense liabilities		36,443
	(Recognising increase in UER for family takaful fund)		

As for gross contribution for family takaful fund, the *wakalah* fees received upfront is recognised in the income statement. The increase in UER is an additional expense provided.

The balance of the expense liabilities for family takaful as at 31 December 2016 is:
= Beginning balance + changes in UER
= RM354,332,000 + RM36,443,000
= RM390,775,000

[5]*Guidelines on Valuation Basis of Liabilities for Family Takaful Business.*

6.4 Presentation and disclosure

Apart from the usual qualitative accounting policy disclosure, the takaful operator is required to disclose movement in the components of both general and family takaful expense liabilities as a way of identifying and explaining these items that arise from takaful contract. Table 8 shows Etiqa Takaful Berhad's disclosure of its expense liabilities borne by the shareholders' fund.

	2016 RM'000
Shareholder's fund/Company:	
UWF of general takaful fund	135,813
UER of family takaful fund	390,775
	526,588

		2016 General Takaful Fund RM'000	2016 Family Takaful Fund RM'000	2016 Total RM'000
At 1 January		116,199	354,332	470,531
Wakalah fee received during the year	21	351,836	–	351,836
Wakalah fee earned during the year		-332,222	–	-332,222
Movement in UWF	30	19,614	–	19,614
Movement in UER	30	–	36,443	36,443
		135,813	390,775	526,588

Table 8: Excerpt from Etiqa Takaful Berhad Statement of Financial Position – Note 15

7.0 TAKAFUL PAYABLES

7.1 Nature/definition

Takaful payables are the amount payable to agents, brokers, retakaful companies and participants.

IFSA 2013 provides that takaful agent means a person who does all or any of the following:

a. solicits or obtains a proposal for takaful certificate on behalf of a takaful operator;
b. offers or assumes to act on behalf of a takaful operator in negotiating a takaful certificate; or
c. does any other act on behalf of a takaful operator in relation to the issuance, renewal, or continuance, of a takaful certificate;

Accordingly, any amount due to agents for such services is included in takaful payables.

IFSA 2013 also defines the role of a broker. A takaful broker means a person who, as an independent contractor, carries on takaful broking business and includes a retakaful broker;' and a takaful broking business means the business of soliciting, negotiating or procuring a takaful certificate with a takaful operator, or the renewal or continuance of the takaful certificate by a person, for a takaful participant other than for himself and includes retakaful broking for a takaful operator. In the same manner, any amount due to brokers is included in takaful payables.

A retakaful is a takaful contract arranged by a takaful operator with a second takaful operator for covering the risks of the takaful fund which the former takaful operator manages. Any amount due to retakaful companies and participants are included in takaful payables.

7.2 Recognition

Takaful payables are recognised as financial liabilities as the takaful operator 'becomes party to the contractual provisions of the instrument' as required under MFRS 9. In other words, the takaful operator has an obligation to pay cash to the other party.

7.3 Measurement

The amount recognised initially is the amount stipulated in the respective contracts. In principle financial liabilities recognised under MFRS 9 are measured initially at fair value and then subsequently at amortised cost using effective interest rate method. There is an option to measure financial liabilities at fair value through profit or loss through designation upon initial recognition.

However, due to the short-term nature of these takaful liabilities at the reporting date, they are commonly carried at the initial recognition amount which approximates the fair value at the reporting date.

7.4 Presentation and disclosure

17. TAKAFUL PAYABLES	Shareholder's Fund RM'000	General Takaful Fund RM'000	Family Takaful Fund RM'000	Company RM'000
Amounts due to agents and brokers	7,762	25,356	21,390	54,508
Amounts due to retakaful operators	—	36,420	16,823	53,243
	7,762	**61,776**	**38,213**	**107,751**

Table 9: Excerpt from Etiqa Takaful Berhad Statement of Financial Position – Note 17

8.0 PARTICIPATION FEATURE

Takaful operators, as well as some conventional insurers, may issue contracts with discretionary participation features. Such a contract provides that the participants participate in a defined share of the return of an identified portfolio of underlying assets.

For example, there is a term in the general takaful contract for participants to receive a certain percentage from the general takaful fund surplus. The surplus may be a result of exceptional performance from investment activities or/and lower than anticipated incidences of claims. The distribution can be in terms of adjustment to contribution or a rebate.

MFRS 4 defines the discretionary participation feature as a contractual right to receive additional benefits besides the guaranteed benefits. The discretionary benefits are a significant portion of the total contractual benefits and at the discretion of the takaful operator in terms of amount and timing. MFRS 4 provides an option for takaful operators to recognise separately the guaranteed and discretionary element as a liability and a component of equity respectively. They need not do so.

The related revenue may also be recognised in total without attributing any to the liability or equity component. The same accounting treatment applies to discretionary participation feature in investment contracts. If the participation feature does not meet the definition of a discretionary participation feature under MFRS 4, then it should be treated as a provision under MFRS 137 (Feedback statement – MASB Discussion papers on takaful, sukuk and shariah-compliant profit and loss sharing contracts).

9.0 OTHER LIABILITIES (NON-TAKAFUL CONTRACT RELATED)

A takaful operator as any other business entity would incur liabilities such as in issuing sukuk/bond or tax/zakat payable that are unrelated to takaful contracts. In other words, these liabilities are obligations that do not arise under an insurance/takaful contract as defined by MFRS 4. These are liabilities incurred in running a business. The accounting treatment for these liabilities is prescribed in MFRS 9 and MFRS 112, respectively.

A takaful operator may also have to consider making provisions for contingent liabilities under MFRS 137, for example in a situation where it is in dispute with customers regarding claims and this leads to litigation.

The following sections discuss liabilities found in Etiqa Takaful Berhad's financial statements for the year ending 31 December 2016 for the purpose of illustrating the applications of those respective standards. MFRS 9 was applicable on 1 January 2018.

However, the standard's requirements for the classification and measurements of liabilities are largely the same as the predecessor MFRS 139 *Financial Instruments: Recognition and Measurement* with very few exceptions, Etiqa Takaful Berhad's financial statements for the year ending 31 December 2016 is still useful.

9.1 Subordinated obligation

9.1.1 Nature/definition

A subordinated obligation, debt or loan is an obligation that ranks below other liabilities with regards to claiming on the takaful operator's assets. The amount of RM300,000 disclosed in Etiqa Takaful Berhad's statement of financial position relates to sukuk or Islamic bond.

9.1.2 Recognition

According to MFRS 9, a financial liability such as the sukuk is recognised when the takaful operator, that is Etiqa Takaful Berhad becomes 'a party to the contractual provisions of the instrument.

9.1.3 Measurement

At initial recognition, the sukuk is measured at fair value plus any transaction costs. Subsequent to initial recognition, the sukuk and other financial liabilities are classified and subsequently measured at amortised cost (paragraph 4.2.1 MFRS 9) using the effective profit method.

An exception to this requirement is financial liabilities designated and measured at fair value to profit and loss (FVTPL). The fair value changes attributed to the changes in the liabilities' own credit risk is accounted for in other comprehensive income (unless this treatment creates or increases an accounting mismatch) and the remaining fair value changes are accounted for in the profit and loss. Impairment losses are recognised as prescribed in section 5 of MFRS 9.

Financial guarantee contracts that do not fall within the definition of insurance contract as in MFRS 4 and commitments to provide loans at below market rate of interest or profit are other exceptions where these liabilities are measured at the higher of a loss allowance (as prescribed in section 5 of MFRS 9) and the amount initially recognised.

9.1.4 Presentation and disclosure

MFRS 7 prescribes disclosure requirements for financial liabilities. The main requirement is the disclosure either in the statement of financial position or in the notes, of the carrying amount of financial liabilities at fair value (either designated as such or held for trading) and those at amortised cost. Etiqa Takaful Berhad discloses the carrying amount of its subordinated sukuk in the statement of financial position as shown in Table 1. This subordinated sukuk is measured at amortised cost.

Other information disclosed in note 14 of the financial statements are issuance and redemption dates and the profit rates. For financial liabilities measured at fair value to profit and loss, MFRS 7 requires disclosure of the changes in fair value, in particular, of the amount that is attributable to changes in its credit risk.

9.1.5 Profit payable on the subordinated obligation

The profit is payable based on the contractual agreement and in the case of Etiqa Takaful Berhad's sukuk it is payable semi-annually in arrears. Thus, the effective profit is accrued as of such.

9.2 Current tax liabilities

MFRS 112 defines current tax as 'the amount of income taxes payable (recoverable) in respect of the taxable profit (tax loss) for a period'. Any amount of the current tax either related to the current profits or prior years' profits that is unpaid is treated as a liability.

SUMMARY

- This chapter discusses the accounting treatment of takaful operators' liabilities by referring to the relevant MFRSs, in particular MFRS 4, MFRS 9 and MFRS139, and various guidelines issued by BNM. The MFRSs and BNM guidelines are complementary in nature.

- Whilst MFRSs provide general principles such as provision for future claims is to be made for claims that arise from only existing takaful contracts and address specific issues such as liability adequacy and the unbundling of deposit component, the BNM guidelines provide detail guidelines on definition, recognition, measurement and disclosure based on existing industry practice and prudential requirement.

- The accounting treatment of liabilities that do not arise from takaful contracts is based on the respective MFRS such as MFRS 9 for financial liabilities, MFRS 112 for taxation and MFRS 137 for provisions and contingent liabilities.

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CHAPTER 12

FINANCIAL REPORTING OF EQUITY BY TAKAFUL OPERATOR

FINANCIAL REPORTING OF EQUITY BY TAKAFUL OPERATOR

LEARNING OBJECTIVES

This chapter covers financial reporting for equity of takaful operators in Malaysia. The chapter explains the income statements that reports the revenues and expenses of takaful operators and the related takaful funds which are the general takaful funds and family takaful funds.

The chapter aims to:

i. provide explanation of the operation of the takaful operator and the different classification of equity reported.
ii. provide illustration on the recognition and disclosure in financial reporting of different classification of equity in the statement of financial position of takaful operator.
iii. provide explanation of the relevant standards and policy documents in relation to reporting of equity in the statement of financial position of takaful operator.

1.0 INTRODUCTION

As discussed in Chapter 9, takaful companies are similar to other business entities incorporated under the Companies Act, 2016 (or the Companies Act, 1965) where takaful company is a legal entity. Similar to other business entities, takaful companies also have an equity component in the financial statements. The chapter aims to give understanding to readers on the equity component in the financial statements of takaful companies.

2.0 DEFINITION AND NATURE

Paragraph 4.63(c) of the Conceptual Framework for Financial Reporting[1] defines equity as the residual interest in the assets of the entity after deducting all its liabilities. Equity can also be defined as the Net Asset Value[2] (NAV) of the entity where it reflects the claims on the residual interest in the assets after deducting all liabilities.

Equity is further classified into share capital and reserves, where:

- share capital is the funds contributed by shareholders; and
- reserves are equity account attributable to the owners of the company other than amounts directly contributed by the owners.

[1]The International Accounting Standards Board (Board) issued the revised Conceptual Framework for Financial Reporting (Conceptual Framework), a comprehensive set of concepts for financial reporting, in March 2018.
[2]NAV represents the net value of an entity and is calculated as the total value of the entity's assets minus the total value of its liabilities.

2.1 Share capital

Takaful companies may issue two types of shares which are ordinary shares and preference shares. Classes of shares are distinguished by the rights, such as rights to distributions and voting attached to them. Ordinary shares are shares held by individuals and/or corporations that carry the rights for holders to attend, participate, speak and vote in a meeting (be it annual or emergency general meeting).

The ordinary shareholders are the owners of the company because they have the right on the surplus assets of the company. The board of directors declare dividends based on the company's profitability. However, as takaful companies are under the purview of BNM, any dividend can only be declared upon approval by BNM.

In contrast, preference shares differ from ordinary shares where: (i) preference share does not grant voting rights; (ii) preference share is less risky; and (iii) preference shares typically has a fixed dividend rate. Among the types of preference shares issued by companies are:

i. Cumulative preference shares – entitled to receive dividends in arrears next year if the payment is insufficient this year;
ii. Non-cumulative preference shares – not entitled to receive dividends in arrears if dividends are not paid during the year;
iii. Participating preference shares – entitled to receive additional dividends when ordinary shareholders have received dividends.
iv. Non-participating preference shares – not entitled to receive additional dividends when ordinary shareholders have received dividends.

2.2 Reserves

In general, the reserve can be divided into two broad categories i.e. (i) capital reserve; and (ii) revenue reserve. The capital reserve is created from capital profit such as profit on the sale of fixed assets. Meanwhile, the revenue reserve is created from the profit of the company from their ordinary business activities. The common revenue reserve is the retained earnings of the company. The retained earnings are the accumulated net profit of the company that is retained by the company at a particular period.

3.0 RECOGNITION AND MEASUREMENT

MFRS 132 *Financial Instruments: Presentation* provides guidance to assess whether shares issued by an entity is a financial liability or equity. It shall be noted that not all shares issued should be automatically classified as equity in the financial statements. The classification of financial instruments either as equity or financial liability shall be made in accordance with the substance of the contractual arrangement and the definition of a financial liability or an equity. Paragraph 16 of MFRS 132 states that to determine whether a financial instrument is an equity instrument rather than a financial liability, the instrument is an equity instrument, if, and only if, both conditions (a) and (b) below are met:

a. The instrument includes no 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 issuer.

b. If the instrument will or may be settled in the issuer's own equity instruments, it is:

   i. A non-derivative that includes no contractual obligation for the issuer to deliver a variable number of its own equity instruments; or
   ii. A derivative that will be settled only by the issuer exchanging a fixed amount of cash or another financial asset for a fixed number of its own equity instruments.

It was further explained that a contractual obligation, including one arising from a derivative financial instrument, that will or may result in the future receipt or delivery of the issuer's own equity instruments but does not meet conditions (a) and (b) above, is not an equity instrument. An exception is also applied for an instrument that meets the definition of financial liability to be classified as an equity instrument if it has all the features and meets the conditions as in paragraphs 16A and 16B or paragraphs 16C and 16D of MFRS 132.

These instruments are referred to as puttable instruments. Hence, it is important for an entity to assess the features of the shares issued to determine their classification rather than by its label.

It is important to note that the equity component is available only for takaful operators but not the takaful funds. This is because takaful funds do not issue share capital to its participants that confers rights similar to a capital provider.

The participant's funds as explained earlier in Table 2A in Chapter 11 which are general takaful funds and family takaful funds are not the capital of takaful operator but are liabilities to the company which are payable to participants.

4.0 PRESENTATION AND DISCLOSURE

Paragraph 4.4 (c) of the Conceptual Framework, defines equity as the residual interest in the assets of the entity after deducting all its liabilities. Furthermore, paragraph 4.20 explains further that although equity is defined in paragraph 4.4 as residual, it may be sub-classified in the balance sheet.

Example 1 is an extract of the statement of financial position that shows the total equity. In this example, the sub-classification of equity are: (i) share capital; and (ii) reserve. The amount of total equity is RM1,773,061,000 which consist of RM400,000,000 share capital and RM1,373,061 reserves. The equity elements only appear to the shareholder's fund and the company and not the takaful funds as those funds are classified under participants' funds. The differences of RM2,373 reserves in the shareholder's fund and the company is due to the amount of seeds money deducted from the shareholder's fund that will be explained in Example 3.

Equity, Liabilities and Participant's Funds					
2016		**Shareholder's Fund RM'000**	**General Takaful Fund RM'000**	**Family Takaful Fund RM'000**	**Company RM'000**
Equity					
Share capital	10	400,000	–	–	400,000
Reserves	11	1,373,061	–	–	1,370,688
Total equity		**1,773,061**	**–**	**–**	**1,770,688**

Example 1: Extract of Equity in the Statement of Financial Position of Etiqa Takaful Berhad as at the year ended 2016

Paragraph 54 (r) of MFRS101 on the information to be presented in the statement of financial position, states the minimum requirement shall include line items to present the amount of the issued capital and reserves attributable to owners of the parent.

Moreover, paragraph 78(e) of MFRS 101 states that regarding the information to be presented either in the statement of financial position or in the notes, the disclosure varies for each item, for example, equity capital and reserves are disaggregated into various classes, such as paid-in capital, share premium and reserves.

Paragraph 79 of MFRS 101 explains that an entity shall disclose the following, either in the statement of financial position or the statement of changes in equity or in notes:

a. for each class of share capital:

   i. the number of shares authorised;
   ii. the number of shares issued and fully paid, and issued but not fully paid;
   iii. per value per share, or that the shares have no par value;
   iv. a reconciliation of the number of shares outstanding at the beginning and at the end of the period;
   v. the rights, preferences and restrictions attaching to the class including restrictions on the distribution of dividends and the repayment of capital;
   vi. shares in the entity held by the entity or its subsidiaries or associates; and
   vii. shares reserve for issue under options and contracts for the sale of shares, including terms and amounts; and

b. a description of the nature and purpose of each reserve within equity.

In Malaysia, section 74 of the Companies Act, 2016 states that all shares issued shall not have par or nominal value. This requirement is applicable to all shares issued before or upon commencement of the Act (the Companies Act 2016 is effective from 31 January 2017). As such, the share premium category is no longer available in the financial statements of takaful operators for financial periods beginning on or after 1 February 2018.

4.1 Share Capital

The takaful company's equity may consist of different types of shares. The paid-up share capital represents the money contributed by the shareholders in the company as an investment in the takaful operation businesses. It may consist of purchases for ordinary shares, the premium paid on share capital and purchases for preference shares. The share premium is the excess amount received by the company over the par value of its shares. The amount of share premium is a non-distributable reserve.

In Example 2, the takaful company only issues ordinary shares of RM1.00 each and the paid-up ordinary shares amount is RM400,000,000 with the number of shares of 400,000,000 units respectively. It is also noted that the authorised ordinary shares of RM1.00 each amounted to RM500,000,000 with the number of authorised ordinary shares of 500,000,000 units.

SHARE CAPITAL **Shareholder's fund / Company**	**No. of shares '000**	**Amount RM'000**
2016/2015		
Authorised:		
Ordinary shares of RM1.00 each		
At 1 January/31 December	500,000	500,000
2016/2015		
Issued and paid-up:		
Ordinary shares of RM1.00 each		
At 1 January/31 December	400,000	400,000

Example 2: Extract of the Note 10 - Share Capital of Etiqa Takaful Berhad as at the year ended 2016

4.2 Retained Profits and Reserves

The retained profits on the statement of financial position show the takaful company's total net profit or loss since the establishment of the company. The retained profits can be reduced by dividends payments and loss for the year. In other words, the retained profits are a portion of the company's net profits that are set aside and not paid as dividend. On the other hand, reserves are equity accounts attributable to the owners of the company other than amounts directly contributed by the company including changes in fair value of AFS reserve.

By referring to Example 3, the reserve for shareholder's fund or company is segregated to (i) non-distributable; and (ii) distributable reserve. The distributable reserve is a reserve that is allowed to be used for distribution from company to shareholders such as dividends. The non-distributable reserve is the portion of accumulated shareholders' equity which could not be distributed in the form of dividends. It may include the share premium accounts and capital redemption reserve which can only be used for limited purposes.

The non-distributable reserve for the company is AFS reserve amounted to RM22,455,000 which consist of AFS reserves (i.e. RM20,082,000) less seed money elimination (i.e. RM2,373,000). The seed money is the initial capital invested by shareholders to establish the investment-linked takaful funds. While the retained profits are the distributable reserve which amounted to RM1,393,143. Hence, the total reserves for the company are RM1,370,688.

The AFS reserves of the company arise from the changes in the fair value of the investments classified as AFS financial assets. This is consistent with the requirement in paragraph 55 of MFRS 139 which states a gain or loss arising from a change in the fair value of an AFS financial asset shall be recognised in other comprehensive income and paragraph 106 of MFRS 101.

However, with the adoption of MFRS 9 from 1 January 2018, the classification of AFS financial assets is no longer available. Instead, the movement in the reserves will reflect fair value changes of financial assets measured at fair value through other comprehensive income (FVOCI) as explained in Chapter 10.

RESERVES **Shareholder's fund / Company**	**2016** **RM'000**
Non-distributable:	
AFS reserve	(20,082)
Less: Seed money elimination	(2,373)
	(22,455)
Distributable:	
Retained profits	1,393,143
	1,370,688

Example 3: Extract of the Note 11 – Reserves of Etiqa Takaful Berhad as at the year ended 2016

SUMMARY

- In summary, part of the element of the financial position of a company is equity.
- The sub-classification of equity may show the primary sources of the shareholder's equity which are usually the contributed capital from the sale of shares; and the retained profits or accumulated profits generated by the company profit-making activities.
- Takaful operator may issue different types of shares, accumulate their profits and create some particular reserve.
- All these elements need to be reported in accordance with the relevant MFRS.

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CHAPTER 13

INCOME STATEMENT

INCOME STATEMENT

LEARNING OBJECTIVES

This chapter covers the financial reporting of income and expenses by takaful operators in Malaysia. The chapter explains the income statements that report the income and expenses of takaful operators and the related takaful funds which are the general takaful funds and family takaful funds.

The chapter aims to provide:

i. Explanation of the operation of takaful operator in relation to their income and expenses;
ii. Illustration on the recognition, measurement and disclosure of income and expenses of takaful operator and the related takaful funds; and
iii. Explanation of the relevant standards and policy documents in relation to the preparation of the income statement of takaful operator.

1.0 INTRODUCTION

As explained in Chapter 9, the Takaful operator and Takaful funds are separated consistent with Shariah requirements. IFSA 2013 requires clear segregation of the assets, liabilities, income and expenses of the shareholder's fund, family fund and general takaful fund. The relationship between the takaful operator and the takaful funds would depend on the takaful model adopted by the takaful companies.

The flowchart of the operation of wakalah takaful model for both general takaful and family takaful is depicted in **Figure 8, Figure 9, Figure 10** and **Figure 11** which are under Mudharabah and Wakalah models, respectively in **Chapter 9**. The models adopted shall impact the recognition of income and expenses in the income statements of takaful companies.

Although the assets and liabilities of takaful funds are separated from takaful operator, it should be noted that for financial reporting, MFRS 10 *Consolidated Financial Statement* requires the assets, liabilities, income and expenses of the takaful funds to be consolidated with takaful operator as it represents the control possessed by the takaful operator over the respective funds. The financial statements of takaful companies however, include separate information of the takaful funds and takaful operator together with the consolidated financial information of the company in the statement of financial position, the income statement, the statement of comprehensive income as well as relevant notes to the financial statements as these are additional supplementary information that

2.0 INCOME AND EXPENSES

The elements of financial statements directly related to performance are both income and expenses which are presented in the income statement based on Paras 4.68 and 4.69 of the Conceptual Framework for Financial Reporting 2018 ("the Conceptual Framework"), the definitions of elements relating to performance as follow:

- Income is increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to contributions from holders of equity claims.
- Expenses are decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims.

The definition of income includes both revenue and gains. Revenue arises during the ordinary activities of takaful company and is referred to by a variety of different names such as contributions fees and profit. Based on Para 7.15 of the Conceptual Framework, income and expenses are classified and included either:

a) in the statement of profit or loss; or
b) outside the statement of profit or loss, in other comprehensive income.

In general, the principal activity of the takaful operator is the management of general takaful, family takaful and takaful investment-linked businesses[1]. Hence, there are two main income for takaful operators which are *Wakalah* fee and investment income where the main activity of the takaful operator includes takaful investment business.

Based on BNM's policy documents, *Wakalah* refers to a contract where a party, as principle authorizes another party as his agent to perform a particular task on matters that may be delegated, with or without the imposition of a fee. Normally, takaful operator for general and family takaful under *Wakalah* model act as an agent is entitled to receive the Wakalah fee in managing the takaful funds. The Wakalah fee payable to the Takaful operator as an agent is made of the periodic contribution[2] by the participants.

Meanwhile, investment income is from contribution received from participants investing in Shariah-compliant assets. Hence, the revenue may include the contributions made by the participants, *Wakalah* fees, investment income and other types of revenue.

On the other hand, the definition of expenses includes losses as well as those expenses that arise from the ordinary activities of the entity. For example, the cost of sales, wages and depreciation. For takaful operators, the main expenses are the benefits and claims paid to the participants and other expenses that include management expenses, fee and commission expenses.

Referring to Para 36 of MFRS 4 *Insurance* requires an explanation of the recognised amounts where an insurer shall disclose information that identifies and explains the amounts in its financial statements arising from insurance contracts. Then, Para 37 of MFRS 4 then states that to comply with Para 36 (a), an insurer shall disclose its accounting policies for insurance contracts and related assets, liabilities, income and expense. Because of this, the takaful operator must disclose all the income and expenses relating to their operations.

Para 82 (a) of MFRS 101 *Presentation of Financial Statements* requires disclosure of total revenue as a line item on the face of the income statement. Hence, the total revenue disclosed in takaful operator income statements should show the net earned contributions and the other revenue where any additional information on operating revenue can be disclosed on the face of the income statements.

Para 99 of MFRS 101 requires expenses to be analysed by either their nature or their function within the entity, whichever provides information that is reliable and more relevant. Moreover, Para 85 of MFRS 101 states that an entity shall present additional line items, headings and subtotals in the statement of comprehensive income and the separate income statement (if presented) when such presentation is relevant to an understanding of the entity's financial performance.

MFRS 4. IG 24 explains that MFRS 101 has listed the minimum line items that an entity should present in its statement of comprehensive income. It also requires the presentation of additional line items when this is necessary to present fairly the entity's financial performance. In the case of takaful operator, it was concluded that in satisfying these requirements takaful operators need to present the following amounts in its statement of comprehensive income:

a) revenue from takaful contracts/certificates issued (without any reduction for retakaful held).
b) income from contracts with retakaful.
c) expenses for policyholder/takaful certificate holder claims and benefits (without any reduction for retakaful held)
d) expenses arising from retakaful held.

[1]Division 2, Para 16 of IFSA states that a licensed takaful operator, other than a licensed professional retakaful operator, shall not carry on both family takaful business and general takaful business.
[2]Contribution can also be made in one single contribution payment.

3.0 INCOME STATEMENT FOR TAKAFUL OPERATORS

The income statement for takaful operators have seven major captions which are: (i) operating revenue[3]; (ii) net earned contributions; (iii) other revenue; (iv) net benefits and claims; (v) operating profit before surplus transfers; (vi) profit or surplus before taxation; and (vii) net profit

In the context of Malaysia, for instance, Para 12.6 of BNM's policy document on *Financial Reporting for Takaful Operators* dated on 28 January 2015 states that the explanatory notes that need to be disclosed in the annual financial statements of takaful operator shall include among others i.e. (i) gross and net earned contribution; (ii) gross and net benefits and claims; (iii) fees and commission income; and (iv) management expenses.

Para 9.1 of BNM's policy document on *Guidelines on Takaful Operational Framework* dated on 26 June 2013 states that the takaful operators are required to segregate the assets of the takaful operators. The takaful operators are required to establish and maintain separate takaful funds in respect of family takaful business and general takaful business. Hence, the income statement also reports the segregation of the shareholder's fund, the general takaful fund and the family takaful fund for the accounting period as in **Example 1**.

However, pursuant to the new BNM's requirement to split composite licences for general takaful and family takaful, the new requirement has led to the creation of separate legal entity for general takaful and family takaful, the income statement of a takaful company may only have (i) takaful operator and general takaful funds or (ii) takaful operator and family takaful funds.

For these three separate funds, the operating profit is derived after the total amount of net earned contributions, other revenue and net benefits and claims being added, and deduction been made on the other expenses in relation to the specific funds. On the other hand, losses are reported if the amount of expenses is larger than the amount of revenue. The operating profits for both general takaful funds and family takaful funds are then transferred to the participants' funds and to the shareholders based on the agreement in the term and conditions of the contract between them. Then, the amount of the net profit for the year is derived after tax and zakat amount are deducted.

[3]It is noted that not all takaful operator presents operating revenue that includes wakalah fees, investment income, and gross contribution as shown by Etiqa Takaful Berhad income statement for the year ended 31st December 2016. Contrary, by referring to Takaful Ikhlas Berhad's statement of comprehensive income for the year ended 31st March 2016, there is no presentation of operating revenue on the face of the statement of comprehensive income. However, the items that represent operating revenue have also been presented in respective line items which are (i) fee and commission income for wakalah fee; (ii) investment income; and (iii) net earned contribution for gross contribution. MFRS 101 only required to show the revenue or income for the takaful contract without emphasize on which items represent the operating revenue for takaful operator.

INCOME STATEMENT FOR THE YEAR ENDED 31 DECEMBER 2016	Note	2016 Shareholder's Fund RM'000	General Takaful Fund RM'000	Family Takaful Fund RM'000	Company RM'000
Operating revenue	**19**	**710,050**	**1,250,561**	**1,581,806**	**2,930,462**
Gross earned contributions	20	–	1,180,095	1,184,225	2,364,207
Earned contributions ceded to retakaful	20	–	(94,905)	(52,658)	(147,563)
Net earned contributions	**20**	**–**	**1,085,190**	**1,131,567**	**2,216,644**
Fee and commission income	21	611,842	15,900	2,498	18,398
Investment income	22	98,208	68,919	397,581	564,708
Net realised gains	23	16,792	13,427	39,111	69,330
Net fair value gains/(losses)	24	–	(369)	48,626	48,257
Other operating (expenses)/income, net	25	(399)	13,229	(15,267)	(2,437)
Other revenue		**726,443**	**111,106**	**472,549**	**698,256**
Gross benefits and claims paid	26	–	(610,410)	(734,578)	(1,344,988)
Claims ceded to retakaful	26	–	29,524	24,595	54,119
Gross change to certificate liabilities	26	–	(52,274)	(203,153)	(725,989)
Change in certificate liabilities ceded to retakaful	26	–	29,935	13,546	43,481
Net benefits and claims		**–**	**(603,225)**	**(899,590)**	**(1,973,377)**
Management expenses	27	(279,982)	(1,031)	(30,134)	(311,034)
Change in expense liabilities	30	(56,057)	–	–	(56,057)
Fee and commission expenses	31	(228,510)	(351,836)	(262,427)	(230,931)
Profit on subordinated obligation		(13,597)	–	–	(13,597)
Tax borne by participants	32	–	5,128	8,859	13,987
Other expenses		**(578,146)**	**(347,739)**	**(283,702)**	**(597,632)**
Operating profit before surplus transfers		148,297	245,332	420,824	343,891
Surplus transferred to participants' funds		–	(137,240)	(333,322)	–
Surplus attributable to shareholders		195,594	(108,092)	(87,502)	–
Profit/surplus before taxation		343,891	–	–	343,891
Taxation	32	(109,573)	–	–	(109,573)
Zakat		(3,456)	–	–	(3,456)
Net profit for the year		**230,862**	**–**	**–**	**230,862**
Basic and diluted earnings per share (sen)	**33**	**58**	**–**	**–**	**58**

Example 1: Extract of Income Statement of Etiqa Takaful Berhad for the year ended 2016

Based on Example 1, the report shows clear segregation of funds i.e. (i) shareholder's fund; (ii) general takaful fund; and (iii) family takaful fund.

The first column (i.e. shareholder's fund) shows the income and expenses related to takaful operator as an agent in managing the takaful funds. The second and the third column shows the income and expenses for both participant's funds (i.e. the general takaful funds and family takaful funds). Any income and expenses in relation to the participant's funds are recorded here.

Diagram 1 explains the *Wakalah* model where the participants are the owner of the takaful funds and the takaful operator is appointed as an agent to manage the takaful funds based on pre-agreed agency fee. The agency fee is deducted from the contribution received and takaful operator also remunerated with performance fees on an agreed percentage when the funds meet certain expected performance agreed upfront with participants.

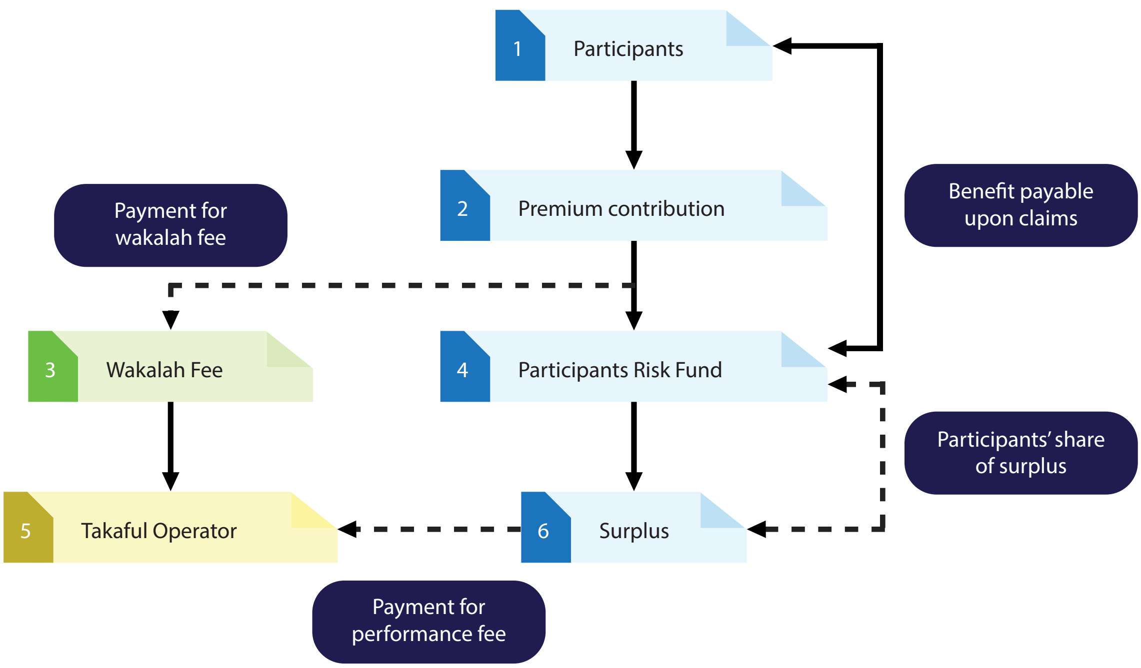


Diagram 1: General takaful under *Wakalah* model

For illustration, in the case of general takaful under wakalah model, Diagram 1 explains the application and the flow of transactions that reported in either the shareholder's funds or takaful fund. The flow of the transactions is as follow:

1. The participants pay the premium contribution are reported in the participant's funds (i.e. takaful fund) (1 to 2)
2. The *wakalah* fees are deducted by a certain percentage from the premium contribution and recorded in takaful operator's fund (i.e. shareholder's fund). (2 to 3 to 5)
3. Simultaneously, the remaining amount of the premium contributions goes to the participant's risk funds and hence recorded in the participant's fund (i.e. takaful fund). (2 to 4)
4. In the case of a claim, benefits payable upon claim are reported in the participant's fund (i.e. takaful fund) (4 to 1)
5. The surplus is reported in the participant's fund (i.e. takaful funds) if there is an operating profit of the participant's fund (4 to 6)
6. The takaful operator is also remunerated with performance fee from the surplus of participant's risk funds based on the agreed percentage is reported in the takaful operator's funds (i.e. shareholder's fund). (6 to 5)
7. Similarly, the participant also shares the surplus after the participant's funds record operating profits. The distribution of the surplus is reported in the participant's fund (i.e. takaful funds). (6 to 4).

Finally, in reporting the takaful operator's financial statement at company-level, the last column shows the income and expenses of the takaful company. Here, the balances and transactions of the shareholder's fund are amalgamated and combined with the takaful funds (i.e. general takaful funds and family takaful funds).

For example, the *Wakalah* fee income from participants are recorded in the shareholder's fund only whereas the *Wakalah* fees expenses are recorded in the takaful funds i.e. the same amount i.e. RM 611,842,000 in shareholder's fund; and RM 611,842,000 (i.e. RM 351,836,000 + RM 260,006,000) in general takaful fund and family takaful fund as in Example 2 and Example 11. Any inter-funds balances, transactions and unrealised gains or losses are fully eliminated during amalgamation.

4.0 OPERATING REVENUE

As explained earlier, not all takaful operators present operating revenue that includes *Wakalah* fees, investment income, and gross contribution in the income statement. However, there are takaful operators that reports operating revenue. Para 82 (a) of MFRS 101 emphasis the minimum requirement on the statement of comprehensive income shall include line items of revenue amounts for the period[4].

The income statement shows the operating revenue which usually consists of the *Wakalah* fees, investment income, and gross contributions can be depicted in Example 2 for shareholder's fund, the general takaful fund, the family takaful fund, and the company. In the shareholder's fund, the *Wakalah* fees are payable to takaful operator are made of the periodic contribution or single payment made by takaful participants.

The investment income appears in all the column in relation to the income generated from the investment made from each of the types of funds. Meanwhile, the gross contributions only appear in both general takaful fund and family takaful fund because the initial premium contributions by the participants are payable directly to the respective funds.

Operating Revenue **2016**	**Shareholder's Fund RM'000**	**General Takaful Fund RM'000**	**Family Takaful Fund RM'000**	**Company RM'000**
Wakalah fees	611,842	—	—	—
Investment income	98,208	68,919	397,581	564,708
Gross contributions	—	1,181,642	1,184,225	2,365,754
	710,050	1,250,561	1,581,806	2,930,462

Example 2: Extract of the Note 19 Operating Revenue of Etiqa Takaful Berhad for the year ended 2016

Referring to shareholder's fund, the total amount of operating revenue is RM710,050,000 consists of both *Wakalah* fees amounting RM611,842,000 and investment income amounting RM98,208,000. The operating revenue of both general takaful fund and family takaful fund are RM1,250,561,000 and RM1,581,806,000; respectively which consists of the total amount of investment income and gross contributions. Similarly, the total amount of operating revenue of the company is RM2,930,462,000 consists of the investment income and gross contributions.

[4]The minimum requirement does not require to report the operating revenue as a line item. In this case, the revenue from wakalah fees, investment income and contributions are also reported separately in different line items.

5.0 CONTRIBUTIONS

In the context of an insurance company, an insurance premium is the amount of money that an individual or business pays for an insurance policy. However, the concept of takaful is different from insurance wherein the context of Malaysia, the IFSA 2013 defines takaful as an arrangement based on mutual assistance under which takaful participants agree to contribute to a common fund providing for mutual financial benefits payable to the takaful participants or their beneficiaries on the occurrence of pre-agreed events.

Para 82 (a) of MFRS 101 requires disclosure of total revenue as a line item on the face of the income statement. Hence, the total revenue disclosed in takaful operator income statements should show the net earned contributions and the other revenue where any additional information on operating revenue can be disclosed on the face of the income statements. Because of this, the contribution as part of the revenue must be disclosed. Here, the contribution is an arrangement whereby a group of individuals each pay a fixed amount of money, and compensation for the losses of members of the group are paid out of the total sum.

Based on Diagram 1, the participants for general takaful under *Wakalah* model pay the periodic contribution or a single contribution payment to the participant's risk funds i.e. in the general takaful fund, and a certain percentage of the contribution is the *Wakalah* fee paid to the takaful operator and reported at the shareholder's fund, as an income received from the participant's fund (i.e. general takaful fund).

Similarly, for family takaful under *Wakalah* model, as shown in Figure 11 (Chapter 9), the premium contribution made by the participants are paid to the participant's fund (i.e. family takaful funds) which can be divided into two types of funds i.e. (i) participants' investment funds and (ii) participants' risk funds. Similarly, a certain percentage of the premium contributions is the wakalah fees to the takaful operator and reported in the shareholder's fund as income from the family takaful fund.

The net earned contribution is equal to the gross earned contribution minus earned contribution ceded to retakaful as in Figure 1.

Net earned contribution = Gross earned contribution - Earned contribution ceded to retakaful

Figure 1: Equation on Net Earned Contribution

The net earned contributions are the amount of gross earned contributions minus earned contributions ceded to retakaful as shown in Example 3. This happens when some proportion of the earned contribution are ceded to retakaful. Hence, the underwriting risks are transferred to retakaful. For instance, it is agreed that 40% of the risks for a participant will be bared or transfer to the retakaful operators. Hence, the initial gross contribution amount of RM 1,000 payable by the participants to the takaful funds will be transferred for an amount of RM 400 (i.e. 40% x RM 1,000) to the retakaful. This is the amount of earned contribution ceded to retakaful operators.

The gross earned contribution is the amount of gross contribution and the change in unearned contribution reserves; and the earned contribution ceded to retakaful is the amount of contributions ceded to retakaful operators and the change in unearned contribution reserves (UCR).

The UCR is an item that appears on the takaful operator statement of financial positions. It shows the total amounts of contribution written but not yet earned. Hence, the changes in UCR will affect the net amount of contribution and contribution that ceded to retakaful.

Net Earned Contribution 2016	General Takaful Fund RM'000	Family Takaful Fund RM'000	Company RM'000
a. Gross contribution	1,181,642	1,184,225	2,365,754
Change in unearned contribution reserves	(1,547)	–	(1,547)
	1,180,095	1,184,225	2,364,207
b. Contributions ceded to retakaful operators	(103,743)	(52,658)	(156,401)
Change in unearned contribution reserves	8,838	–	8,838
	(94,905)	(52,658)	(147,563)
Net earned contributions	1,085,190	1,131,567	2,216,644

Example 3: Extract of the Note 20 - Net Earned Contributions of Etiqa Takaful Berhad for the year ended 2016

Based on Example 3, the net earned contributions of general takaful fund amounts to RM1,085,190,000 which is obtained after deducting the earned contributions ceded to retakaful operators from the gross earned contribution. Meanwhile, the net earned contributions for family takaful fund amounts to RM1,131,567,000.

The gross contribution is contributions on the original gross rate charged to clients in respect of takaful business without any deduction for any commission or brokerage. Both gross contributions and contributions ceded to retakaful operators must be deducted with the change in UCR to determine the gross earned contributions and earned contribution ceded to retakaful. The UCR is the contributions that have already been received in respect of risks which are still unexpired at the end of the accounting period. Hence, the changes amount of UCR must be deducted since it is not a contribution for the respective year.

6.0 OTHER REVENUE

Takaful operator reports among others, fee and commission income; investment income; net realised gains or losses; and net fair value gains or losses as part of the other revenue of takaful operations.

6.1 *Wakalah* fees and commission Income

Wakalah is a contract of agency where an agency relationship is agreed between two parties to conduct a certain business undertaking. The participants remain the actual owners of the takaful fund and the takaful operator acts as an agent of the participants who manage the fund for a fee. As an agent, the operator is entitled to an agency fee. The agency fee rate is fixed annually in advance, in consultation with the Shariah committee or Shariah Board of the takaful operator.

In other words, the *Wakalah* fees represent fees charged by the shareholder's fund to manage takaful certificate issued by the general and family takaful funds under the principle of *wakalah* and are recognised as soon as the contributions to which they relate can be reliably measured in accordance with the principle of Shariah. Participants are charged for the policy administration services, surrenders and other contract fees.

These fees are recognised as revenue over the period in which the related services are performed. However, if the fees are for services to be provided in future periods, the fees are deferred and recognised over those future periods. In the case of management fee income earned from the investment-linked business, it is recognised on an accrual basis based on the net asset value of the investment-linked funds.

For both general takaful and family takaful that apply *Wakalah* model as in Figure 10 and Figure 11 in Chapter 9, when participants pay contributions under the takaful scheme, the contributions are divided into (a) Wakalah fee; and (b) payment to participant's fund. This division is made on the agreed ratio between the takaful operator and the participants in the contract. This *Wakalah* fee, which consists of the agent's commission and operating expense, is channelled to the takaful operator i.e. reported in shareholder's fund.The *Wakalah* fee income in the shareholder's fund is from the participant's fund (i.e. both general takaful fund and family takaful fund) which are illustrated in Example 4. Not only that, both general takaful fund and family takaful fund received other commission income which is profit commission and retakaful commission income[5].

The profit commission refers to the surplus share of the participant's funds from the retakaful operator. The profit commission is the income for the participant's fund (i.e. in this case the family takaful fund) due to the surplus of the retakaful fund being shared with the participants.

On the other hand, the retakaful commission income is a fee paid by the retakaful operator to the ceding company (i.e. takaful operator) in obtaining retakaful business from the takaful operator. The retakaful commission income will be credited into the participant's fund (i.e. in this case general takaful fund) since all retakaful costs and its contribution are taken from the participant's risk fund and not from shareholder's fund.

[5]*It is noted that no investment performance fee from participant's investment fund in this illustration. Some Takaful operator such as Takaful Ikhlas reported investment performance fee from family takaful fund as part of their income in Shareholder's fund. This performance fee may be based on mudarabah contracts.*

6.2 Fee and Commission Income

2016	Shareholder's Fund RM'000	General Takaful Fund RM'000	Family Takaful Fund RM'000	Company RM'000
Wakalah fee income from:				
General takaful fund	351,836	–	–	–
Family takaful fund	260,006	–	–	–
Profit commission	–	–	2,337	2,337
Retakaful commission income	–	15,479	–	15,479
Others	–	421	161	582
	611,842	15,900	2,498	18,398

Example 4: Extract of the Note 21- Fee and Commission Income of Etiqa Takaful Berhad for the year ended 2016

Based on the *wakalah* model, the takaful operator is entitled to *wakalah* fee income from both general takaful and family takaful fund. Based on Example 4, the total income of shareholder's fund amounting to RM611,842,000 consists of the income from the *wakalah* fee of general takaful fund RM351,836,000 and family takaful fund RM260,006,000. Both *wakalah* fee from general and family takaful is placed in shareholders' fund to support the operating expenses and commission to provide to the agents. The total income for general takaful fund consists of retakaful commission income amounting to RM15,479,000 and other income amounting to RM421,000 yield total income amounting to RM15,900,000. Meanwhile, the total income for family takaful fund amounting to RM2,498,000 consists of profit commission RM2,337,000 and other income amounting to RM161,000.

7.0 INVESTMENT INCOME

The investment income for takaful operator is the profit generated from investing in Shariah-compliant assets in the financial markets and other investments such as rental income from investment properties. The details of the takaful operator's financial investment from each type of funds have been explained in Chapter 10. Accordingly, under MFRS 139 the financial assets are classified as one of the following categories which are financial assets at fair value through profit or loss (FVTPL), held-to-maturity (HTM), loans and receivables (LAR), and available-for-sale (AFS) financial assets.

The takaful operator may generate income from the takaful funds of both general and family takaful fund for investment purposes. As explained in Figure 10 and Figure 11 on the application of *wakalah* model in both general and family takaful in Chapter 9, the funds in participants' investment funds and participant's risk funds can be used for investment for family takaful, meanwhile, the funds in participant's risk funds will be used for investments for general takaful. The income may be in the form of profits, dividends and rental. In the context of Takaful, the investment of the funds that have been invested in Shariah-compliant instruments may generate profits or dividends as in Figure 2.

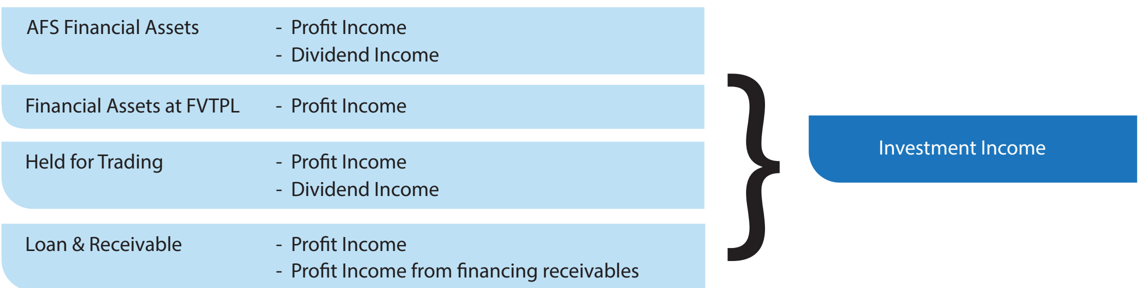


Figure 2: Investment Income of Takaful Operator

In this case, the profit shall be recognised using effective profit rate methods and the dividends income from the investment in quoted equity securities and trust funds which are Shariah-compliant shall be recognised when the shareholders or funds holders' right to receive the payment is established.

For family takaful, the fund in the participants' investment funds is used for making an investment in the Shariah-compliant assets. The investment profits if any will be added to the fund. However, for general takaful, the investment is made from the participants' risk funds in the Shariah-compliant assets. When there is any income or profit generated, it will be added to the participant's fund. Investment also can be made from the shareholder's funds and may generate income to the company. Those investments may provide income to the respective funds in term of profit income and dividend income as in Example 5.

Investment Income **2016**	**Shareholder's Fund RM'000**	**General Takaful Fund RM'000**	**Family Takaful Fund RM'000**	**Company RM'000**
AFS financial assets:				
Profit income	88,897	59,289	96,882	245,068
Dividend/distribution income:				
Quoted equity securities in Malaysia	1,984	290	17,343	19,617
Quoted unit and property trusts funds in Malaysia	178	14	2,179	2,371
Financial assets at FVTPL: recognition - Designated upon initial recognition				
Profit income	—	—	262,233	262,233
- HFT				
Profit income	—	—	720	720
Dividend income:				
Quoted equity securities in Malaysia	—	—	206	206
Quoted unit and property trusts funds in Malaysia	—	—	1	1
- LAR:				
Profit income	10,471	11,059	30,627	52,157
Profit income from financing receivables	580	—	—	580
Net amortisation of premiums	(3,407)	(1,423)	(10,023)	(14,853)
Other investment income	16	28	135	179
Investment related expenses	(511)	(338)	(2,722)	(3,571)
	98,208	68,919	397,581	564,708

Example 5: Extract of Note 22 - Investment Income of Etiqa Takaful Berhad for the year ended 2016

Example 5 shows the investment income from the shareholder's fund, general takaful fund and family takaful fund. All the three funds recognised investment income from the available for sale (AFS) financial assets which consist of profit income and dividend income from quoted equity securities and quoted unit and property trust funds outside Malaysia.

Based on the figure, investment income for AFS financial assets for shareholders' fund consists of profit income amounting to RM88,897,000; dividend income from quoted equity securities amounting to RM1,984,000, and from quoted unit and property trusts fund outside Malaysia amounting to RM178,000. The investment income for AFS financial assets for general takaful fund consists of profit income amounting to RM59,289,000; dividend income from quoted equity securities amounting to RM290,000, and from quoted unit and property trusts fund outside Malaysia amounting to RM14,000.

Whereas, the investment income for AFS financial assets for family takaful fund consists of profit income amounting to RM96,882,000; dividend income from quoted equity securities amounting to RM17,343,000 and from quoted unit and property trusts fund outside Malaysia amounting to RM2,179,000.

Other than investment income from AFS financial assets, investment from participant's investment account may provide income from any of the financial assets that are designated on initial recognition as one to be measured at fair value and financial assets held for trading (HFT). Both of these financial assets are measured at fair value through profit or loss.

Based on the information above, only participants' investment account for family takaful fund is invested in those types of financial assets. The profit income from financial assets that are designated on initial recognition as one to be measured at fair value amounting to RM262,233,000. Meanwhile, income for financial assets held for trading is consists of profit income amounting to RM720,000 and dividend income from equity securities amounting to RM206,000.

Takaful operator also received investment income from the loans and receivables (LAR) which is the non-derivative financial assets with fixed or determinable payments that are not quoted in an active market, other than held for trading or designated on initial recognition as assets at fair value through profit or loss or as available-for-sale. The figure shows that the company received investment income from LAR for all the three funds which consist of profit income amounting to RM52,157,000; profit income from financing receivables RM580,000 and other investment income amounting to RM179,000.

All types of investment income for all the three types of funds consists of AFS, financial designated at fair value, HFT and LAR are totalled up and deducted with net amortisation of premiums and investment-related expenses to obtain the final total of investment income. For example, total investment income for shareholders' fund is amounting to RM98,208,000 after adding up investment income from AFS financial assets and LAR and deducted with the net amortisation of premiums and investment-related expenses.

In the context of MFRS 9 *Financial Instruments*, investment income of Takaful operator may come from different classification of financial assets. Under MFRS 9, the basis on which assets are measured is the way they are classified. Hence, the investment income may come from financial assets that are measured and classified as (i) Amortised cost; (ii) Fair Value through Other Comprehensive Income (FVOCI); and (iii) Fair Value through Profit or Loss (FVTPL). In the context of MFRS 9 Financial Instruments, investment income of takaful operator may come from different classification of financial assets. Under MFRS 9, the basis on which assets are measured is the way they are classified. Hence, the investment income may come from financial assets that are measured and classified as (i) FVTPL; (ii) FVOCI; and (iii) Amortised cost. Accordingly, the profits or dividends generated from investment of the funds in Shariah-compliant instruments will be as in Figure 3.

FVTPL	- Profit Income - Dividend Income	Investment Income
FVOCI	- Profit Income	
Amortised Cost	- Profit Income - Profit income from financing receivables	

Figure 3: Investment Income of Takaful Operator (MFRS 9)

Example 6 shows the investment income from the shareholder's fund and family takaful fund when applying MFRS 9.

2018	Shareholder's Fund RM'000	Family Takaful Fund RM'000	Company RM'000
Financial assets at FVTPL:			
- Designated upon initial recognition	92.220	283,788	376,008
- HFT			
Profit income	–	2,446	2,446
Dividend income:			
Quoted equity securities in Malaysia	3,399	17,692	2,1091
FVOCI Financial assets:			
Profit income	861	147,891	148,752
Amortised cost financial assets:			
Profit income	4,675	21,361	26,036
Profit income from financing receivables	816	–	816
Net amortisation of premiums	(1819)	(3,605)	(5,424)
Investment related expenses	(531)	(2,756)	(3,287)
	99,621	566,438	466,817

Example 6: Extract of Note 22 - Investment Income of Etiqa Family Takaful Berhad for the year ended 2018

Based on the figures, investment income for financial assets at FVTPL for shareholders' fund consists of profit income amounting to RM92,220,000; dividend income from quoted equity securities amounting to RM3,399,000. The investment income for financial assets at FVTPL for family takaful fund consists of profit income (designated upon initial recognition) amounting to RM283,788,000; profit income (held for trading) amounting to RM2,446,000 and dividend income from quoted equity securities amounting to RM17,692,000.

Profit income from FVOCI financial assets are amounting to RM861,000 and RM147,891,000 for shareholder's fund and family takaful fund respectively. Based on the information above, participants' investment account for family takaful fund is invested in those types of financial assets. Also, takaful operator receives investment income from amortised cost financial assets which consist of profit income, profit income from financing receivables after deducting the net amortisation of premiums and investment related expenses.

All types of investment income for all funds consist of financial assets at FVTPL, FVOCI financial assets, and amortised cost financial assets are totalled up and deducted with net amortisation of premiums and investment-related expenses to obtain the final total of investment income. For example, total investment income for shareholders' fund is amounting to RM99,621,000 after adding up investment income from financial assets at FVTPL, FVOCI financial assets and amortised cost financial assets; and deducting the net amortisation of premiums and investment-related expenses.

8.0 NET REALISED GAINS OR LOSSES AND NET FAIR VALUE GAINS OR LOSSES

In addition to the investment, realised gains and losses are also reported in the income statement, whereas the realised gains and losses are also reported in the income statement. The net realised gains or losses include any gains and losses on financial assets, for instance, securities, trust funds and government papers as in Example 7. The realised gains or losses are resulted from selling an asset at a price which is higher or lower than the original purchasing price respectively.

Net Realised Gains 2016	Shareholder's Fund RM'000	General Takaful Fund RM'000	Family Takaful Fund RM'000	Company RM'000
Net realised gains/(losses) on disposal of:				
AFS financial assets				
Malaysian government papers	3,926	4,588	1,363	9,877
Equity securities	2,133	1,164	18,563	21,860
Debt securities	10,733	7,672	4,160	22,565
Unit and property trust funds	–	3	–	3
	16,792	13,427	24,086	54,305
Financial assets at FVTPL **- Designated upon initial recognition**				
Malaysian government papers	–	–	2,816	2,816
Debt securities	–	–	11,390	11,390
	–	–	14,206	14,206
- HFT				
Malaysian government papers	–	–	192	192
Equity securities	–	–	155	155
Debt securities	–	–	472	472
	–	–	819	819
Total net realised gains	16,792	13,427	39,111	69,330

Example 7: Extract of Note 23 - Net Realised Gains of Etiqa Takaful Berhad for the year ended 2016

Other than income from the Shariah-compliant investment, the takaful operator has also recognised the net realised gain from the disposal of their financial assets as in Example 7.For example, the net gain realised from the disposal of AFS financial assets is amounting to RM24,086,000, disposal of financial asset designated at fair value upon initial recognition amounting to RM14,206,000 and disposal of HFT financial assets amounting to RM819,000 in family takaful fund. Examples of the disposed financial assets are Malaysian government papers, equity securities, debt securities, unit and property trust funds. Thus, the total net realised gains derived from the disposal of financial assets for family takaful fund is RM39,111,000.

The fair value gains or losses arise when there is a difference between the current market price and the book value of the securities. Para 55 of MFRS 139, states that a gain or loss from a change in the fair value of financial assets or financial liabilities that is not part of a hedging relationship (see Paras 89 – 102), shall be recognised, as follows:

(a) A gain or loss on financial assets or financial liabilities classified as at fair value through profit or loss shall be recognised in profit or loss;
(b) A gain or loss on available-for-sale financial asset shall be recognised in other comprehensive income, except for impairment losses (see Para 67 – 70) and foreign exchange gains and losses (see Appendix A of Para AG83), until the financial asset is derecognized. At that time, the cumulative gain or loss previously recognised in other comprehensive income shall be reclassified from equity to profit or loss as a reclassification adjustment. However, interest calculated using the effective interest method is recognised in profit or loss. Dividends on an available-for-sale equity instrument are recognised in profit or loss when the entity's right to receive payment is established.

When applying MFRS 9, the net realised gain from disposal of financial assets (HFT and FVOCI financial assets) are recognised as in Example 8.

Realised (Losses)/Gains 2018	Shareholder's Fund RM'000	Family Takaful Fund RM'000	Company RM'000
Net realised gains/(losses):			
Property, plant and equipment	(4)	–	(4)
Financial assets at FVTPL			
- Designated upon initial recognition			
Malaysian government papers	(380)	(1,021)	(1,401)
Debt securities	2,154	9,226	11,380
	1,774	8,205	9,979
- HFT			
Malaysian government papers	–	156	156
Equity securities	(28,134)	(170,605)	(198,739)
Debt securities	–	209	209
Unit and property trust funds	–	35	35
	(28,134)	(170,205)	(198,339)
FVOCI financial assets			
Malaysian government papers	–	(14)	(14)
Equity securities	–	–	–
Debt securities	–	3,842	3,842
Other investments	–	–	–
	–	3,828	3,828
Total net realised losses	**(26,364)**	**(158,172)**	**(184,536)**

Example 8: Extract of Note 23 - Realised (Losses)/Gains of Etiqa Family Takaful Berhad for the year ended 2018

Based on Example 9, the takaful operator shall recognise gains or incur losses from the valuation of financial assets at fair value. The total loss incurred from the valuation of HFT financial asset amounting to RM369,000 for the general takaful fund.

For family takaful fund, the total gain earned from the valuation of a designated financial asset at fair value amounting to RM48,718,000 and total loss incurred from the valuation of HFT financial asset is amounting to RM92,000. Therefore, total gain earned for the company from the valuation of financial assets amounting to RM48,257,000 consists of gain earned from the valuation of financial asset designated at fair value minus the loss incurred from the valuation of HFT financial asset.

Net Fair Value Gains / (Losses) 2016	Shareholder's Fund RM'000	General Takaful Fund RM'000	Family Takaful Fund RM'000	Company RM'000
Financial assets at FVTPL:				
- Designated upon initial Recognition	–	48,718	–	48,718
- HFT	–	(92)	–	(461)
	–	48,626	–	48,257

Example 9: Extract of Note 24 - Net Fair Value Gains or Losses of Etiqa Takaful Berhad for the year ended 2016

When applying MFRS 9, the takaful operator shall recognise gains or incur losses from the valuation of financial assets at fair value as in Example 10.

Fair Value Gains / (Losses) 2018	Shareholder's Fund RM'000	Family Takaful Fund RM'000	Company RM'000
Financial assets at FVTPL:			
- Designated upon initial Recognition	20,848	53,407	74,255
- HFT	(6,181)	352	(5,529)
Total fair value gain	14,667	53,759	68,726

Example 10: Extract of the Note 24 - Net Fair Value Gains or Losses of Etiqa Takaful Berhad for the year ended 2016

Based on Example 10, the takaful operator shall recognise gains or incur losses from the valuation of financial assets at FVTPL. The total fair value gains are amounting to RM14,667,000 and RM 53,759,000 for shareholder's fund and family takaful fund respectively. The fair value gain for both shareholder's fund and family takaful fund are the total amount of fair value gains or losses of financial assets at FVTPL designated upon initial recognition and HFT. For example, for family takaful fund, the amount of total fair value gains of RM53,759,000 consists of fair value gains from financial assets at FVTPL designed upon initial recognition i.e. RM53,407,000 and HFT i.e. RM352,000.

9.0 OTHER OPERATING INCOME OR EXPENSES

The net other operating income or expenses are the difference between the total of other operating income such as surrender charge and processing fee income; and the total of other expenses such as sundry expenses.

Other Net Operating Income or Expenses 2016	Shareholder's Fund RM'000	General Takaful Fund RM'000	Family Takaful Fund RM'000	Company RM'000
Other income				
Surrender charges	28	—	—	28
Reversal of impairment losses on:				
- Financing receivables	3	—	1	4
- Takaful receivables	—	8,153	1,131	9,284
- Retakaful assets	—	2,540	—	2,540
- Other receivables	57	32	—	89
Processing fee income	35	—	—	35
Gain on foreign exchange:				
- realised	4	—	5	9
- unrealised	—	—	6	6
Sundry income	916	2,929	5	3,850
	1,043	13,654	1,148	15,845
Other expenses Allowances for impairment losses on:				
-Investments	(1,427)	(236)	(16,415)	(18,078)
Loss on foreign exchange:				
-realised	—	(10)	—	(10)
Sundry expenses	(15)	(179)	—	(194)
	(1,442)	(425)	(16,415)	(18,282)
	(399)	13,229	(15,267)	(2,437)

Example 11: Extract of Note 25 - Other Net Operating Income or Expenses of Etiqa Takaful Berhad for the year ended 2016

Referring to Example 11, Takaful operator must recognise the other operating income such as income from surrender charges, processing fee income and other non-cash income such as reversal of impairment losses and gain on foreign exchange. All the other operating income will be added and deducted with other non-cash expenses such as allowances for impairment losses, loss on foreign exchange and sundry expenditure. For example, total other operating income for shareholders' fund is RM1,043,000 is deducted with total other expenses amounting to RM1,442,000 resulting in net expenses amounting to RM399,000.

10.0 NET BENEFITS AND CLAIMS

Similar to the disclosure of other revenue, Para 85 of MFRS 101 states that an entity shall present additional line items, headings and subtotals in the statement of comprehensive income and the separate income statement (if presented) when such presentation is relevant to an understanding of the entity's financial performance. Then, Para 99 of MFRS 101 further explains that an entity shall present an analysis of expenses recognised in profit or loss using a classification based on either their nature or their function within the entity, whichever provides that is reliable and more relevant. Hence, the main expenses of the takaful operator are the benefits and claims made by the takaful participants.

A takaful contract is a document with a promise to pay if certain events happen. The termination of a family takaful certificate is usually marked by the settlement of benefits and claims. The following situations may lead to a claim:

i. death of the participant;
ii. maturity of the takaful certificate;
iii. sickness or disability benefit claims;
iv. claims arising under supplementary contracts.

For family takaful fund, benefits and claims expenses incurred during the financial year are recognised when a claimable event occurs and/or the takaful operator is notified. Benefits and claims expenses, including settlement, costs less retakaful recoveries, are accounted for using the case basis method and for this purpose, the amounts payables under a certificate are recognised as follow:

i. maturity and other certificate benefit payments due on specified dates are treated as claims payable on the due dates; and
ii. death, surrender and other benefits without due dates are treated as claims payable on the date of receipt of intimation of death of the assured or occurrence of the contingency covered.

For general takaful fund, claim expenses represent compensation paid or payable on behalf of the certificate holders in relation to a specific loss event that has occurred. It includes claims, handling costs and settlement costs and arise from events that have occurred up to the end of the reporting year even if they had not been reported to the company.

Similarly, in Para 37 of MFRS 4 states that to comply with Para 36 (a), an insurer shall disclose its accounting policies for insurance contracts and related assets, liabilities, income and expense. Hence, the benefits and claims, and expenses recognition of takaful operator need to be disclosed on the gross amount as in Example 12. The gross benefits and claims paid are expenses to the related takaful funds. This are the benefits and claims expenses incurred during the financial year are recognised when a claimable event occurs and/or the takaful operator is notified.

Similar to the gross contribution, where the amount of contribution payable will be deducted by the contributions ceded to retakaful operators, part of the amount of gross benefits and claims paid will be ceded to retakaful if some proportion of the underwriting risks are transferred to retakaful. For instance, it is agreed that 40% of the risks for a participant will be ceded or transfer to the retakaful operators. Hence, when the claims transpire, the initial gross benefits and claims paid an amount of RM 100 payable to the participants will be paid from retakaful amounting to RM 40 (i.e. 40% x RM 100). This is the amount of claims ceded to retakaful operators.

The gross change in certificate liabilities is the reduction in liabilities due to payments of claims in the year and are offset by liabilities arising from new certificates. Similarly, the change in certificate liabilities ceded to retakaful liabilities is the reduction in liabilities due to payments of claims ceded out in the year and are offset by liabilities arising from new certificates ceded out. The movements reflect the assumption of changes relating to claim expectation of the previous period.

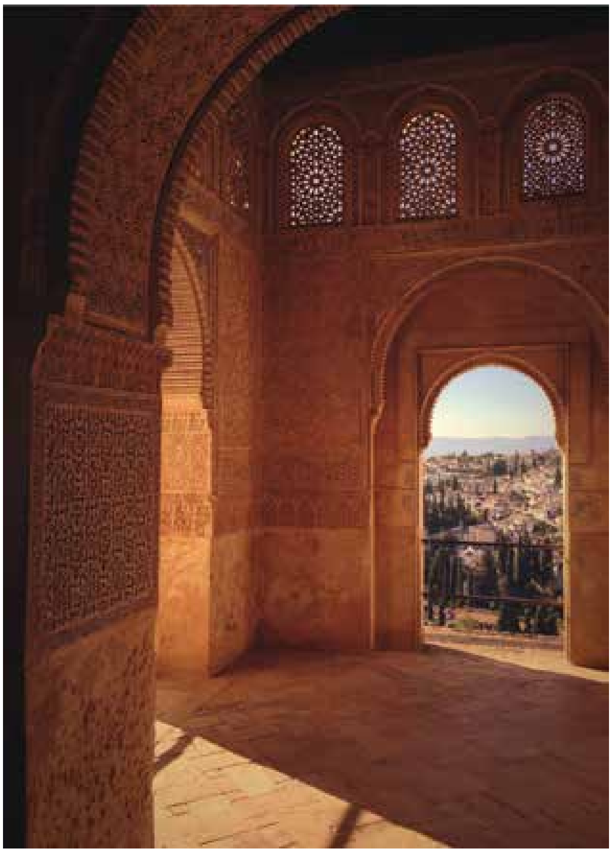
Net benefits and claims 2016	General Takaful Fund RM'000	Family Takaful Fund RM'000	Company RM'000
Gross benefits and claims paid	(610,410)	(734,578)	(1,344,988)
Claims ceded to retakaful	29,524	24,595	54,119
Gross change in certificate liabilities	(52,274)	(203,153)	(725,989)
Change in certificate liabilities ceded to retakaful	29,935	13,546	43,481
	(603,225)	(899,590)	(1,973,377)

Example 12: Extract of Note 26 -Net benefits and claims of Etiqa Takaful Berhad for the year ended 2016

Based on Example 12, the net benefit and claims paid amounting to RM603,225,000 consists of gross benefits and claims paid RM610,410,000 less claims ceded to retakaful amounting to RM29,524,000; and the deduction of gross change in certificate liabilities amounting to RM52,274,000 on change in certificate liabilities ceded to retakaful amounting to RM29,935,000 for general takaful. Similar for Family Takaful fund, the net benefit and claims paid amounting to RM899,590,000.

11.0 OTHER EXPENSES

In determining whether takaful operator incurs surplus or deficit, the net earned contribution and other revenue of takaful need to be deducted by the net benefits and claims as well as other expenses. Examples of other expenses are management expenses; fee and commission expenses; and any other expenses of the takaful operator



11.1 Management Expenses

Para 99 of MFRS 101 explains that an entity shall present an analysis of expenses recognised in profit or loss using a classification based on either their nature or their function within the entity, whichever provides that is reliable and more relevant. The takaful operator must disclose the other expenses incurred by them in relation to all the types of funds. Among the main expenses incurred are the management expenses.

Based on the Example 13 the total management expenses for shareholders' funds are RM279,982,000. Meanwhile, total management expenses for general takaful fund and family takaful fund are RM1,031,000 and RM30,134,000 respectively. The total amount of management expenses is RM311,034,000 consists of total expenses for all the three funds.

The details of management expenses incurred for the takaful operators are as in Example 13.

Management Expenses 2016	Shareholder's Fund RM'000	General Takaful Fund RM'000	Family Takaful Fund RM'000	Company RM'000
Employee benefits expenses (Note (a))	142,171	750	22,196	165,117
Directors' remuneration (Note 28)	1,071	—	—	1,071
Shariah Committee remuneration (Note 29)	222	—	—	222
Auditors' remuneration:				
- statutory audits	381	6	166	553
- regulatory services	24	—	11	35
- other services	15	—	7	22
Depreciation of property, plant and equipment (Note 3)	401	—	—	401
Amortisation of intangible assets (Note 4)	710	—	—	710
Auto assist service	5,160	—	—	5,160
Assured medical fees	2,161	—	—	2,161
Bank and financing charges	13,189	1	1,904	15,094
Electronic data processing services	8,485	43	825	9,353
Entertainment expenses	449	3	16	468
Goods and services tax	3,106	17	477	3,600
Interest expenses	402	—	—	402
Legal fees	729	—	22	751
Maybank shared services - IT	8,855	67	1,286	10,208
Office facilities expenses	3,211	19	345	3,462
Other management fees	335	1	17	353
Postage and stamp duties	2,692	—	8	2,700
Printing and stationery	4,320	1	86	4,407
Professional fees	2,053	4	146	2,203
Promotional and marketing costs	35,512	34	12	35,558
Rental of offices/premises	10,027	49	1,389	11,465
Training expenses	1,463	5	85	1,553
Travelling expenses	1,441	7	66	1,514
Utilities, assessment and maintenance	1,444	6	91	1,541
Other expenses	29,953	18	979	30,950
	279,982	1,031	30,134	311,034

Example 13: Extract of Note 27 - Management Expenses of Etiqa Takaful Berhad for the year ended 2016

11.2 Fee and Commission Expenses

Fee and commission expenses are in the category of other expenses for takaful operator. Here, the expenses include both commission expenses and *Wakalah* fee expenses incur for all the three funds in Example 14 The commission expenses appear in shareholder's fund indicates that under the *Wakalah* model, the commission payable to the agents are made by the shareholders. Meanwhile, the *Wakalah* fees expenses appear in both general takaful funds and family takaful funds indicate that these expenses are payable to the company which is the agent for the participants for the operating expenses and payment of agent commission.

Based on Example 14, commission expenses for shareholder's fund amounting to RM228,510,000. Meanwhile *Wakalah* fee expenses for general takaful fund amounting to RM351,836,000. For family takaful fund, the expenses consist of both commission expenses amounting to RM2,421,000 and *Wakalah* fee expenses amounting to RM260,006,000.

Fee and Commission Expenses 2016	Shareholder's Fund RM'000	General Takaful Fund RM'000	Family Takaful Fund RM'000	Company RM'000
Commission expenses	228,510	—	2,421	230,931
Wakalah fee expense	—	351,836	260,006	—
	228,510	351,836	262,427	230,931

Example 14: Extract of Note 31 - Fee and Commission Expenses of Etiqa Takaful Berhad for the year ended 2016

12.0 SURPLUS TRANSFERRED TO PARTICIPANTS' FUNDS AND SURPLUS ATTRIBUTABLE TO SHAREHOLDERS

The operating profit or loss can be determined for each of the funds (i.e. shareholder's fund and participant's funds) after deducting the expenses from the income related to each of the funds. In the case that the participant's funds are performing well and gain profit at the end of the accounting period, the surplus will be shared between the participants and the shareholders of the takaful operators.

This surplus distribution from the participant's fund to the shareholders are known as a performance fee. The performance fee is based on either *hibah muallaqah*" (conditional hibah) or *jualah*" (commission). In the extract of the Income statement in Example 1, the reported operating profit before surplus transfers of RM245,332,000 and RM420,824,000 for general takaful fund and family takaful fund, respectively.

Based on the performance fee, RM108,092,000 and RM87,502,000 are attributed to the shareholders from the respective participant's funds resulting in the total amount of RM195,594,000. This surplus will increase the amount of profit in the shareholder's fund to RM343,891,000 (i.e. RM148,297,000 + RM195,594,000).

The balance of the surplus for each participant's funds also been transferred to the participants, in this case RM137,240,000 and RM333,322,000 for general takaful fund and family takaful fund respectively, as shown in Example 1

SUMMARY

- In summary, the income statement for takaful operator not only show the performance of their company but also the three different types of funds which are shareholder's fund, general takaful fund and family takaful fund.
- The reporting of the segregation of fund is in line with IFSA 2013. The main income for takaful operators is from the *Wakalah* fees and investment income. The *Wakalah* fee is a certain percentage of the premium contribution made by the participants.
- The concept of contribution earned by takaful operator are different from the insurance premium, whereby the contribution is agreed by the participants to provide for mutual financial benefits payables to the takaful participants and beneficiaries.
- The insured deals with the insurance company by paying regular instalments (i.e. premium) in return for the guarantee to pay compensation, if the event stipulated in the contract happens. Also, the takaful operator can only make investment on Shariah compliant assets.
- The main expenses for takaful operator are the payment of benefits and claims which the takaful participant's funds have agreed to pay for the mutual financial benefits to the other takaful participants or their beneficiaries on the occurrence or event stipulated in the contract.
- In term of financial reporting, the MFRS are applicable to takaful operator in the preparation of the income statement.

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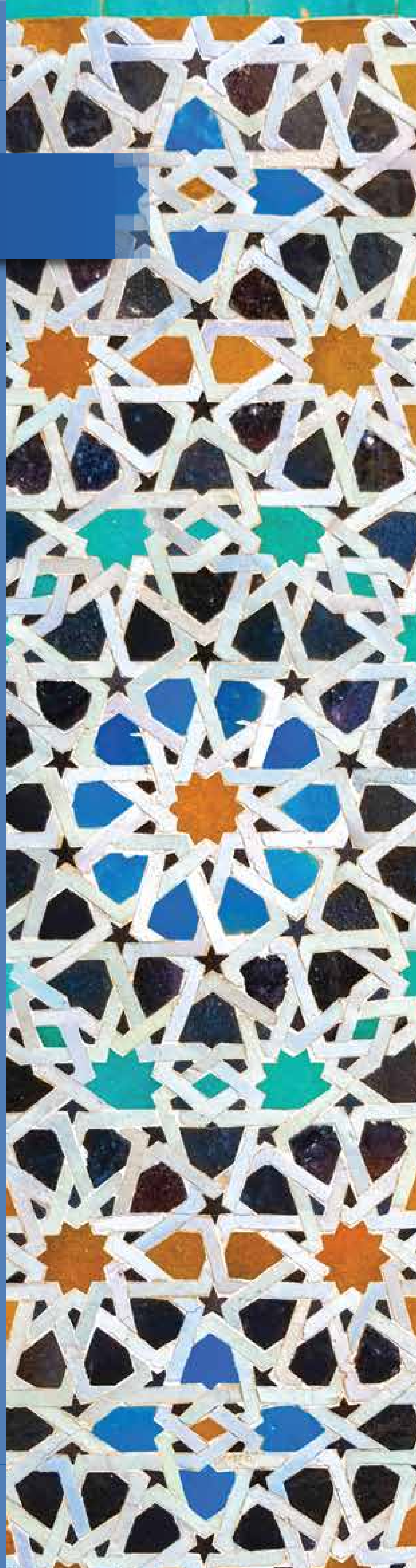
CHAPTER 14



ISLAMIC FUND MANAGEMENT

ISLAMIC FUND MANAGEMENT

LEARNING OBJECTIVES

The chapter aims to:

i. provide an understanding on the concept and principles of Islamic fund management;
ii. provide an understanding on the conceptual framework of financial reporting for Islamic fund management;
iii. explain the basis for the presentation of financial statement for Islamic fund management; and
iv. provide disclosure requirements of Malaysian Financial Reporting Standard ("MFRS") and the International Financial Reporting Standard ("IFRS") relating to Islamic fund management.

1.0 INTRODUCTION

Islamic fund management refers to the management of Shariah-compliant investment assets that can be divided into different classes such as equities, sukuk and money market. An Islamic investment is premised on Shariah principles, which aims to meet investors' financial needs with integrity and in a manner that is fair and trustworthy and ensures a more equitable wealth distribution. The investment objective of Islamic fund management is to provide investors with competitive returns and liquidity, whilst maintaining capital stability by investing primarily into asset classes that conform to Shariah principles.

The financial reporting on Islamic fund management can be categorised into two types; the financial statements of the fund manager, and the financial statements of the Islamic funds themselves.

1.1 Islamic Fund Management

All investment activities are managed by fund managers who are licensed under the Capital Market & Services Act 2007 (CMSA 2007). There are 2 main licenses for asset management and they are:

i. New Capital Market Services License ("CMSL") for the principal companies; and
ii. New Capital Market Services Representatives License ("CMSRL") granted to a representative i.e. the fund manager himself to carry on regulated activities on behalf of the principal e.g. the fund manager that manages any unit trust funds.

A fund manager that carries on the Islamic fund management is governed by the *Guidelines on Islamic Fund Management* issued by the Securities Commission ("SC") under section 377 of the CMSA 2007. These guidelines are to be read in conjunction with the following:

a. Guidelines on Compliance Functions for Fund Managers;
b. Guidelines on Unit Trusts Fund; and
c. All other relevant guidelines, applicable requirements stipulated in the CMSA 2007 and the *Licensing Handbook.*

Whilst the Islamic licensed fund management companies only manage Shariah-compliant investment assets, conventional fund management companies can carry out both Islamic and conventional fund management businesses under the Islamic 'window'. The above guidelines also set out the requirements for carrying on an Islamic fund management business under an Islamic window. One of the key requirements for Islamic fund management is the appointment of an independent Shariah advisor. Any entity that carries Islamic fund management must appoint either:

a. an individual or a corporation as an independent Shariah advisor, approved and registered by the SC, and meets the following criteria:

   i. Not an undischarged bankrupt;
   ii. Has not been convicted for any offence arising from a criminal proceeding;
   iii. Has good reputation and character; and
   iv. Possesses the necessary qualifications and expertise, particularly in *Fiqh Muamalat* and Islamic jurisprudence together with experience and/or exposure in Islamic finance; or

b. an Islamic bank or a licensed institution approved by Bank Negara Malaysia to carry on an Islamic business.

An Islamic fund manager may also appoint a non-resident Shariah advisor who may be an individual, a corporation or an Islamic bank. For such an appointment, the Islamic fund manager is required to make a submission for SC's approval.

1.1.1 The role of Shariah advisor

a. To advise on all aspects of the fund management business in accordance with Shariah principles;
b. To provide Shariah expertise and guidance on all matters, particularly in the documentation, structuring and investment instruments, and ensure compliance with relevant SC regulations and standards, including resolutions issued by the SC's Shariah Advisory Council ("SAC").
c. To review reports of the compliance officer of the fund manager or any investment transaction report to ensure investment activities are Shariah-compliant; and
d. To provide a written opinion and/or periodic report and to confirm and certify whether the Islamic fund management business has been managed and administered in accordance with Shariah principles.

1.1.2 Shariah-compliant investment

a. Any fund manager that manages Islamic fund must ensure that its investment activities are in accordance with Shariah principles;
b. For investment in listed securities on Bursa Malaysia, the fund manager should invest only in Shariah-compliant securities as listed by the SAC;
c. For investment in unlisted securities, the fund manager is to adopt the SAC's Shariah screening methodology in screening the stocks; and
d. For investment on securities traded on other recognised stock exchanges outside of Malaysia, the fund manager should only invest in securities endorsed by the Shariah advisor of the recognised stock exchange or by an international Shariah standard-setting body.

1.1.3 Responsibilities of a compliance officer

a. In addition to complying with the statutory and rules and regulations imposed by SC, a compliance officer must ensure that its investment complies with these guidelines and relevant SC regulations and/or standards, including rules and regulations issued by the SAC.
b. Monthly certification that all investments are Shariah-compliant.
c. In the event of a Shariah non-compliance, the compliance officer must report any Shariah non-compliance directly to the board of directors, for consideration and/or immediate remedial actions. The compliance officer must also report the matter to the SC.
d. The compliance officer is expected to assist the Shariah advisor in preparing and certifying that the Islamic fund management business is carried out in accordance with Shariah principles.

1.1.4 Written disclosure and declaration

a. An Islamic fund manager is expected to prepare at least, annually a written disclosure and declaration to the board of directors of the Islamic fund manager and the SC, that the Islamic fund management business is carried out in accordance with Shariah principles.
b. An Islamic fund manager must ensure that the disclosure, declaration and other records, made by the Shariah advisor are maintained as required under the *Guidelines on Compliance Function for Fund Managers*. The records must be available for examination upon SC's request.

1.1.5 Islamic funds

There are several types of funds, depending on the asset allocation strategy. Generally, there are equity funds, balanced funds i.e. combination of equity and sukuk, and sukuk funds. Strategies of the types of funds can be domestic, regional or global. Hence Shariah screening, take for example equity, will also be different. In Malaysia, the securities screening process is based on SC's SAC screening methodology who is responsible in determining Shariah-compliant securities including those listed on Bursa Malaysia. For investment in securities traded on other recognised stock exchanges, SC prescribes that such investments should only be in securities endorsed by the Shariah advisor of the stock exchanges or by international Shariah standard setting bodies.

Using an equity fund ("Fund") as an example, the fund manager may invest 70% to 98% of the Fund's Net Asset Value ("NAV") in Shariah-compliant Malaysian equities. The fund manager may also invest up to 30% of the Fund's NAV in other Shariah-compliant investments such as sukuk, and Shariah-compliant liquid assets, with at least 2% of the Fund's NAV maintained in the form of Shariah-compliant liquid assets such as Islamic money market instruments and/or Shariah-compliant Deposits for liquidity purposes.

The investment in sukuk must satisfy a minimum credit rating of A3 or P2 by RAM or equivalent rating by MARC; BBB by S&P or equivalent rating by Moody's or Fitch. The investment strategy and policy of the fund is to rebalance the portfolio to suit market conditions in order to reduce short-term volatility and provide consistency in capital growth.

A fund is governed by a trust deed, a legal document that is entered between the management company and the trustee. A management company is a company that establishes a fund and operates and administers the fund. The management company should operate the fund and exercise its responsibilities according to the deed and prospectus, guidelines and securities laws, and acceptable business practices. Under sections 288(1)(a) and 289(1) of CMSA, a trustee must be appointed for a fund and the appointment must be approved by SC. Trustee's obligations amongst others, is to actively monitor the operation and management of the fund by the management company to safeguard the interest of unit holders. A trustee should, at all times, through proper and adequate supervision, ensure that the fund is operated and managed by the management company, in accordance with the deed, the prospectus, guidelines and securities laws and acceptable business practices. Where a fund is expressed to be managed in accordance with specific principles, the trustee should ensure that the fund is managed in accordance with those principles.

As part of the trustee's reporting and disclosure obligations, a trustee should notify the SC any irregularities, any breach of the provisions or covenants of the deed, any contravention of securities laws or any inconsistency between the disclosures in the prospectus and the provisions and covenants of the deed, which may indicate that the interests of the unit holders are not being served.

2.0 ACCOUNTING FOR ASSETS

2.1 Definition

For an asset to be recognised in the financial statements, it has to meet the general definition underlined by the revised Conceptual Framework ("Conceptual Framework") issued by the Malaysian Accounting Standards Board ("MASB") in April 2018. Under the definition of an asset, paragraphs 4.3 and 4.4 of the Conceptual Framework states that *'an asset is a present economic resource controlled by the entity as a result of past events and is a right that has the potential to produce economic benefits'.*

It is worth noting that the Conceptual Framework defines asset in terms of control rather than ownership. Whilst control is generally evidenced through ownership, this may not always be the case. Therefore, an asset may be recognised in the financial statements of the entity even though the ownership belongs to someone else. The element of control is further discussed in paragraphs 4.19 to 4.25 of the Conceptual Framework.

The future economic benefit embodied in an asset is the potential to contribute, directly or indirectly, to the flow of cash and the cash equivalents to the entity. The potential may be the productive one that is part of the operating activities of the entity. It may also take the form of convertibility into cash and cash equivalents, or a capability to reduce cash outflows, such as when an alternative manufacturing process lowers the cost of production.

2.2 Recognition

Apart from meeting the elements in the above definition, the Conceptual Framework also underlines the following recognition criteria that must be met before an asset can be recognised in the financial statements:

- The inflow of the economic benefits to the entity is probable; and
- The cost or value of the item can be measured reliably.

2.3 Presentation and Disclosure

In accordance with paragraph 60 of MFRS 101 *Presentation of Financial Statements*, an entity shall present current and non-current assets as separate classifications in its statement of financial position except when a presentation based on liquidity provides information that is reliable and more relevant.

Below is an extract of the statement of financial position of an Islamic asset management company:

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2016		
	2016 RM	**2015 RM**
ASSETS		
Non-current assets		
Plant and equipment	14,730	21,444
Current assets		
Trade receivables	8,361,294	1,576,830
Amount due from related companies	3,920,974	3,193,901
Other receivables	99,597	96,905
Deposits with a licensed Islamic bank	4,100,000	5,000,000
Cash and bank balances	240,311	533,097
	16,722,176	**10,400,733**
Total Assets	**16,736,906**	**10,422,177**

Table 1: Extract of statement of financial position for an Islamic asset management company as at 31 December 2016

In accordance with paragraph 15 of MFRS 116 *Property, Plant and Equipment*, an item of plant and equipment that qualifies for recognition as an asset shall be measured at its cost. Subsequent to the initial recognition, plant and equipment are stated at cost less accumulated depreciation and any accumulated impairment losses. Depreciation of plant and equipment is provided on a straight-line basis to write-off the cost of each asset to its residual value over the estimated useful life.

Similar to a conventional fund management company, the trade receivables of an Islamic asset management company are normally very substantial in relation to the size of its shareholder's fund. They normally consist of the following 3 items:

i. <u>Amount owing from trustee of the fund for cancellation of units</u>
Upon processing the redemption orders from the investors, the fund manager will submit cancellation advice to the trustee to satisfy the redemption requests from the investor. The trustee would remit the proceeds to the fund manager within 10 days as required under paragraph 10.04 of SC's Guidelines on Unit Trust Funds.

ii. <u>Amount owing from distributors of the fund for subscription/sales of units</u>
The fund manager may appoint distributors such as the Institutional Unit Trust Advisors (IUTA), banks or agencies to distribute its products.

The distributors would remit the proceeds from sales of the funds to the fund manager within a few days. The Distribution Agreements entered into between the fund manager and the distributors govern such settlement timeframes.

iii. <u>Management fees receivable from the fund</u>
The fund would normally accrue management fees daily and they are calculated based on the NAV of the fund. The trustee then pays the outstanding management fees at the end of each month to the fund manager.

In comparison, Table 2 below shows an extract of the statement of financial position of an equity fund. As there is no distinction between current and non-current assets in the statement of financial position of the equity fund, the financial assets are arranged in the order of liquidity as provided for by paragraph 60 of MFRS 101.

STATEMENT OF FINANCIAL POSITION AS AT 28 FEBRUARY 2017			
	Note	**2017 RM**	**2016 RM**
ASSETS			
Cash and cash equivalent (Shariah-compliant)	(i)	13,952,603	3,228,843
Financial assets at fair value through profit or loss (Shariah-compliant)	(ii)	43,816,613	16,756,901
Amount due from stockbrokers	(iii)	2,446,915	452,957
Amount due from Manager	(iv)	1,234,471	52,898
Dividends receivable	(v)	72,739	25,275
Total Assets		**61,523,341**	**20,516,874**

Table 2: Extract of the Statement of Financial Position of an Equity Fund as at 28 February 2017

The financial assets of the Equity Fund above are explained below:

i. Cash and cash equivalents
Cash and cash equivalents comprise bank balances and Shariah-compliant deposits.

ii. Financial assets at fair value through profit or loss (FVTPL)
These consists of the fund's investments in Shariah-compliant securities which are invested in accordance with Shariah principles, Deed of the Fund and SC Guidelines on Unit Trust Funds.

iii. Amount due from stockbrokers
These relate to proceeds from the disposal of Shariah-compliant securities, which will be received from the stockbrokers upon settlement and clearing process in the stock exchange.

iv. Amount due from Manager
These consists of proceeds from the creation of units which are receivable from the fund manager. They are due from the manager within 10 days of such creation instructions being sent to the trustee of the fund as provided for under paragraph 10.03 of SC Guidelines on Unit Trust Funds.

v. Dividends receivable
This consists of dividends which the fund is entitled to, due to the fund holding the securities on entitlement date (ex-date) but for which the company has yet to pay as they are only due on their respective pay dates after the financial year-end.

2.4 Recognition and Classification

Effective 1 January 2018, a new standard on recognition and measurement of financial instruments, MFRS 9 *Financial Instruments*, was issued by MASB to replace MFRS 139 *Financial Instruments: Recognition and Measurement.*

Under paragraph 3.1.1 of MFRS 9, an entity shall recognise a financial asset or a financial liability in its statement of financial position when, and only when the entity becomes a party to the contractual provisions of the instrument. Unconditional receivables and payables are recognised as assets or liabilities when the entity becomes a party to the contract and, as a consequence, has a legal right to receive or a legal obligation to pay. Assets to be acquired and liabilities to be incurred as a result of a firm commitment to purchase or sell goods or services are generally not recognised until at least one of the parties has performed under the agreement. For example, an entity that receives a firm order does not recognise an asset (and an entity that places the order does not recognise a liability) at the time of commitment but instead delays recognition until the goods or services have been delivered or rendered.

Under paragraph 4.1.1 of MFRS 9, an entity shall classify financial assets as subsequently measured at either amortised cost, fair value through other comprehensive income (FVTOCI) or FVTPL based on both:

a. the entity's business model for managing the financial assets; and
b. the contractual cash flow characteristics of the financial assets.

Paragraph 4.1.2 of MFRS 9 states that a financial asset shall be measured at amortised cost if both the following conditions are met:

a. the asset is held within a business model whose objective is to hold assets to collect contractual cash flows, and
b. the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding amount.

Examples of financial assets that are likely to be measured at amortised cost include trade receivables, loan receivables with basic features, investment in government bonds that are not held for trading and investments in term deposits at standard interest rates.

In accordance with paragraph 4.1.2A, a financial asset shall be measured at FVTOCI if both of the following conditions are met:

a. the asset is held within a business model whose objective is achieved by both collecting the contractual cash flows and selling financial assets, and
b. the contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal outstanding amount.

Examples of financial assets that may be measured and accounted for at FVTOCI include investments in government and corporate bonds where the investment period is likely to be shorter than maturity. In addition, for equity investments that are not held for trading, entities can make an irrevocable election at initial recognition to classify the asset as at FVTOCI, with all subsequent changes in fair value being recognised in other comprehensive income.

Under Para 4.1.4, a financial asset shall be measured at FVTPL unless it is measured at amortised cost in accordance with Para 4.1.2 or FVTOCI in accordance with Para 4.1.2A. FVTPL is a residual category under MFRS 9. Examples of financial assets under this category include investments in shares of listed companies that the entity has not elected to account for as at FVTOCI, derivatives that have not been designated in a hedging relations and investments in convertible notes.

2.4.1 Derecognition

As per paragraph 3.2.3 of MFRS 9, a financial asset is derecognised when, and only when:

a. The contractual rights to the cash flows from the financial asset expire, or
b. The entity transfers the financial asset as set out in paragraphs 3.2.4 and 3.2.5 of MFRS 9 and the transfer qualifies for derecognition in accordance with paragraph 3.2.6 of MFRS 9.

According to paragraph 3.2.4 of MFRS 9, an entity transfers a financial asset if, and only if, it either:

a. transfers the contractual rights to receive the cash flows of the financial asset, or
b. retains the contractual rights to receive the cash flows but assumes a contractual obligation to pay the cash flows to one or more recipients in an arrangement that meets the conditions in paragraph 3.2.5 of MFRS 9.

For the above example, financial assets are derecognised when the rights to receive cash flows from the Shariah-compliant investments have expired or have been transferred and the fund has transferred substantially all risks and rewards of ownership as per paragraph 3.2.3 of MFRS 9 above. On derecognition of a financial asset in its entirety, the difference between the carrying amount (measured at the date of derecognition) and the sum of the consideration received and any cumulative gain or loss that has been previously recognised in other comprehensive income, shall be recognised in profit or loss (paragraph 3.2.12 of MFRS 9). Similarly, any unrealised gains or losses arising from changes in the fair value of financial assets at FVTPL are presented in the statement of comprehensive income within net gain or loss on financial assets at FVTPL, in the financial year which they arise.

2.4.2 Measurement

Paragraph 5.1.1 of MFRS 9 prescribes that, at initial recognition, an entity shall measure a financial asset or financial liability at its fair value plus or minus, in the case of a financial asset or financial liability not at FVTPL, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability.

As stated above, after initial recognition, an entity shall measure a financial asset in accordance with paragraphs 4.1.1-4.1.5 of MFRS 9 at either:

a. amortised cost; or
b. FVTOCI; or
c. FVTPL.

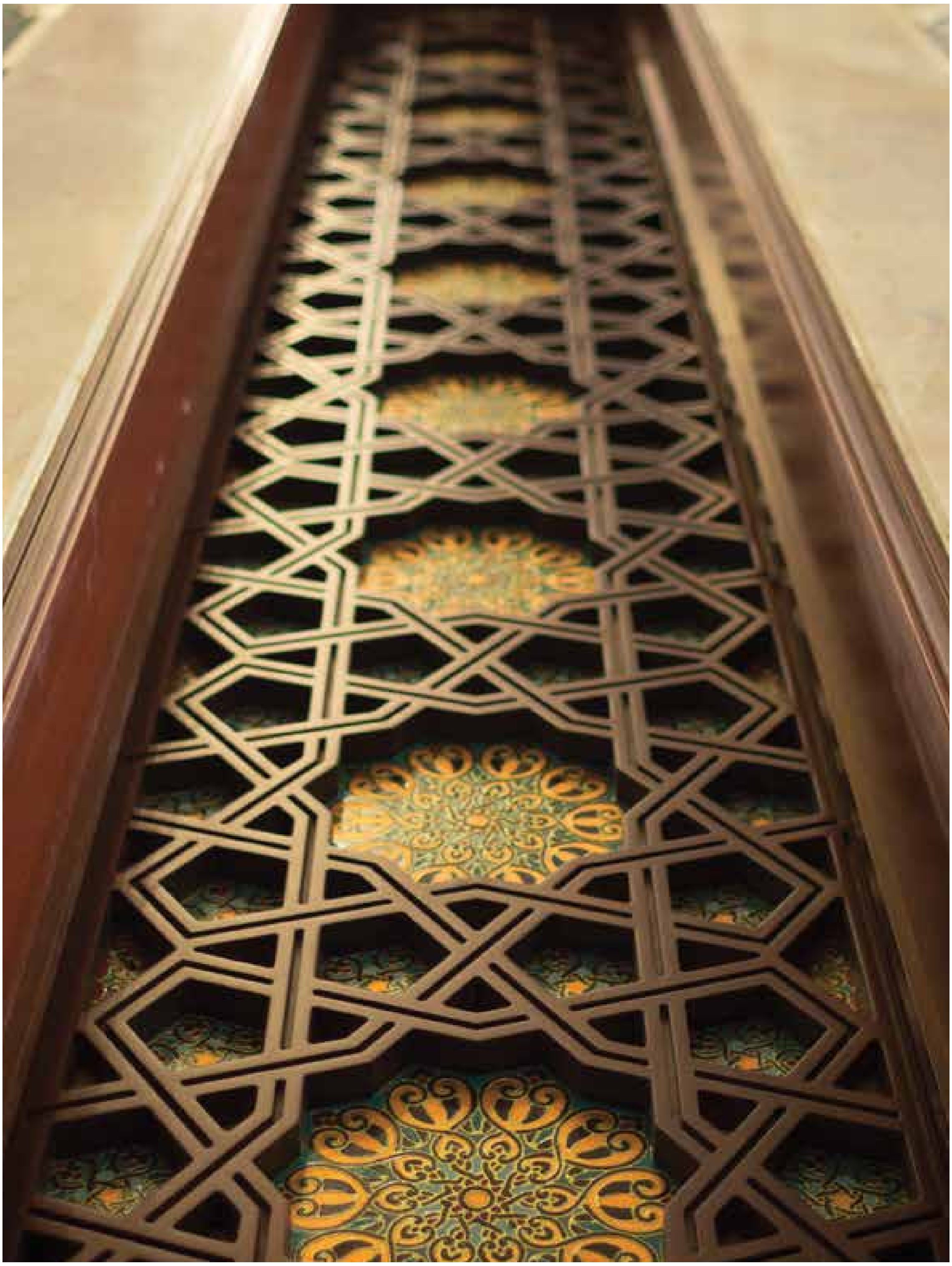
2.4.3 Financial assets at FVTPL

A portfolio of financial assets that is managed and whose performance is evaluated on a fair value basis is neither held to collect contractual cash flows nor held both to collect contractual cash flows and to sell financial assets. The entity is primarily focused on fair value information and uses that information to assess the assets' performance and to make decisions. In addition, a portfolio of financial assets that meets the definition of held for trading is not held to collect contractual cash flows or held both to collect contractual cash flows and to sell financial assets. For such portfolios, the collection of contractual cash flows is only incidental to achieving the business model's objective. Consequently, such portfolios of financial assets must be measured at FVTPL. As such investments of an Islamic fund are measured at FVTPL.

Pursuant to paragraph 3.1.2 of MFRS 9, regular purchases or sales of financial assets are recognised on the trade date, the date on which the fund commits to purchase or sell the asset. Shariah-compliant investments are initially recognised at fair value and transaction costs are expensed in the statement of comprehensive income.

2.4.4 Financing and receivables

Referring to the statement of financial position in the Table 2, financing and receivables are non-derivative financial assets with fixed or determinable payments that are not quoted in an active market and have been included in current assets. The fund's financing and receivable comprise cash and cash equivalents, the amount due from stockbrokers, the amount due from Manager and dividends receivable. Financing and receivables are subsequently carried at amortised cost using the effective profit method.



2.4.5 Impairment of assets carried at amortised costs

The above statement of financial position was prepared based on MFRS 139 and hence the following accompanying notes were prepared as such. In accordance with paragraphs 58 and 63 of MFRS 139, for assets carried at amortised costs, the fund assesses at the end of the reporting year whether a financial asset or a group of financial assets is impaired. A financial asset or a group of financial assets is impaired or impairment loss is incurred only if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the assets (i.e. a loss event) or that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated. In order to determine whether impairment has incurred, factors such as the probability of insolvency and default or significant delay in payments are taken into consideration.

The amount of the loss is measured as the difference between the asset's carrying amount and the present value of the estimated future cash flows (excluding future credit losses that have not incurred) discounted at the asset's original effective profit rate. The asset carrying amount is reduced and the amount of the loss is recognised in the profit or loss. If financing and receivables have a variable profit rate, the discount rate for measuring any impairment loss is the current effective profit rate determined under the contract. As a practical expedient, the fund may measure impairment on the basis of an instrument's fair value using an observable market price.

The carrying amount of the financial asset is reduced by the impairment loss directly for all financial assets except trade receivables, where the carrying amount is reduced through the use of an allowance account. When a trade receivable becomes uncollectible, it is written off against the allowance account. If in the subsequent year, the amount of the impairment loss decreases and the decrease can be related to an event occurring after the impairment, the reversal of the previously recognised impairment loss is recognised in the profit or loss.

Moving on to MFRS 9, the new standard introduces a single impairment measurement model known as expected credit losses ("ECL") model for all financial instruments subject to credit risk, regardless of the type of instruments held and how they are measured, to replace the requirements under MFRS 139. Paragraph 5.5.1 of MFRS 9 states that an entity shall recognise a loss allowance for ECL on a financial asset that is measured in accordance with the relevant paragraphs prescribed in the standard. The objective of the impairment requirements is to recognise lifetime ECL for all financial instruments for which there has been a significant increase in credit risk since initial recognition, whether assessed on an individual or collective basis, considering all reasonable and supportable information, including that which is forward-looking. Entities are required to book in day 1 credit losses under the ECL model. The occurrence of a loss event i.e. an impairment indicator is not required before impairment is recognised. The general approach in MFRS 9 outlines a three-stage impairment model that looks at changes in credit quality since initial recognition. Financial assets move through the three stages as credit quality changes and the stages dictate how the entity measures the impairment losses at each reporting date. The impairment will be reversed if credit quality improves. If at a reporting date, the credit risk on a financial instrument has not increased significantly since initial recognition, an entity shall measure the loss allowance for that financial instrument at an amount equal to 12- month ECL as prescribed under paragraph 5.5.5 of the standard.

For Islamic funds, the manager of Islamic funds needs to measure the credit risk and expected credit losses using the probability of default, exposure at default and loss given default. Management considers both historical analysis and forward-looking information in determining any expected credit loss. Normally, an Islamic fund manager would consider the probability of default to be close to zero as these instruments have a low risk of default and the counterparties have a strong capacity to meet their contractual obligations in the near term. As a result, no loss allowance would be recognised based on 12 months expected credit losses as any such impairment would normally be wholly insignificant to the Islamic fund.

3.0 ACCOUNTING FOR LIABILITIES

3.1 Definition

According to paragraph 4.26 of the Conceptual Framework, a liability is a present obligation of the entity to transfer an economic resource as a result of past events. For a liability to exist, all the following three criteria must be satisfied.

- the entity has an obligation;
- the obligation is to transfer an economic resource; and
- the obligation is a present obligation that exists as a result of past events.

<u>Obligation</u>
An obligation is a duty or responsibility that an entity has no practical ability to avoid and is always owed to another party (or parties). Many obligations are established by contracts, legislation or similar means and are legally enforceable by the party (or parties) to whom they are owed. This is normally the case with the amount payable for goods and services received. In some situations, an entity's duty or responsibility to transfer an economic resource is conditional on a particular future action that the entity may take such as operating a particular business, operating in a particular market on a specified future date or exercising particular options within a contract. In these situations, the entity has an obligation if it has no practical ability to avoid taking such action.

<u>Transfer of an economic resource</u>
To satisfy this criterion, the obligation must have the potential to require the entity to transfer an economic resource to another party (or parties). For that potential to exist, it does not need to be certain that the entity will be required to transfer an economic resource – the transfer may for example be required only if a specified uncertain future event occurs. It is only necessary that the obligation already exists and that, in at least one circumstance, it would require the entity to transfer an economic resource.

Obligations to transfer an economic resource include:

- obligations to pay cash.
- obligations to deliver goods or provide services.
- obligations to exchange economic resources with another party on unfavourable terms. Such obligations include, for example, a forward contract to sell an economic resource on terms that are currently unfavourable or an option that entitles another party to buy an economic resource from the entity.
- obligations to transfer an economic resource if a specified uncertain future event occurs.
- obligations to issue a financial instrument if that financial instrument will oblige the entity to transfer an economic resource.

<u>Present obligation as a result of past events</u>

A present obligation exists as a result of past events only if:

- the entity has already obtained economic benefits or taken an action; and
- as a consequence, the entity will and may have to transfer an economic resource that it would not otherwise have had to transfer.

For example, the acquisition of goods and the use of services give rise to trade payables and the receipt of a bank loan results in an obligation to repay the bank loan. A present obligation can exist even if a transfer of economic resources cannot be enforced until some point in the future. For example, a contractual liability to pay cash may exist now even if the contract does not require a payment until a future date.

3.2 Recognition and measurement

A liability is recognised in the balance sheet when it is probable that an outflow of resources embodying economic benefits will result from the settlement of a present obligation and the amount at which the settlement will take place can be measured reliably. In practice, obligations under contracts that are equally proportionately unperformed (for example, liabilities for inventories ordered but not yet received) are not recognised as liabilities in the financial statements.

Financial liabilities are classified according to the substance of the contractual arrangements entered and the definition of financial liability. A financial liability, as stated in paragraph 3.1.1 of MFRS 9, is recognised in the statement of financial position when, and only when, the entity becomes a party to the contractual provisions of the financial instrument. The classification and measurement of financial liabilities in accordance with MFRS 9 remains largely unchanged from MFRS 139. Financial liabilities are either classified as:

a. financial liabilities at amortised cost; or
b. financial liabilities at FVTPL

Financial liabilities are measured at amortised cost unless either the financial liability is held for trading and therefore required to be measured at FVTPL, or the entity elects to measure the financial liability at FVTPL. Financial liabilities that are likely to be classified and measured at amortised cost include trade payables, loan payables with standard interest rates and bank borrowings. As for financial liabilities at FVTPL, they include interest rate swaps, commodity futures/option contracts and foreign exchange futures/option contracts.

In the statement of financial position for equity fund shown in Table 4, the fund classifies amount due to stockbrokers, the amount due to manager, accrued management fee, amount due to trustee, a donation to charitable bodies, and other payables and accruals as other financial liabilities. The fund's other financial liabilities are recognised initially at fair value plus directly attributable transaction costs and subsequently measured at amortised cost using effective profit rate method.

3.3 Derecognition

In accordance with paragraph 3.3.1 of MFRS 9, a financial liability is derecognised when the obligation under the liability is extinguished i.e. when the obligation specified in the contract is discharged or cancelled or expired. Paragraph 3.3.3 adds that the difference between the carrying amount of the financial liability extinguished or transferred to another party and the consideration paid, including any non-cash assets transferred or liabilities assumed, shall be recognised in profit or loss.

Below is an extract of the statement of financial position of an Islamic asset management company:

STATEMENT OF FINANCIAL POSITION AS AT 31 DECEMBER 2016		
	2016 **RM**	**2015** **RM**
EQUITIES AND LIABILITIES		
Current Liabilities		
Provision for zakat	186,625	31,173
Other payables	648,950	1,092,514
Amount due to related companies	6,648,986	2,460,473
Amount due to holding company	1,903,976	2,880,453
	9,388,537	**6,464,613**

Table 3: Extract of the Statement of the Financial Position of an Islamic Asset Management Company as at 31 December 2016

The other payables of an Islamic asset management company normally consist of the following:

i. Amount due to Trustee for creation of units
Upon processing the sales/subscription order from the investors, the fund manager will submit a piece of creation advice to the trustee in order to satisfy the sales requests from the investor. The manager would remit the proceeds to the trustee within 10 days as required under paragraph 10.03 of SC Guidelines on Unit Trust Funds.

ii. Redemptions payable to unitholders
Upon receiving redemption requests from an investor, the fund manager must pay the unit holder within 10 days of receiving the requests as provided under paragraph 10.17 of SC Guidelines on Unit Trust Funds.

The fund manager may appoint distributors such as the IUTAs, banks or agencies to distribute its products.

In the event that the redemption request originated from a distributor, the fund manager would remit the proceeds from redemptions of the units to the distributors within a few days. The distribution agreements entered into between the fund manager and the distributors govern such settlement timeframes.

iii. Commission payable to distributors/agents
An Islamic fund management company may have appointed agents/distributors to distribute its products. These agents/distributors are entitled to sales commissions and trailer commissions that are normally accrued/provided for in the statement of financial position. Whilst sales commission is a periodic commission paid to the agents/distributors for every investment made, trailer commission is an additional commission paid to the agents/distributors as long as there is still investment in the funds.

Below is an extract of the statement of financial position of an equity fund:

STATEMENT OF FINANCIAL POSITION AS AT 28 FEBRUARY 2017			
	Note	**2017** **RM**	**2016** **RM**
LIABILITIES			
Amount due to stockbrokers	(i)	8,087,728	63,776
Amount due to Manager	(ii)	79,181	-
Accrued management fee	(iii)	51,903	24,480
Amount due to Trustee	(iv)	1,730	816
Donation to charitable bodies	(v)	4,158	29,847
Other payables and accruals	(vi)	23,003	17,372
		8,247,703	**136,291**

Table 4: Extract of the Statement of Financial Position of an Equity Fund as at 28 February 2017

The liabilities of the equity fund in Table 4 are explained below:

i. Amount due to stockbrokers
These relate to purchases of Shariah-compliant securities, which will be paid to the stockbrokers as part of the settlement and clearing process in the stock exchange.

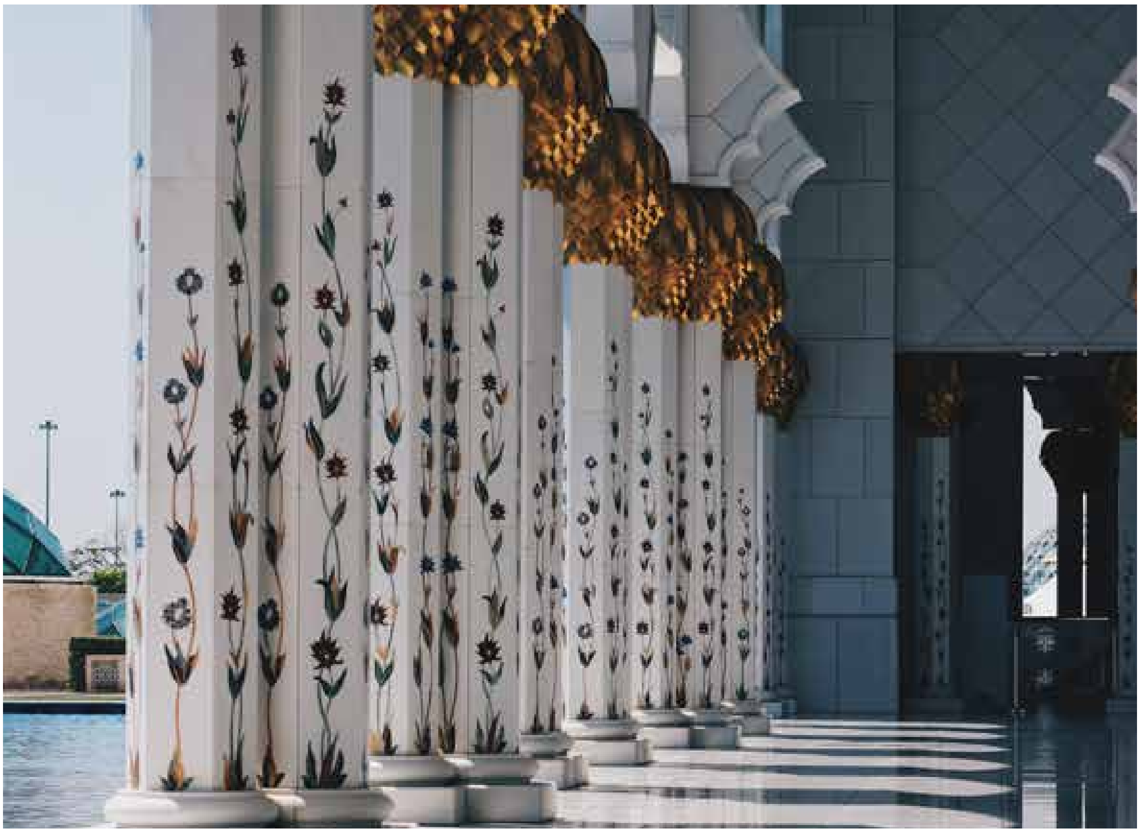
ii. Amount due to Manager
Upon processing the redemption order from the investors, the fund manager will submit cancellation advice to the trustee in order to satisfy the redemption requests from the investor. The trustee would remit the proceeds to the manager within 10 days as required under paragraph 10.04 of SC Guidelines on Unit Trust Funds.

iii. Accrued management fee
The fund would normally accrue management fees on a daily basis. The trustee then pays the outstanding management fees at the end of each month to the fund manager.

iv. Amount due to Trustee
The trustee is entitled to a fee, calculated daily based on the NAV of the fund. The fee includes local custodian fees and charges.

v. Donation to charitable bodies
If the fund inadvertently made a non Shariah-compliant investment, the investment will be disposed off or withdrawn with immediate effect. Any capital gain and/or dividends received will be channelled to the *Baitumal* or any other charitable bodies. Such gains and/or dividend received will be first accrued pending the disbursement to the charitable bodies.

vi. Other payables and accruals
These consist largely of accruals on printing and postage fees, audit fees, tax agent fees and other miscellaneous expenses of the funds.



4.0 ACCOUNTING FOR EQUITY

4.1 Definition

Paragraph 4.63 of the Conceptual Framework defines equity as the residual interest of the assets of the entity after deducting all its liabilities. However, it may be sub-classified in the balance sheet. In the financial statements of a corporate entity, items like shareholder's fund, retained earnings, reserves representing appropriations of retained earnings and reserves representing capital maintenance adjustments may be shown separately. Different classes of equity claims, such as ordinary shares and preference shares, may confer on their holders, different rights to receive some or all of the following from the entity:

a. dividends, if the decides to pay dividends to eligible holders;
b. the proceeds from satisfying the equity claims, either in full on liquidation, or in part at other times; or
c. other equity claims.

For an Equity Fund, the equity comprises of:

- Unit holder's capital
- Reserves

4.2 Unit holders' capital

Generally, the units held by unitholders of a unit trust fund is classified as puttable instruments as these instruments can be redeemed with the fund manager based on the NAV. Such puttable instruments are classified as a financial liability. However, it can be classified as an equity instrument if it meets the required criteria under paragraph 16A of MFRS 132 *Financial Instruments: Presentation.*

Those criteria include:

- the units entitle the holder to a proportionate share of the fund's NAV;
- the units are the most subordinated class and class feature are identical;
- there are no contractual obligations to deliver cash or another financial asset other than the obligation on the Fund to repurchase; and
- the total expected cash flows from the units over its life are based substantially on the profit or loss of the Fund

The outstanding unit is carried at the redemption amount that is payable at each financial year if the unit holder exercises the right to put the unit back to the fund.

Units are created and cancelled at prices based on the fund's NAV per unit at the time of creation or cancellation. The fund's NAV per unit is calculated by dividing the net assets attributable to unit holders with the total number of outstanding units.

There are instances where the criteria above could not be met due to the nature of the units issued. One example would be Multi Class Funds. Multi Class Funds would issue a different class of units where each unit would have different features unique to its own class. The different features of the classes of units do not meet the criteria of units being identical in terms of the features and therefore they are classified as a financial liability instead of equity.

5.0 ACCOUNTING FOR INCOME

5.1 Definition

The Conceptual Framework, under paragraph 4.68 defines Income as increases in assets, or decreases in liabilities, that result in increases in equity, other than those relating to the contributions from holders of equity claims. The definition of income encompasses both revenue and gains. Revenue arises in the course of ordinary activities of an entity and is referred to by a variety of different names including sales, fees, interest, dividends, royalties and rent. The gain represents other items that meet the definition of income and may or may not arise, in the course of the ordinary activities of an entity. Gains include those arising on the disposal of non-current assets. The definition of income also includes unrealised gain, for example, those arising on the revaluation of marketable securities and those resulting from increases in the carrying amount of long-term assets. When gains are recognised in the income statement they are usually displayed separately because knowledge of them is useful for the purpose of making economic decisions. Gains are often reported net of the related expenses.

5.2 Recognition and measurement

Income is recognised in the income statement when an increase in future economic benefits related to an increase in an asset or a decrease in liability has arisen that can be measured reliably. This means in effect, that recognition of income occurs simultaneously with the recognition of increases in assets or decreases in liabilities.

In the statement of comprehensive income for the equity fund, dividend income is recognised on the ex-dividend date when the right to receive payment is established in accordance with paragraph 30 of MFRS 118 *Revenue*. Profit income from Shariah-compliant deposits with licensed Islamic financial institutions is recognised on a time proportionate basis using the effective profit rate method on an accrual basis. Realised gain or loss on disposal of Shariah-compliant quoted securities is accounted for as the difference between the net disposal proceeds and the carrying amount of the Shariah-compliant quoted securities, determined on a weighted average cost basis.

Beginning 1 January 2018, a new standard on revenue recognition was introduced by MASB to replace most revenue recognition standards. MFRS 15 *Revenue from Contracts with Customers*, aims to provide one comprehensive revenue recognition model for all contracts with customers to improve comparability within and across industries. The new standard focuses on the performance obligations in a contract and allocating a transaction price to those obligations by applying a 5-step model. They are; identify the contract(s) with a customer, identify the performance obligations in the contract, determine the transaction price, allocate the transaction price and recognise revenue when (or as) the performance obligation is satisfied. However, dividend income is excluded from the scope of MFRS 15 and are recognised in profit or loss in accordance with the requirements under MFRS 9.

Below is an extract of the statement of comprehensive income of an Islamic asset management company:

STATEMENT OF COMPREHENSIVE INCOME FOR THE FINANCIAL YEAR ENDED 31 DECEMBER 2016			
	Note	**2016 RM**	**2015 RM**
Revenue	1	8,308,202	5,541,257
Direct cost	2	(237,596)	(210,794)
Profit Income		73,713	61,981
Personnel costs		(2,791,846)	(1,937,095)
Other operating expenses		(1,757,299)	(2,094,456)
Profit before zakat and tax		3,595,174	1,360,983
Zakat		(186.678)	(31,225)
Income Tax expense		(17,691)	(11,799)
Net profit after zakat and tax, representing total comprehensive income for the financial year		**3,390,805**	**1,317,869**

Table 5: Extract of Statement of Comprehensive Income for Islamic Asset Management company for the financial year ended 31 December 2016

1. For an Islamic asset management company, its revenue is normally earned from:

   i. Management fee from the management of Islamic funds; and
   ii. Initial sales charge earned from the sales of Islamic funds

2. Meanwhile, its direct costs are normally:

   i. Trailer fee commission paid/payable to agents and distributors of the Islamic funds; and
   ii. Sales commission paid/payable to agents and distributors of the Islamic funds.

Below is an extract of the statement of comprehensive income of an equity fund:

STATEMENT OF COMPREHENSIVE INCOME FOR THE FINANCIAL YEAR ENDED 28 FEBRUARY 2017			
	Note	2017 RM	2016 RM
INVESTMENT INCOME			
Dividend income	(i)	716,438	900,230
Profit income	(ii)	118,058	91,415
Net gain on financial asset at FVTPL	(iii)	445,674	34,949
		1,280,170	**1,026,594**
EXPENSES			
Management fee	(iv)	438,350	460,612
Trustee's fee	(v)	14,612	15,354
Audit fee		12,120	8,240
Tax agent's fee		4,000	12,700
Transaction costs	(vi)	429,842	357,845
Other expenses		71,543	61,510
		970,467	**916,261**
PROFIT BEFORE TAXATION		309,703	110,333
Taxation		-	435
PROFIT AFTER TAXATION AND TOTAL COMPREHENSIVE INCOME FOR THE YEAR		**309,703**	**109,898**
Profit after taxation is made up of the following:			
Realised amount		302,604	3,749,132
Unrealised amount		7,099	(3,639,234)
		309,703	**109,898**

Table 6: Extract of Statement of Comprehensive Income of an Equity Fund for the financial year ended 28 February 2017

The typical revenue earned by an equity fund is explained below:

i. Dividend income
Consists of dividend received from company which the fund has invested in on the ex-date of the dividends.

ii. Profit income
Consists of profit earned from Shariah-compliant money market placements with licensed financial institutions.

iii. Net gain on financial assets at FVTPL
These consists of net realised gain on disposals of Shariah-compliant investments and net unrealised gains on Shariah-compliant investments for those investments that are still held in the portfolio.

6.0 ACCOUNTING FOR EXPENSES

6.1 Definition

Paragraph 4.69 of the Conceptual Framework defines expenses as decreases in assets, or increases in liabilities, that result in decreases in equity, other than those relating to distributions to holders of equity claims. The definition of expenses encompasses losses as well as those expenses that arise in the course of ordinary activities of the entity. Expenses that arise in the course of the ordinary activities of the entity include the cost of sales, wages and depreciation. They usually take the form of an outflow or depletion of assets such as cash and cash equivalent, inventory, property, plant and equipment. Losses represent the other items that meet the definition of expenses and may or may not arise in the course of the ordinary activities of the entity. Losses include for example those resulting from disasters such as fire and flood, as well as those arising on the disposal of non-current assets. The definition of expenses also includes unrealised losses. When losses are recognised in the income statement, they are displayed separately because knowledge of them is useful in making economic decisions. Losses are often reported net of related income.

6.2 Recognition

Expenses are recognised in the income statement when a decrease in future economic benefits related to a decrease in an asset or an increase of a liability has arisen and can be measured reliably. This means, in effect, that recognition of expenses, occurs simultaneously with the recognition of an increase in liabilities or a decrease in assets. Expenses are recognised in the income statement based on a direct association between the costs incurred and the earning of specific items of income and this process is commonly referred as the matching of costs with revenues. When economic benefits are expected to arise over several accounting periods and the association can only be broadly or indirectly determined, expenses are recognised in the income statement on the basis of systematic and rational allocation procedures. This is often necessary in recognising the expenses associated with the using up of assets and in such cases the expenses are referred to as depreciation or amortisation. An expense is recognised in the income statement when an expenditure produces no future economic benefits or when future economic benefits do not qualify or cease to qualify, for recognition in the balance sheet as an asset. An expense is also recognised in the income statement in those case when a liability is incurred without the recognition of an asset, as when a liability under a product warranty arises.

Based on the example illustrated above, typical expenses recorded in the statement of comprehensive income for the Islamic fund are:

i. Management fee
   The Management fee payable to the manager is based on the rate agreed in the Deed and calculated daily based on the NAV of the Fund.

ii. Trustee's fee
   Similarly, the Trustee fee is also based on the rate agreed in the Deed and calculated daily based on the NAV of the Fund. The trustee's fee includes the local custodian fee but excludes the foreign sub-custodian fee (if any).

iii. Transaction costs
   Transaction costs are costs incurred to acquire or dispose of financial assets and liabilities at FVTPL. They include fees and commissions paid to agents, advisors, brokers and dealers. Transaction costs when incurred are immediately recognised in the statement of comprehensive income as expenses.

The expenses paid by the various Islamic funds are regulated by the SC Guidelines on Unit Trust Funds under Chapter 9.

7.0 ISSUE ON DISTRIBUTION EQUALISATION IN UNIT TRUST FUNDS

The issue on distribution equalisation concerns the practice of some unit trust funds to present the equalisation payment in the fund's income statement. The proponents of the treatment argue that equitable interest of the unit holders is safeguarded as the NAV per unit of the fund remains unchanged upon issuance or redemption of the units. However, it is argued that such treatment may not be appropriate from the context of MFRS.

A unit trust fund is an open-ended collective investment scheme constituted under a trust deed. The fund is equitably divided into units which vary in price, directly proportionate to the variation in the value of the fund's NAV. Since it is an open-ended fund, units can be issued and redeemed at any time. Fund managers, however, allocate the same amount from the income of the fund to each unit and this give rise to the argument that holders of newly created units should not be entitled to any share of undistributable income which arose before the creation of such units. In order to ensure equitable distribution, certain unit trust funds account for Dividend Equalisation by allocating part of the consideration received from the newly created units as an equalisation payment and represented as the fund's undistributable income that has arisen up to the creation of new units. Similarly, an equalisation payment is allocated to the consideration paid for any units redeemed, representing the entitlement of the holder of redeemed units over the fund's undistributed income up to redemption date.

The Financial Reporting Standards Implementation Committee (FRSIC) is of the opinion that the Dividend Equalisation does not meet the required definition of income and expenses, hence the presentation in the income statement is a contravention to MFRS. The equalisation payment is a contribution from, or distribution to, unit holders upon issuance or redemption of units respectively. In the accounting for dividend equalisation, the equalisation payment shall be added to, or deducted from, the unit holders' capital. FRSIC further opined that unit trust funds which had previously presented the equalisation payments in the income statement shall correct this error in accordance with MFRS 108 *Accounting Policies, Changes in Accounting Estimates and Errors.*

SUMMARY

- This chapter discusses the concept and principles of Islamic fund management including the various regulatory requirements under Securities Commission Malaysia as well as Shariah requirements.
- This chapter also highlighted the relevant conceptual framework of financial reporting relating to assets, liabilities, equity, income and expenses under Islamic fund management.
- Also included in the chapter are the financial statements of the Islamic fund management company as well as the Islamic fund itself, together with the relevant explanation and notes.
- Lastly, the chapter covers the relevant disclosure requirements under MFRS in relation to Islamic fund management.

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Securities Commission Malaysia's Guidelines on Unit Trust Funds (March 2008 & latest revision January 2014)

Securities Commission Malaysia's Guidelines on Wholesale Funds (February 2009)

Standard & Poor's (www.standardpoors.com)

CHAPTER 15

MFRS 17 INSURANCE CONTRACTS

MFRS 17 INSURANCE CONTRACTS

LEARNING OBJECTIVES

The chapter aims to provide an overview of IFRS 17 Insurance Contracts as issued by IASB in May 2017.

1.0 INTRODUCTION

The International Accounting Standards Board (IASB) issued IFRS17 *Insurance Contracts* (the standard) in May 2017, effective for annual periods beginning on or after 1 January 2021, with earlier application permitted. IFRS 17 supersedes IFRS 4 *Insurance Contracts*, an interim standard issued in 2004 that allows entities to use a wide variety of accounting practices for insurance contracts. The IASB has announced to delay the effective date for another year to 1 January 2022.

More than 20 years in development, IFRS 17 represents a complete overhaul of accounting for insurance contracts. The new standard will increase the transparency of insurers' financial positions, performance and is intended to make their financial statements more comparable with both other insurers and other industries.

The new standard applies a current value approach to measuring insurance contracts and recognises profit as insurers provide services and are released from risk. The profit or loss earned from underwriting activities are reported separately from financing activities. Detailed disclosure notes explain how items like new business issued, experience in the year, cash receipts and payments, and changes in assumptions affected the performance and the carrying amount of insurance contracts.

IFRS 17 is a complex standard. It covers accounting for a wide range of contracts that insurers issue globally. The degree of change compared to existing practice will vary based on existing accounting policies and the types of business insurers write. However, the change will be significant for nearly all insurers. This is why the IASB has allowed more than three years after the issue date for the standard to become effective.

The change will affect both users and preparers of financial statements. Users of financial statements will receive more and different information about an entity's insurance contracts in the IFRS financial statements than in the past, which may change the way they assess and compare insurers. Preparers will need to help analysts and other users of their financial statements to interpret the new information and understand how it relates to what they receive currently. Analysts may wish to evaluate an insurer's performance on the new basis (albeit estimated), even for comparative periods, before the standard is effective.

In Malaysia, MFRS 17 *Insurance Contracts* is the equivalent standard to IFRS 17.

2.0 OVERVIEW OF MFRS 17

MFRS 17 establishes principles for the recognition, measurement, presentation and disclosure of insurance contracts issued, reinsurance contracts held and investment contracts with discretionary participation features an entity issue.

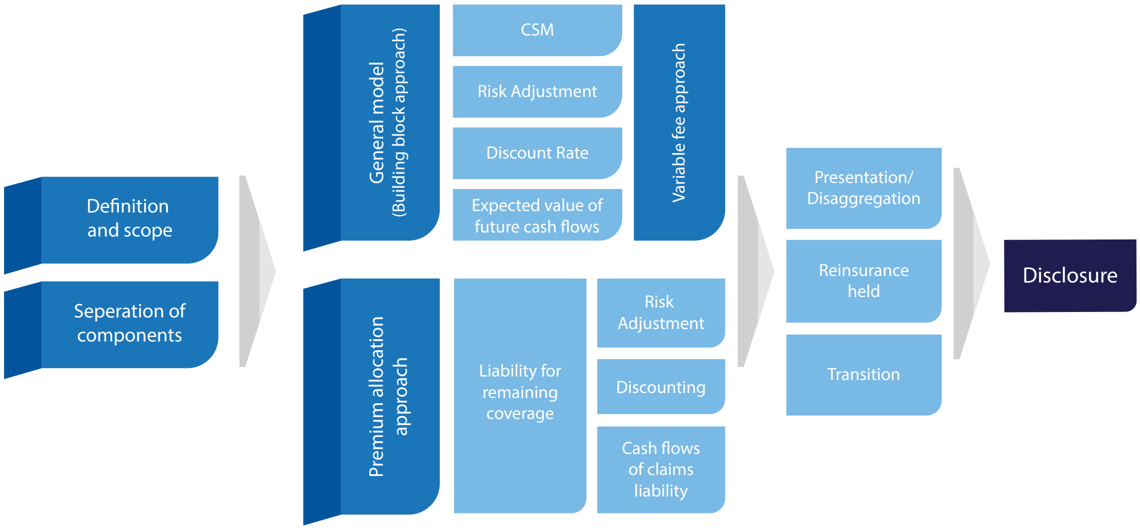

Diagram 1[1]

The key principles of MFRS 17 are that an entity:

- Identifies insurance contracts as those under which the entity accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder.
- Separates specified embedded derivatives, distinct investment components and distinct (i.e. non-insurance) goods or services from insurance contracts.
- Divides the contracts into groups it will recognise and measure.
- Recognises and measures groups of insurance contracts at:

  - A risk-adjusted present value of the future cash flows (the fulfilment cash flows) that incorporates all available information about the fulfilment cash flows in a way that is consistent with observable market information, plus
  - An amount representing the unearned profit in the group of contracts i.e. the contractual service margin (CSM).

- Recognises profit from a group of insurance contracts over the period the entity provides insurance coverage, and as the entity is released from risk. If a group of contracts is expected to be onerous (i.e. loss-making) over the remaining coverage period, an entity recognises the loss immediately
- Presents insurance revenue, insurance service expenses and insurance finance income or expenses separately.
- Discloses information to enable financial statement users to assess the effect that contracts within the scope of MFRS 17 have on an entity's financial position, financial performance and cash flows. Thus, an entity discloses qualitative and quantitative information about:

  - Amounts recognised in its financial statements from insurance contracts
  - Significant judgements, and changes in those judgments, when applying the standard
  - The nature and extent of the risks from contracts within the scope of the standard.

[1] *EY's Applying IFRS 17: A closer look at the new Insurance Contracts Standard May 2018, page 7.*

The standard contains a core measurement approach that we will refer to in this chapter as the 'general model'. The standard includes an adaptation of the general model, the 'variable fee approach' that should be applied to certain types of contracts with direct participation features. If certain criteria are met, an entity may apply a simplified measurement approach (i.e. premium allocation approach (PAA) – detailed explanation in 13.0 of this Chapter). This approach allows an entity to measure the amount of remaining coverage by allocating the premium over the coverage period.

For reinsurance contracts held, an entity should apply either a modified version of the general model or the PAA. The general model is modified because the CSM for reinsurance contracts held can be either a net cost or a net gain of purchasing reinsurance for services yet to be received. In contrast, the CSM for insurance contracts issued can only be the unearned profit for services yet to be provided. For investment contracts with discretionary participation features, an entity applies a modified general model because of the absence of significant insurance risk in the contracts.

3.0 SCOPE AND DEFINITION

3.1 Definition of an insurance contract

An entity applies MFRS 17 to insurance contracts, including reinsurance contracts, it issues, reinsurance contracts it holds, and Investment contracts with discretionary participation features that it issues, provided the entity also issues insurance contracts.

The definition of an insurance contract is, in essence, the same as for MFRS 4. Insurance risk is significant if, and only if, an insured event could cause the issuer to pay additional amounts that are significant in any single scenario, excluding scenarios that have no commercial substance (i.e. scenarios with no discernible effect on the economics of the transaction). MFRS 17 clarifies this to require that:

- An insurer must consider the time value of money in assessing whether the additional amounts payable in any scenario are significant.
- A contract does not transfer significant insurance risk if there is no scenario with commercial substance in which the insurer can suffer a loss on a present value basis.

If an insurance contract requires payment when an event with uncertain timing occurs and the payment is not adjusted for the time value of money, there may be scenarios in which the present value of the payment increases, even if its nominal value is fixed. An example is an insurance that provides a fixed death benefit when the policyholder dies. It is certain that the policyholder will die, but the date of death is uncertain. If the policyholder dies earlier than expected significant insurance risk could exist, as those payments are not adjusted for the time value of money, even if there is no overall loss on the portfolio of contracts.

3.2 Reinsurance contracts

A reinsurer accepts significant insurance risk from the issuer of underlying insurance contracts (a cedant) via a reinsurance contract and applies MFRS 17 to the reinsurance contracts it issues. A cedant applies MFRS 17 to reinsurance contracts that it holds. The requirement that a reinsurance contract transfers significant insurance risk is the same as for an insurance contract. However, even if a reinsurance contract does not expose the issuer to the possibility of a significant loss, that contract is deemed to transfer significant insurance risk if it transfers substantially all of the insurance risk relating to the reinsured portions of the underlying insurance contracts to the reinsurer.

3.3 Investment contracts with discretionary participation features

Investment contracts with discretionary participation features do not include a transfer of significant insurance risk. These contracts are included within the scope of MFRS 17, provided the entity also issues insurance contracts, for the following reasons:

- Investment contracts with discretionary participation features and insurance contracts that specify a link to returns on underlying items are sometimes linked to the same underlying pool of assets (one provides additional insurance benefits and the other does not). Using the same accounting for both types of contracts simplifies the accounting and enhances comparability within an entity.

- Both types of contracts often have characteristics (long maturities, recurring premiums and high acquisition cash flows) that appear more frequently in insurance contracts than in most other financial instruments. The accounting model in MFRS 17 specifically generates useful information about contracts containing such features.
- The accounting model in MFRS 17 provides more appropriate treatment of discretionary cash flows than any other model for these types of contracts.

3.4 Scope exclusions

MFRS 17 excludes the following transactions that may meet the definition of insurance contracts:

- Warranties provided by a manufacturer, dealer or retailer in connection with the sale of its goods or services to a customer (see MFRS 15 and MFRS 137 *Provisions, Contingent Liabilities and Contingent Assets*).
- Employers' assets and liabilities that arise from employee benefit plans, and retirement benefit obligations reported by defined benefit retirement plans (see MFRS 119 *Employee Benefits, MFRS Share-based Payments* and MFRS 126 *Accounting and Reporting by Retirement Benefit Plans*).
- Contractual rights or contractual obligations contingent on the future use of, or right to use, a non-financial item (for example, some licence fees, royalties, variable and other contingent lease payments and similar items (*see* MFRS 15, MFRS 138 *Intangible Assets* and MFRS 16 *Leases*).
- Residual value guarantees provided by the manufacturer, dealer or retailer and lessees' residual value guarantees embedded in a lease (*see MFRS 15 and MFRS 16*).
- Financial guarantee contracts, unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used accounting applicable to insurance contracts.
- Contingent consideration payable or receivable in a business combination (see MFRS 3 *Business Combinations*).
- Insurance contracts in which the entity is the policyholder unless those contracts are reinsurance contracts held.

The list of items excluded from the scope of MFRS 17 is similar to MFRS 4 except for the addition of residual value guarantees provided by a manufacturer, dealer or retailer. Stand-alone residual value guarantees that transfer insurance risk is within the scope of MFRS 17.

3.5 Financial guarantee contracts

MFRS defines a financial guarantee contract as a contract that requires the issuer to make specified payments to reimburse the holder for a loss it incurs because a specified debtor fails to make payment when due in accordance with the original or modified terms of a debt instrument. These contracts transfer credit risk and may take various legal forms, such as a guarantee, some types of letters of credit, a credit default contract or an insurance contract. MFRS 17 excludes financial guarantee contracts unless the issuer has previously asserted explicitly that it regards such contracts as insurance contracts and has used the applicable accounting model. If so, the issuer may elect to apply either MFRS 17 or MFRS 132 *Financial Instruments: Presentation*, MFRS 7 *Financial instruments: Disclosures* and MFRS 9 to the financial guarantee contracts. The issuer may make that choice contract by contract, but the choice for each contract is irrevocable. This accounting policy election is the same as it was in MFRS 4.

3.6 Fixed-fee service contracts

A fixed-fee service contract is one in which the level of service depends on an uncertain event but the fee does not. Examples include roadside assistance programmes and maintenance contracts in which the service provider agrees to repair specified equipment after a malfunction. Such contracts can meet the definition of an insurance contract because:

- It is uncertain whether, or when, assistance or a repair will be needed.
- The owner is adversely affected by the occurrence.
- The service provider compensates the owner if assistance or repair is needed.

Although they may meet the definition of insurance contracts, their primary purpose is to provide services for a fixed fee. MFRS 17 permits entities a choice of applying MFRS 15 instead of MFRS 17 to such contracts that it issues if, and only if, they meet specified conditions. The entity may make that choice contract by contract, but the choice for each contract is irrevocable. The conditions are:

- The entity does not reflect an assessment of the risk associated with an individual customer in setting the price of the contract with that customer.
- The contract compensates the customer by providing services, rather than by making cash payments to the customer.
- Insurance risk transferred by the contract arises primarily from the customer's use of services, rather than from uncertainty over the cost of those services.

4.0 SEPARATING COMPONENTS FROM AN INSURANCE CONTRACT AND COMBINING INSURANCE CONTRACTS

Insurance contracts create rights and obligations that work together to generate cash inflows and outflows. Some insurance contracts may:

- Contain embedded derivatives that, if bifurcated, would be within the scope of MFRS 9.
- Include investment components that, if provided under separate contracts, would be within the scope of MFRS 9.
- Provide goods and non-insurance services that, if provided under separate contracts, would be within the scope of MFRS 15.

MFRS 17 requires an insurer to identify and separate distinct components in certain circumstances. When separated, those components are accounted for under the relevant MFRS (i.e., not under MFRS 17). The IASB considers that accounting for such components separately using other applicable MFRSs makes them more comparable. It also offers users of financial statements a better way to compare the risks of similar contracts issued by entities in different businesses or industries. After separating the distinct components, an entity should apply MFRS 17 to all remaining components of the (host) insurance contract.

The diagram below illustrates the approach to separating non-insurance components.

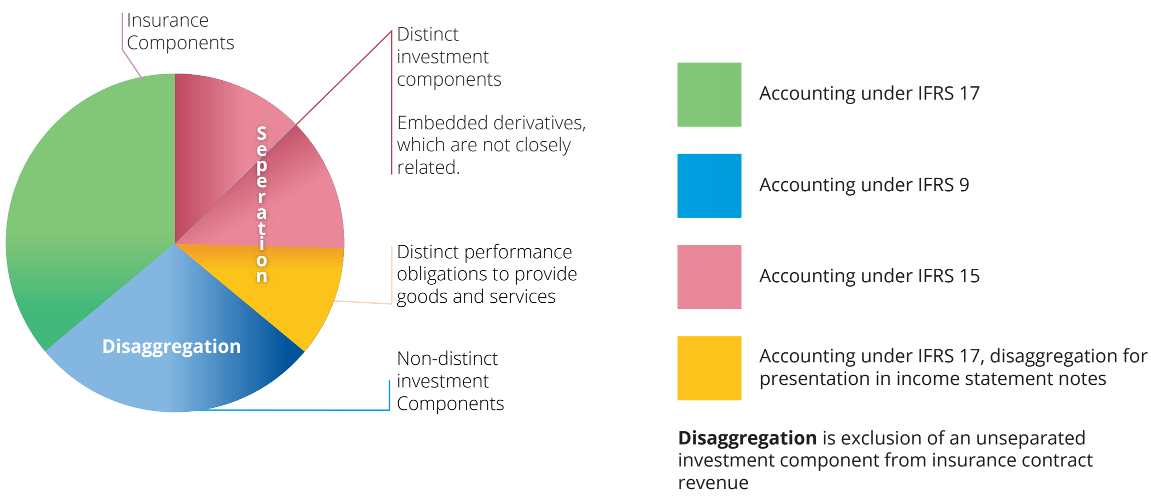

Diagram 2[2]

[2] EY's Applying IFRS 17: A closer look at the new Insurance Contracts Standard May 2018, page 15.

5.0 LEVEL OF AGGREGATION

The level of aggregation deals with grouping individual insurance contracts for the purposes of recognising losses when a group of contracts is onerous and the timing of the recognition of profits arising from a group of profitable contracts.

The starting point for aggregating contracts is to identify portfolios of insurance contracts. A portfolio comprises contracts that are subject to similar risks and managed together. MFRS 17 then requires an entity to divide the contracts in each portfolio on initial recognition into the following groups:

- Contracts that are onerous at initial recognition, if any
- Contracts that have no significant possibility of becoming onerous subsequently, if any
- Remaining contracts in the portfolio, if any

An entity is prohibited from grouping contracts issued more than one year apart (except in certain circumstances when applying MFRS 17 for the first time):

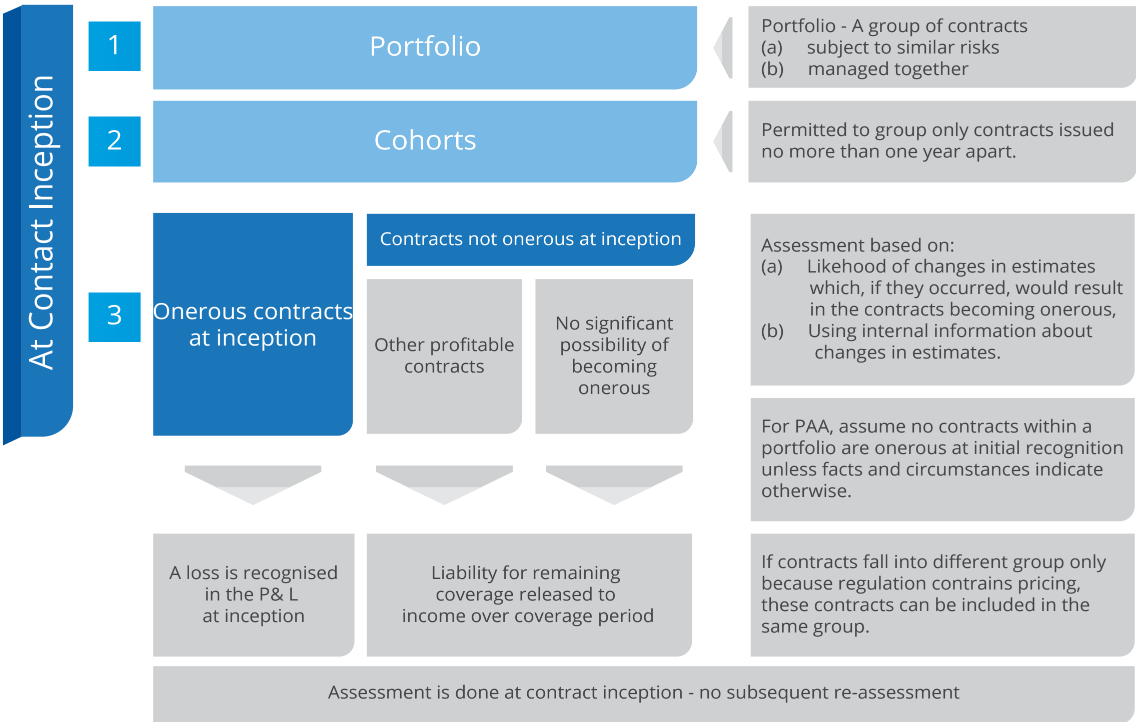

Diagram 3 [3]

Groups of contracts are established on initial recognition and are not reassessed. An entity is permitted, but not required, to subdivide contracts into further groups based on information from its internal reporting, if that information meets certain criteria.

To measure a group of contracts, an entity may estimate the fulfilment cash flows at a higher level of aggregation than the group or portfolio.

This assumes that the entity is able to include the appropriate fulfilment cash flows in the measurement of the group by allocating such estimates to groups of contracts.

[3] *Ernst & Young Malaysia's "MFRS 17 - Understanding its impact and consequences" training material.*

6.0 INITIAL RECOGNITION

An entity should recognise a group of insurance contracts it issues from the earliest of the following:

- The beginning of the coverage period of the group of contracts.
- Date when the first payment from a policyholder in the group is due or when the first payment is received if there is no due date.
- For a group of onerous contracts, when the group becomes onerous, if facts and circumstances indicate that the group is onerous.

An insurance contract may, at initial recognition, join an existing group of insurance contracts if all the contracts have similar expected profitability at the time of initial recognition and are issued within a year of each other (i.e., same cohort). When contracts are added to a group in a subsequent reporting period, this may result in a change in determining discount rates at the date of initial recognition of the group as discount rates may be determined using weighted average rates over the period that contracts in the group are issued. When this occurs, an entity should apply the revised (weighted average) discount rates from the start of the reporting period in which the new contracts are added to the group. There is no retrospective catch-up adjustment.

In some cases, an entity will pay or receive insurance acquisition cash flows for contracts issued prior to the date of recognition of the group of insurance contracts to which those insurance acquisitions cash flows are attributable (unless the insurer chooses to recognise these as expenses or income under the PAA. In these situations, an insurer should recognise an asset or a liability for these cash flows (i.e. a prepayment or an accrual). When the group of insurance contracts to which the insurance acquisition cash flows are allocated is recognised, the asset or liability should be derecognised (because the insurance acquisition cash flows are now part of the cash flows of the group of insurance contracts).

7.0 MEASUREMENT

The core approach to the measurement of insurance contracts in MFRS 17 is referred to throughout this chapter as the 'general model'. MFRS 17 includes modifications and simplification to the general model that is applicable in specified circumstances.

7.1 Overview of the general model

The general model measures a group of insurance contracts as the sum of the following 'building blocks':

- Fulfilment cash flows, comprising:
  - An unbiased and probability-weighted estimate of future cash flows.
  - A discount adjustment to present value to reflect the time value of money and financial risks.
  - A risk adjustment for non-financial risk.
- A CSM representing unearned profit an entity will recognise as it provides service under the insurance contracts in the group.

After initial recognition of a group of insurance contracts, the carrying amount of the group at each reporting date is the sum of:

- The liability for remaining coverage, comprising:
  - The fulfilment cash flows related to future service allocated to the group at that date.
  - The CSM of the group at that date.
- The liability for incurred claims comprising the fulfilment cash flows related to past service.

7.2 Modification to the general model

Modifications to the general model apply to the following groups of contracts:

- Reinsurance contracts held.
- Investment contracts with discretionary participation features.
- Contracts with direct participation features.

7.3 Simplification to the general model

An entity is permitted to simplify the measurement of eligible groups of insurance contracts by applying an approach referred to as 'the premium allocation approach' as explained earlier in paragraph 2.0 of this chapter. The PAA does not require an entity to measure the CSM explicitly or update the liability for remaining coverage for changes in discount rates and other financial variables.

8.0 ESTIMATES OF FUTURE CASH FLOWS

The first element of measuring fulfilment cash flows in the general model is an estimate of future cash flows within the contract boundary period of each contract in a group. Estimates of future cash flows should:

- Include all cash flows that are within the contract boundary.
- Incorporate, in an unbiased way, all reasonable and supportable information available without undue cost or effort about the amount, timing and uncertainty of those future cash flows.
- Reflect the perspective of the entity, provided that estimates of any relevant market variables are consistent with observable market prices for those variables.
- Be current.

An entity may estimate the future cash flows at a higher level of aggregation than a group and then allocate the resulting fulfilment cash flows to individual groups of contracts.

8.1 Contract boundary

Cash flows are within the boundary of an insurance contract if they arise from substantive rights and obligations that exist during the reporting period in which the entity can compel the policyholder to pay the premiums or in which the entity has a substantive obligation to provide the policyholder with services. A substantive obligation to provide services ends when:

- The entity has the practical ability to reassess the risks of the particular policyholder and, as a result, can set a price or level of benefits that fully reflects those risks; or
- Both of the following criteria are satisfied:

  i. The entity has the practical ability to reassess the risks of the portfolio of insurance contracts that contains the contract and, as a result, can set price or level of benefits that fully reflect the risk of that portfolio.

  ii. The pricing of the premiums for coverage up to the date when the risks are reassessed does not take into account the risks that relate to periods after the reassessment date.

A liability or asset relating to expected premiums or claims outside the boundary of the insurance contract must not be recognised. Such amounts relate to future insurance contracts.

MFRS 17 does not explicitly state whether the boundary condition relating to repricing for risk refers to insurance risk only or whether it also reflects other types of risk under the contract.

8.2 Cash flows within the contract boundary

Cash flows within the boundary of an insurance contract are those that relate directly to the fulfilment of the contract, including those for which the entity has discretion over the amount or timing. MFRS 17 provides the following examples of such cash flows:

- Premiums and related cash flows.
- Claims and benefits, including reported claims not yet paid, incurred claims not yet reported and expected future claims within the contract boundary.
- Payments to policyholders (or on behalf of policyholders) that vary depending on underlying items.
- Payments to policyholders resulting from embedded derivatives, for example, options and guarantees.
- Allocation of insurance acquisition cash flows attributable to the portfolio to which the contract belongs.
- Claims handling costs.
- Contractual benefit costs paid in kind.
- Policy administration and maintenance costs, including recurring commissions that are expected to be paid to intermediaries.
- Transaction-based taxes and levies (such as premium taxes).
- Payments by the insurer in a fiduciary capacity to meet tax obligations incurred by the policyholder, and related receipts.
- Claim recoveries, such as salvage and subrogation (to the extent they are not recognised as separate assets).
- Allocation of fixed and variable overheads directly attributable to fulfilling insurance contracts. (Such overheads are allocated to groups of contracts using methods that are systematic and rational, and are consistently applied to all costs that have similar characteristics).
- Any other costs that may be charged specifically to the policyholder under the terms of the contract.

Insurance acquisition cash flows are those arising from the cost of selling, underwriting and starting a group of insurance contracts that are directly attributable to the portfolio of insurance contracts to which the group belongs. Such cash flows include cash flows that are not directly attributable to individual contracts or groups of insurance contracts within the portfolio.

There is no restriction of insurance acquisition cash flows to only those resulting from successful efforts. Therefore, the directly attributable costs of an underwriter of a portfolio of motor insurance contracts, for example, need not be apportioned between costs for contracts issued and the cost of efforts that did not result in the issuance of a contract.

MFRS 17 provides a list of cash flows that should not be included in cash flows that arise as an entity fulfils an existing insurance contract, these include, for example:

- Investment returns (accounted for separately under applicable MFRSs).
- Cash flows (payments or receipts) that arise under reinsurance contracts held (accounted for separately).
- Cash flows that may arise from future insurance contracts, i.e., cash flows outside the boundary of existing contracts.
- Cash flows relating to costs that cannot be directly attributed to the portfolio of insurance contracts that contain the contract, such as some product development and training costs; these are recognised in profit or loss when incurred.
- Cash flows that arise from abnormal amounts of wasted labour or other resources that are used to fulfil the contract; such costs are recognised in profit or loss when incurred.
- Income tax payments and receipts the insurer does not pay or receive in a fiduciary capacity.
- Cash flows between different components of the reporting entity, such as policyholder and shareholder funds, if these cash flows do not change the amounts paid to policyholders.
- Cash flows arising from components separated from the insurance contract and accounted for using other applicable MFRSs.

8.3 Incorporate all reasonable and supportable information available without undue cost or effort

The objective of estimating future cash flows is to determine the expected value, or the probability-weighted mean, of the full range of possible outcomes, considering all reasonable and supportable information available at the reporting date without undue cost or effort.

An entity need not identify every possible scenario. The complexity of techniques an entity uses to estimate the full range of outcomes will depend on the complexity of the cash flows of a group of insurance contracts and the underlying factors that drive cash flows. In some cases, relatively simple modelling may give an answer within an acceptable range of precision, without the need for many detailed simulations. However, in some cases, the cash flows may be driven by complex underlying factors and may respond in a non-linear fashion to changes in economic conditions. This may occur if, for example, the cash flows reflect a series of interrelated options that are implicit or explicit. In such cases, it is likely that more sophisticated stochastic modelling will be necessary to satisfy the measurement objective.

The future cash flow estimates must be on an expected value basis and be unbiased. This means that they should exclude any additional estimates above the probability-weighted mean for “uncertainty”, “prudence” or what is sometimes described as “management loading”. The risk adjustment for non-financial risk is intended to reflect the compensation for bearing the non-financial risk resulting from the uncertain amount and the timing of cash flows.

Reasonable and supportable information available at the reporting date without undue cost or effort includes information available from an entity’s own information systems about past events and current conditions, and forecasts of future conditions. An entity should estimate the probabilities and amounts of future payments under existing contracts based on information obtained, including:

- Information about claims already reported by policyholders
- Other information about the known or estimated characteristics of the insurance contracts
- Historical data about the entity’s own experience, supplemented when necessary with data from other sources. Historical data is adjusted to reflect current conditions, for example, if:
    - Characteristics of the insured population differ (or will differ, for example, because of adverse selection) from those of the population that has been used as a basis for the historical data.
    - There are indications that historical trends will not continue, that new trends will emerge or that economic, demographic and other changes may affect the cash flows that arise from the existing insurance contracts.
    - There have been changes in items such as underwriting and claims management procedures that may affect the relevance of historical data to the insurance contracts.
- Current price information, if available. The standard refers to reinsurance contracts and other financial instruments (if any) covering similar risks, such as catastrophe bonds and weather derivatives, and recent market prices for transfers of insurance contracts.

The measurement of a group of insurance contracts should reflect, on an expected value basis, the entity’s current estimates of how the policyholders in the group will exercise the options available, e.g., renewal, surrender and conversion options, and options to stop paying premiums while still receiving benefits under the contracts.

8.4. Market variables and non-market variables

MFRS 17 identifies two types of variable that can affect cash flow estimates:

i. Market variables (i.e. those that can be observed in, or derived directly from, markets (for example, prices of publicly-traded securities and interest rates).
ii. Non-market variables (i.e. all other variables, such as the frequency and severity of insurance claims and mortality).

8.5 Using current estimates

Estimated cash flows should be current, i.e. reflect conditions existing at the measurement date, including assumptions about the future. An entity should review and update its estimates from the close of the previous reporting period. In doing so, an entity should consider whether updated estimates faithfully represent the conditions at the end of the reporting period and changes during the period.

8.6 Explicit cash flows

An entity estimates future cash flows separately from other estimates, for example the risk adjustment for non-financial risk or the adjustment to reflect the time value of money and financial risks. There is an exception if the entity uses the fair value of a replicating portfolio of assets to measure some of the cash flows that arise from insurance contracts. This will combine the cash flows and the adjustment to reflect the time value of money and financial risks. The fair value of a replicating portfolio of assets reflects both the expected present value of cash flows from the portfolio of assets and the associated risk.

9.0 DISCOUNT RATES

The second element of measuring fulfilment cash flows under the general model is an adjustment to the estimates of future cash flows to reflect the time value of money and financial risks related to those cash flows (to the extent that they are not included in the cash flow estimates). The adjustment is made by discounting estimated future cash flows. Discount rates must:

- Reflect the time value of money, characteristics of the cash flows and liquidity characteristics of the insurance contracts
- Be consistent with observable current market prices (if any) for financial instruments with cash flows whose characteristics are consistent with those of the insurance contracts (e.g., timing, currency and liquidity)
- Exclude the effect of factors that influence such observable market prices, but do not affect the future cash flows of the insurance contracts

Discount rates used to measure the present value of future cash flows should reflect the characteristics of the cash flows; for example, in terms of currency and timing of cash flows and uncertainty due to financial risk. The effects of uncertainty in cash flows due to non-financial risks are included in the risk adjustment for non-financial risk.

Insurance liability measurement component	Discount Rate
Fulfilment cash flows	Current rate at reporting date
Contractual service margin interest accretion for contracts without direct participation features	Rate at date of initial recognition of group
Changes in the contractual service margin for contracts without direct participation features	Rate at date of initial recognition of group
Changes in the contractual service margin for contracts with direct participation features	A rate consistent with that used for the allocation of finance income or expenses
Liability for remaining coverage under PAA	Rate at date of initial recognition of group
Profit or loss component	
Disaggregated insurance finance income included in profit or loss for groups of contracts for which changes in financial risk do not have a significant effect on amounts paid to policyholders	Rate at date of initial recognition of group
Disaggregated insurance finance income included in profit or loss for groups of contracts for which changes in financial risk assumptions have a significant effect on amounts paid to policyholders	Rate that allocates the remaining revised finance income or expense over the duration of the group at a constant rate or, for contracts that use a crediting rate, uses an allocation based on the amounts credited in the period and expected to be credited in future periods
Disaggregated insurance finance income included in profit or loss for groups of contracts applying the PAA	Rate at date of incurred claim

The discount rates should be determined as follows:

- To determine the discount rates at the date of initial recognition of a group of contracts, an entity may use weighted-average discount rates over the period that contracts in the group are issued, which cannot exceed one year. This can result in a change in the discount rates during the period of the contracts. When contracts are added to a group in a subsequent reporting period (because the period of the group spans two reporting periods) and discount rates are revised, an entity should apply the revised discount rates from the start of the reporting period in which the new contracts are added to the group. This means that there is no retrospective catch-up adjustment.

- For insurance contracts with direct participation features, the contractual service margin is adjusted based on changes in the fair value of underlying items, which includes the impact of discount rate changes.

10.0 RISK ADJUSTMENT FOR NON-FINANCIAL RISKS

The third element of measuring fulfilment cash flows in the general model is a risk adjustment for non-financial risk.

The risk adjustment for non-financial risk is the compensation that the entity requires for bearing the uncertainty about the amount and timing of cash flows that arise from non-financial risk. The risks covered by the risk adjustment for non-financial risk are insurance risk and other non-financial risks such as lapse risk and expense risk.

In theory, the risk adjustment for non-financial risk for insurance contracts measures the compensation that the entity would require to make it indifferent between:

- Fulfilling a liability that has a range of possible outcomes arising from non-financial risk
- Fulfilling a liability that will generate fixed cash flows with the same expected present value as the insurance contracts

The risk adjustment for non-financial risk reflects the entity's perception of the economic burden of its non-financial risks; it is not a current exit value or fair value, which reflects the transfer to a market participant. The risk adjustment for non-financial risk reflects:

- The degree of diversification benefits the entity includes when determining the compensation, it requires for bearing that risk
- Both favourable and unfavourable outcomes, in a way that reflects the entity's degree of risk aversion

MFRS 17 does not specify the estimation technique(s) used to determine the risk adjustment for non-financial risk. However, the risk adjustment for non-financial risk must have the following characteristics:

- Risks with low frequency and high severity generally will result in higher risk adjustments for non-financial risk than those with high frequency and low severity.
- For similar risks, contracts with a longer duration generally will result in higher risk adjustments for non-financial risk.
- Risks with a wider probability distribution generally will result in higher risk adjustments for non-financial risk than those with a narrower distribution.
- The less that is known about underlying assumptions used to determine the current estimate and its trend, the higher the risk adjustment for non-financial risk.

To the extent that emerging experience reduces uncertainty about the amount and timing of cash flows, risk adjustments for non-financial risk will decrease and vice versa. MFRS 17 does not specify the estimation technique(s) used to determine the risk adjustment for non-financial risk. Because the risk adjustment for non-financial risk is an entity-specific perception, rather than a market participant's perception, different entities may determine different risk adjustments for similar groups of insurance contracts. Accordingly, to enable users of financial statements to understand how entity-specific assessments of risk aversion might differ from entity to entity, the entity must disclose the confidence level used to determine the risk adjustment for non-financial risk or, if a technique other than confidence level is used, the entity must disclose the technique used and the confidence level corresponding to the technique.

11.0 CONTRACTUAL SERVICE MARGIN

The fourth element of the building blocks in the general model is the contractual service margin (CSM). This is a component of the asset or liability for the group of insurance contracts that represents the unearned profit the entity will recognise as it provides services in the future.

11.1 Initial recognition

An entity should measure the CSM on initial recognition of a group of insurance contracts at an amount that, unless the group of contracts is onerous, results in no income or expenses arising from:

- Initial recognition of an amount for the fulfilment cash flows
- Derecognition at the date of initial recognition of any asset or liability recognised for insurance
- acquisition cash flows
- Any cash flows arising from the contracts in the group at that date

Therefore, the CSM on initial recognition, assuming a contract is not onerous, is no more than the balancing number needed to avoid a Day-1 profit. The CSM cannot depict unearned losses. Instead, MFRS 17 requires an entity to recognise a loss in profit or loss for onerous groups of contracts.

The approach above on initial recognition applies to contracts with and without participation features, including investment contracts with discretionary participation features.

For groups of reinsurance contracts held, the calculation of the CSM at initial recognition is modified to take into account the fact such groups are usually assets rather than liabilities and that a margin payable to the reinsurer, rather than making profits, is an implicit part of the premium.

A CSM is not specifically identified for contracts subject to the PAA, although the same underlying principle of profit recognition (i.e., no Day-1 profit) applies.

For insurance contracts acquired in a business combination or transfer, the CSM at initial recognition is calculated as the difference between the consideration and the fulfilment cash flows.

11.2 Subsequent measurement

The CSM at the end of the reporting period represents the profit in the group of insurance contracts that have not yet been recognised in profit or loss because it relates to the future service to be provided under the contracts in the group.

For a group of insurance contracts without direct participation features, the carrying amount of the CSM of the group at the end of the reporting period equals the carrying amount at the beginning of the reporting period adjusted, as follows:

A. Interest accretion

For insurance contracts without direct participation features, interest is accreted on the carrying amount of the CSM at discount rates determined at the date of initial recognition ("locked-in discount rate") of a group of contracts applicable to nominal cash flows that do not vary based on the returns on any underlying items.

The locked-in discount rate applicable to a group of contracts can be the weighted average of the rates applicable at the date of initial recognition of contracts that can join a group over a 12-month period.

B. Adjust CSM for changes in fulfilment cash flows relating to future service

An entity adjusts the CSM for changes in fulfilment cash flows relating to future service, except to the extent that:

- Such increases in the fulfilment cash flows exceed the carrying amount of the CSM, giving rise to a loss
  Or
- Such decreases in the fulfilment cash flows are allocated to the loss component of the liability for remaining coverage.

For insurance contracts without direct participation features, changes in fulfilment cash flows relating to future service that adjust the CSM comprise:

- Experience adjustments arising from premiums received in the period that relate to future service (and related cash flows, such as insurance acquisition cash flows and premium-based taxes).
- Changes in estimates of the present value of the future cash flows in the liability for remaining coverage, except those relating to the time value of money and changes in financial risk (recognised in the statement of profit or loss and other comprehensive income rather than adjusting the CSM).
- Differences between any investment component expected to become payable in the period and the actual investment component that becomes payable in the period.
- Changes in the risk adjustment for non-financial risk that relate to future service.

Except for changes in the risk adjustment, adjustments to the CSM noted above are measured at discount rates that reflect the characteristics of the cash flows of the group of insurance contracts at initial recognition.

For participating contracts without direct participation features, this discount rate (i.e. the rate that reflects the characteristics of the cash-flows on initial recognition) will be made up of a mix of an asset-based discount rate (for asset-dependent cash flows) and a rate for cash flows that are not asset-dependant (calculated using either the "top-down" or "bottom-up" approaches). This rate will, therefore, be different from the rate used to accrete interest on the carrying amount of the CSM. Interest is accreted in the CSM using either the top-down or bottom-up approach locked in at inception.

An experience adjustment is a difference between:

- For premium receipts (and any related cash flows such as insurance acquisition cash flows and insurance premium taxes), the estimate at the beginning of the period of the amounts expected in the period and the actual cash flows in the period.
  Or
- For insurance service expenses (excluding insurance acquisition expenses) - the estimate at the beginning of the period of the amounts expected to be incurred in the period and the actual amounts incurred in the period.

Experience adjustments generally relate to current or past service and are recognised immediately in profit or loss. However, experience adjustments for premiums received (or due) for future coverage relate to future service and consequently adjust the CSM.

Investment components are amounts that an insurance contract requires the entity to repay to a policyholder even if an insured event does not occur. MFRS 17 requires any unexpected repayment of an investment component to adjust the CSM. The CSM also will be adjusted for changes in future estimates of cash flows which will include (but not separately identify) the reduction in future repayments of investment components.

Consequently, the net effect on the CSM of a delay or acceleration of repayment of an investment component is the effect of the change in timing of the repayment.

The terms of some insurance contracts without direct participation features give an entity discretion over the payments to policyholders. A change in the discretionary cash flows is regarded as relating to future service and, therefore, adjusts the CSM and will be reflected in profit or loss over time.

C. Currency exchange differences

The carrying amount of a group of insurance contracts that generate cash flows in a foreign currency, including the CSM, is treated as a monetary item when applying MFRS 121 *The Effects of Changes in Foreign Exchange Rates.*

Treating insurance contracts as monetary items means that groups of insurance contracts in a foreign currency are retranslated to the entity's functional currency using the exchange rate applying at each reporting date. Exchange differences arising on retranslation are accounted for in profit or loss and are accounted for under MFRS 121.

D. Release of the CSM in profit or loss

An amount of the CSM for a group of insurance contracts is recognised in profit or loss in each period to reflect the services provided under the group of insurance contracts in that period. The amount is determined by:

- Identifying the coverage units in the group.
- Allocating the CSM at the end of the period (before recognising any amounts in profit or loss to reflect the services provided in the period) equally to each coverage unit provided in the current period and expected to be provided in the future.
- Recognising in profit or loss the amount allocated to coverage units provided in the period.

The number of coverage units in a group is the quantity of coverage provided by the contracts in the group, determined by considering for each contract the quantity of the benefits provided under a contract and its expected coverage duration.

The CSM is recognised over the expected period of coverage for a group of contracts. The CSM remaining at the end of the reporting period is allocated to the services provided in the current period and the services expected to be provided in future periods based on coverage units.

MFRS 17 does not specify whether an entity should consider the time value of money in determining the allocation and, consequently, does not specify whether the allocation should reflect the timing of the expected provision of the coverage units. For example, an entity could place more weight on the current period of coverage compared with expected coverage in the future, by reflecting the time value. The Board concluded that it should be a matter of judgement.

E. Subsequent measurement of the CSM and interim reporting

The CSM is adjusted for changes in estimates of future fulfilment cash flows, whereas experience adjustments relating to current or past service are recognised in profit or loss instead of the CSM. One of the consequences is that the total liability and profit reported will be influenced by the frequency of reporting and the reporting date.

An entity that publishes interim financial statements would therefore ordinarily need to maintain separate carrying amounts for CSMs for purposes of interim and annual financial statements to meet the requirement in MFRS 134 Interim Financial Reporting that the frequency of an entity's reporting should not affect the measurement of its annual results.

MFRS 17 avoids a requirement to maintain separate CSMs for annual and interim reporting, by making an exception to the requirement of MFRS 134. It prohibits entities from changing the treatment of accounting estimates made in previous interim financial statements when applying MFRS 17 in subsequent interim financial statements or in the annual reporting period.

12.0 ONEROUS CONTRACTS

12.1 Initial recognition

An insurance contract is onerous at the date of initial recognition if the fulfilment cash flows allocated to the contract, including any previously recognised acquisition cash flows and any cash flows arising from the contract at the date of initial recognition in total are a net outflow.

An entity must group contracts that are onerous at initial recognition separately from contracts in the same portfolio that are not onerous at initial recognition. An entity must:

- Recognise a loss in profit or loss for the net outflow for the group of onerous contracts, resulting in the carrying amount of the liability for the group being equal to the fulfilment cash flows and the CSM of the group equaling zero.
- Establish a loss component of the liability for remaining coverage for an onerous group depicting the losses recognised.

A loss component is a notional record of the losses attributable to each group of onerous insurance contracts. The liability for the expected loss is included within the liability for remaining coverage for the onerous group (as it is within the fulfilment cash flows). It is necessary to keep a record of the loss component of the liability for remaining coverage to account for subsequent changes in the fulfilment cash flows of the liability for remaining coverage and to disclose separately their effect on the loss component. The loss component determines the amount presented in profit or loss as a reversal of losses on onerous groups and is excluded when determining insurance revenue.

12.2 Subsequent measurement

A group of insurance contracts to which an entity applies the general model becomes onerous (or more onerous) on subsequent measurement if unfavourable changes in the fulfilment cash flows allocated to the group arising from changes in estimates of future cash flows relating to future service exceed the carrying amount of the CSM.

After an entity has recognised a loss on an onerous group of insurance contracts, it should allocate subsequent changes in the liability for remaining coverage between the loss component and the liability for remaining coverage, excluding the loss component, on a systematic basis.

Changes in the liability for remaining coverage that are allocated on a systematic basis between the loss component and the remaining (non-loss) component are:

- Estimates of the present value of future cash flows for claims and expenses released from the liability for remaining coverage because of incurred insurance service expenses.
- Changes in risk adjustment for non-financial risk recognised in profit or loss because of the release from risk.
- Insurance finance income or expenses.

As required by MFRS 17, the systematic allocation of these changes to the liability for remaining coverage should result in the total amounts allocated to the loss being equal to zero for a group of contracts by the end of the coverage period.

Subsequent increases or decreases in fulfilment cash flows allocated to the group arising from changes in estimates of future cash flows for future service should be allocated solely to the loss component until that component is reduced to zero. The decreases in fulfilment cash flow for future service, in excess of amounts that reduce the loss component of the liability for remaining coverage to nil, re-establish a CSM.

13.0 PREMIUM ALLOCATION APPROACH (PAA)

A PAA is a simplified form of measuring insurance contracts in comparison with the general model. Use of the PAA is optional for each group of insurance contracts that meets the eligibility criteria.

Differences between the PAA and the general model include:

- Simplified measurement of the liability for remaining coverage for groups of insurance contracts that are not onerous. The overall liability measurement of the PAA and the general model would be the same for groups of contracts that are onerous.
- An option not to adjust future cash flows in the liability for incurred claims for the effect of the time value of money and financial risk if those cash flows are expected to be paid or received in one year or less from the date they are incurred.
- An option to recognise any insurance acquisition cash flows as expenses when these costs are incurred, provided that the coverage period of each contract in the group is no more than a year (rather than adjust the liability for remaining coverage).
- An entity need only assess whether a group of insurance contracts is onerous if facts and circumstances indicate that the group is onerous (the general model effectively requires an assessment of whether a group of contracts is onerous at each reporting date after the initial recognition of a group).

The accounting model for the PAA is broadly similar to the accounting model used under MFRS 4 by most non-life or short-duration insurers, sometimes referred to as “an earned premium approach”. There are some differences, for example, presentation in the balance sheet:

- No separate asset is recognised for deferred acquisition costs. Instead, deferred acquisition costs are subsumed into the insurance liability for remaining coverage.
- No separate presentation of a premium receivable asset in the balance sheet under MFRS 17 (implicitly included in the insurance liability for remaining coverage).
- Measurement of the liability for remaining coverage includes an explicit risk adjustment for non-financial risk when a group of contracts is onerous.
- Measurement of the liability for incurred claims includes an explicit risk adjustment for non-financial risk and is subject to discounting (an entity need not discount the liability for incurred claims if the settlement is expected within a year).

14.0 REINSURANCE CONTRACTS HELD

A reinsurance contract is an insurance contract issued by one entity (the reinsurer) to compensate another entity for claims arising from one or more insurance contracts issued by the other entity (underlying contracts).

MFRS 17 requires a reinsurance contract held to be accounted for separately from the underlying insurance contracts to which it relates. This is because an entity that holds a reinsurance contract (a cedant) does not normally have a right to reduce the amounts it owes to the underlying policyholder by amounts it expects to receive from the reinsurer.

A cedant measures reinsurance contracts it holds by applying a modified version of the general model or, if the contract is eligible, the PAA. The requirements of the general model are modified for reinsurance contracts held to reflect that:

- Groups of reinsurance contracts held are usually assets rather than liabilities.
- Entities holding reinsurance contracts generally pay a margin to the reinsurer as an implicit part of the premium rather than making profits from the reinsurance contracts.
- Mismatches can arise from accounting for reinsurance contracts held separately from the underlying insurance contracts. The general model has been adjusted to reduce some of those mismatches.

The overall result of the modifications of the general model for reinsurance contracts held are that:

- Both Day-1 gains and losses are initially recognised in the statement of financial position as a contractual service margin and recognised in profit or loss as the reinsurer renders services, except for any portion of a Day-1 loss that relates to events before initial recognition. This is quite different from the accounting for (re)insurance contracts issued, where all Day-1 losses are recognised in profit or loss immediately.
- Assumptions used for measurement should be consistent with those for measurement of the underlying insurance contracts issued.
- Non-performance risk of the reinsurer should be included in the measurement of the performance cash flows (non-performance risk is not included within the measurement of the underlying insurance contracts issued).
- The risk adjustment for non-financial risk reflects the amount of risk transferred from the insurer to the reinsurer.
- Changes in the fulfilment cash flows adjust the contractual service margin if they relate to future coverage and other future services. However, changes in fulfilment cash flows are recognised in profit or loss if the related changes arising on the underlying ceded contracts have been recognised in profit or loss. This would usually be the case when the underlying ceded contracts are onerous.

15.0 MEASUREMENT OF CONTRACTS WITH PARTICIPATION FEATURES

Entities that issue participating contracts (referred to in the standard as contracts with participation features) provide policyholders with a financial return on the premiums they pay by sharing the performance of underlying items with policyholders. Participating contracts can include cash flows with different characteristics, for example:

- Cash flows that do not vary with returns from underlying items, e.g. death benefits and financial guarantees.
- Cash flows that vary with returns from underlying items - either via a contractual link to the returns on underlying items or through an entity's right to exercise discretion in determining payments to policyholders.

The cash flows of some contracts can affect the cash flows to other contracts via a process sometimes referred to as "mutualisation".

MFRS 17 includes an adaptation to the general model to cater for some of these features. It distinguishes two types of contracts with participation features that are eligible for modifications to the general model:

i. insurance contracts with direct participation features; and
ii. investment contracts with discretionary participation features.

Insurance contracts with direct participation features apply a modified version of the general model called the variable fee approach. Insurance contracts without direct participation features must apply the general model without adaptation even though such contracts may have participation features. Participating contracts are not excluded from applying the PAA, but they may be unlikely to meet the eligibility criteria (as the coverage period may be significantly in excess of one year).

16.0 CONTRACT MODIFICATION AND DERECOGNITION

A contract that qualifies as an insurance contract remains so until all rights and obligations are extinguished (i.e. discharged, cancelled or expired) unless the contract is derecognised because of a contract modification. MFRS 4 contains no guidance on when or whether a modification of an insurance contract might cause derecognition of that contract.

17.0 ACQUISITION OF INSURANCE CONTRACTS

Insurance contracts may be acquired in a transfer (often referred to as a portfolio transfer) or in a business combination, as defined in MFRS 3 *Business Combinations*.

In summary, insurance contracts acquired in a transfer or a business combination are classified and measured in the same way as those issued by the entity at the date of the combination or transfer, except that the fulfilment cash flows are recognised at that date.

18.0 PRESENTATION

MFRS 17 specifies minimum amounts of information that need to be presented on the face of the statement of financial position and statement of financial performance. These are supplemented by disclosures to explain the amounts recognised on the face of the primary financial statements.

MFRS 17 requires separate presentation of amounts relating to insurance contracts issued and reinsurance contracts held in the primary statements. There is nothing to prevent an entity from providing further sub-analysis of the required line items (which may make the relationship of the reconciliations to the face of the statement of financial position more understandable).

Indeed, MFRS 101 *Presentation of Financial Statements* requires presentation of additional line items (including the disaggregation of line items specifically required), headings and subtotals on the face of the statements of financial position and financial performance when such presentation is relevant to an understanding of the entity's financial position or financial performance.

19.0 DISCLOSURE

The disclosure requirements in MFRS 17 aim to provide users of the financial statements with a basis to assess the effect that contracts within the scope of the standard have on an entity’s financial position, financial performance and cash flows.

The standard requires disclosure of qualitative and quantitative information on:

- Amounts recognised in its financial statements for contracts within the scope of MFRS 17.
- Significant judgements, and changes in those judgements, when applying MFRS 17.
- The nature and extent of risks arising from contracts within the scope of MFRS 17.

The standard does not specify the level of aggregation an entity should apply when making disclosures, although it gives the following examples of aggregation bases that might be appropriate for information disclosed about insurance contracts:

- Type of contract (e.g. major product lines).
- Geographical area (e.g. country or region) .
- The reportable segment as defined in MFRS 8 *Operating Segments*

20.0 EFFECTIVE DATE AND TRANSITION

An entity must apply MFRS 17 for annual reporting periods beginning on or after 1 January 2021. MFRS 17 supersedes MFRS 4. Early application of MFRS 17 is permitted if an entity also applies MFRS 9 and MFRS 15 on or before the date of initial application of MFRS 17.

For the purposes of the transition requirements in MFRS 17, the date of initial application is the beginning of the annual reporting period in which an entity first applies MFRS 17 (i.e. 1 January 2021 for an entity first applying the standard with an annual reporting period ending 31 December 2021). MFRS 17 also refers to the transition date as the beginning of the annual reporting period immediately preceding the date of initial application (i.e. 1 January 2020 for an entity first applying the standard with an annual reporting period ending 31 December 2021, which reports only one comparative period).

An entity should apply MFRS 17 retrospectively from the transition date unless impracticable and:

- Identify, recognise and measure each group of insurance contracts as if MFRS 17 had always applied.
- Derecognise any existing balances that would not exist had MFRS 17 always applied.
- Recognise any resulting net difference in equity.

This means the balances derecognised upon application of MFRS 17 would include balances recognised previously under MFRS 4, as well as items such as deferred acquisition costs, deferred origination costs (for investment contracts with discretionary participation features) and some intangible assets that relate solely to existing contracts. The requirement to recognise any net difference in equity means that no adjustment is made to the carrying amounts of goodwill from any previous business combination. However, the value of contracts within the scope of MFRS 17, that were acquired in prior period business combinations or transfers, would have to be adjusted by the acquiring entity from the date of acquisition (i.e. the initial recognition of the contracts) together with any intangible related to those in-force contracts.

Any intangible asset derecognised would include an intangible asset that represents the difference between the fair value of insurance contracts acquired in a business combination or transfer. It would also include a liability measured in accordance with an insurer's previous accounting practices for insurance contracts where an insurer previously chose the option in MFRS 4 to use an expanded presentation that split the fair value of acquired insurance contracts into two components.

Applying the standard retrospectively means that the comparative period (i.e. the annual reporting period immediately preceding the date of initial application) must be restated and comparative disclosures made in full in the first year of application. An entity may also present adjusted comparative information applying MFRS 17 for any earlier periods (i.e. earlier than the annual reporting period immediately preceding the date of initial application). If an entity does present adjusted comparative information for any prior periods, the reference to "the beginning of the annual reporting period immediately preceding the date of initial application" must be read as "the beginning of the earliest adjusted comparative period presented".

The measurement of fulfilment cash flows (risk-adjusted present value of expected cash flows) in MFRS 17 is prospective. Consequently, the measurement of fulfilment cash flows at the transition date for contracts recognised before that date is a relatively straightforward application of MFRS 17. However, measurement of the CSM, identification of the loss component of the liability for remaining coverage and accumulated other comprehensive income at the transition date (for the purposes of subsequent presentation of revenue and insurance finance income or expenses) depend on past events. These aspects of the measurement and subsequent presentation of contracts in force at the transition date require historical information and make retrospective application of MFRS 17 challenging, particularly for entities that have issued or purchased long-duration contracts for many years prior to the transition.

21.0 THE LATEST DEVELOPMENT - PROPOSED AMENDMENTS TO IFRS 17

The IASB issued IFRS 17 on 18 May 2017 which introduces consistent accounting requirements to address inadequacies in IFRS 4, that allows companies to use a wide range of different insurance accounting practices. IFRS 17, as originally issued, would replace the accounting requirements in IFRS 4 *Insurance Contracts* on 1 January 2021.

The IASB recognises that IFRS 17 introduces fundamental changes to existing insurance accounting practices and that implementing the new accounting requirements involves significant operational costs, including system development costs.

Consequently, since IFRS 17 was issued, the IASB has been carrying out activities to support and monitor companies' progress in implementing IFRS 17. These activities include establishing the Transition Resource Group for IFRS 17 to discuss implementation questions and meeting with companies affected by the changes introduced by IFRS 17, as well as with auditors, investors and regulators.

The activities have enabled insurers to better understand the new requirements and to prepare for the application of IFRS 17. They have also helped the IASB to understand the concerns and challenges that some companies have identified while implementing IFRS 17. The IASB considered the concerns and challenges raised and decided to propose targeted amendments to IFRS 17 to assist companies implementing IFRS 17, without unduly disrupting implementation or diminishing the usefulness of the improvements introduced by IFRS 17.

To maintain the usefulness of the improvements introduced by IFRS 17, the IASB decided that it would propose amendments to IFRS 17 only if these amendments would not change the fundamental principles of IFRS 17 because that would result in a significant loss of useful information for investors relative to that which would otherwise result from applying IFRS 17 as originally issued.

The IASB expects that the proposed targeted amendments will ease implementation of IFRS 17 by:

- reducing implementation costs for companies; and
- making it easier for companies to explain the results of applying IFRS 17 to investors and others.

The IASB proposes the following targeted amendments to IFRS 17:
1. Deferral of the effective date from 2021 to 2022
2. Additional scope exclusions
3. Allocation of acquisition costs to expected contract renewals
4. Attribution of profit to service relating to investment activities
5. Extension of the risk mitigation option
6. Reduced accounting mismatches for reinsurance
7. Simplified balance sheet presentation
8. Additional transition reliefs

SUMMARY

- The IASB issued IFRS 17, a comprehensive new accounting standard for insurance contracts in May 2017.
- IFRS 17 will become effective for annual reporting periods beginning on or after 1 January 2021, with early application permitted. The IASB is proposing to delay this date for another year to 1 January 2022.
- The IFRS 17 model combines a current balance sheet measurement of insurance contracts with recognition of profit over the period that services are provided.
- The general model in the standard requires insurance contract liabilities to be measured using probability-weighted current estimates of future cash flows, an adjustment for risk, and a contractual service margin representing the profit expected from fulfilling the contracts.
- Effects of changes in the estimates of future cash flows and the risk adjustment relating to future services are recognised over the period services are provided rather than immediately in profit or loss.
- The standard includes specific adaptations for the measurement and presentation of insurance contracts with participation features; and for reinsurance contracts held.
- The standard contains a simplified model, which can be used for contracts with coverage periods of one year or less, or when doing so approximates the general model.
- Entities have an option to present the effect of changes in discount rates in profit or loss or in other comprehensive income.

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GLOSSARY

A	
Adjusted growth method	*Zakat* computation based on owners' equity and long-term liabilities, deducted for property, plant and equipment and non-current assets, and adjusted for items that do not meet the conditions for *zakat* assets and liabilities as determined by the relevant *zakat* authorities.
Adjusted working capital method	*Zakat* computation based on net current assets, adjusted for items that do not meet the conditions for *zakat* assets and liabilities.
Amortised cost	The amount at which the financial asset or financial liability is measured at initial recognition minus principal repayments, plus or minus the cumulative amortisation using the effective interest method of any difference between that initial amount and the maturity amount and, for financial assets adjusted for any loss allowance.
Ar Rahnu	A contract where a party (the pledger or *rahin*) pledges an asset as collateral (the *Marhun*) to another party (the pledgee or *murtahin*) to fulfil an obligator's liability or obligation (*marhun bih*) owed to the pledgee in the event of default of such obligor.
Asset	A resource: (a) controlled by an entity as a result of past events; and (b) from which future economic benefits are expected to flow to the entity.
B	
Best estimate value	The statistical central estimate value of the liabilities concerned.
Bills and acceptance payable	Obligations of the bank due to transactions in banker cheques, remittance payable and money order postal order clearing settlement.
C	
Cash	Cash on hand and demand deposits.
Cash equivalents	Short-term, highly liquid investments that are readily convertible to known amounts of cash and which are subject to an insignificant risk of change in value.
Claims incurred but not enough reserved (IBNER)	An amount of claims that have been incurred and reported but the total amount of damages is more than initially provided.
Claims incurred but not reported (IBNR)	An estimation of claims that takaful operators could not have known but have possibly incurred and not reported.
Claims liabilities	Obligations of the takaful operator to pay participants as agreed in the takaful contracts.
Claims reported	Actual claims made by participants on the occurrence of agreed events.
Contribution liabilities	Estimates of the takaful operator's future obligations which correspond with the unexpired period of the takaful contracts at the reporting date.

D	
Deferred tax assets	The amounts of income taxes recoverable in future periods in respect of: (a) deductible temporary differences; (b) the carryforward of unused tax losses; and (c) the carryforward of unused tax credits.
Depreciation	The systematic allocation of the depreciable amount of an asset over its useful life.
Derecognition	The removal of a previously recognised financial asset or financial liability from an entity's statement of financial position.
E	
Earned contribution ceded to retakaful	Amount of contributions ceded to retakaful operators and the change in unearned contribution reserves.
Equity	The residual interest in the assets after deducting all liabilities.
Expense liabilities	Anticipated future costs to be incurred in managing takaful contracts that are payable from the shareholder's fund.
F	
Financial instruments	Any contract that gives rise to a financial asset to one entity and a financial liability or equity instrument to another entity
Fiqh Muamalat	A branch of Islamic jurisprudence that deals with commercial and business activities in an economy.
FVOCI	Fair value through other comprehensive income.
FVTPL	Fair value through profit or loss.
G	
Gharar	Uncertainty or nature and consequences are hidden.
Goodwill	An asset representing the future economic benefits arising from other assets acquired in a business combination that are not individually identified and separately recognised.
Gross contribution	Contributions on the original gross rate charged to clients in respect of takaful business without any deduction for any commission or brokerage.
Gross earned contribution	Amount of gross contribution and the change in unearned contribution reserves.
I	
Ijarah	A contract over a desirable, known, permissible, and accessible usufruct for a known period in exchange for compensation.
Impairment	An asset is impaired when its carrying amount exceeds its recoverable amount.
Intangible assets	Identifiable non-monetary assets without physical substance.
Investment property	A property (land or a building—or part of a building—or both) that is held (by the owner of the property or by the lessee of the property under a finance lease) to earn rentals or for capital appreciation or both
Islamic Fund Management	Fund management that complies with *Shariah* requirements.
Islamic Fund Manager	A Capital Market Services License ("CMSL") holder, whose sole purpose is to carry on Islamic fund management business.

Istisna'	A contract to sell a non-existent asset that is to be constructed, built or manufactured according to the agreed specifications and delivered on a specified future date at a pre-determined price.
IUTA	Institutional Unit Trust Adviser is an institution, a corporation or an organisation that is licensed by SC or a registered person, for the regulated activity of dealing in securities, and registered with Federation of Malaysian Unit Trust Managers ("FMUTM").
L	
Liability	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.
M	
Maysir	Gambling or games of chance.
Measurement	The process of determining the monetary amounts at which the elements of the financial statements are to be recognised and carried in the balance sheet [statement of comprehensive income].
MFRS	Malaysian Financial Reporting Standards.
Mudarabah	A contract between a capital provider (*rabbul mal*) and an entrepreneur (*mudarib*) and any profit generated is shared between the *rabbul mal* and the *mudarib* according to a mutually agreed profit-sharing ratio (PSR) whilst financial losses are borne by the *rabbul mal.*
Mudarib	The entrepreneurial partner in a *mudarabah* arrangement who provides the expertise and management.
***Murabahah* to the Purchase Orderer (MPO)**	An arrangement whereby the purchase orderer (purchaser) promises to purchase an identified and specified asset from a seller on *Murabahah* terms upon the latter's acquisition of the asset.
Murabahah	A sale and purchase of an asset where the acquisition cost and the mark-up are disclosed to the purchaser.
Musyarakah	A partnership between two or more parties, where all contracting parties contribute capital to the *Musyarakah* venture and profits are shared according to the agreed profit-sharing ratio and losses are shared according to the capital contribution.
N	
NAV	The value of all the fund's assets less the value of all the fund's liabilities at the valuation point.
Net earned contribution	The gross earned contribution minus earned contribution ceded to retakaful.
Non-current liability	A liability that does not meet the definition of a current liability.
Nostro accounts	A bank account held by the bank with a foreign bank, usually in the currency of that country.
O	
Ordinary share	An equity instrument that is subordinate to all other classes of equity instruments.

P	
Paid-up share capital	Money contributed by the shareholders in the company as an investment in businesses.
Participants' funds	Accumulated surplus from underwriting operations and from investment activities.
Participants' investment fund (PIF)	A portion of the contributions allocated for the purpose of savings and/or investment.
Participants' risk fund (PRF)	The pool of contributions paid by participants on the basis of *tabarru'*.
Performance fee	Surplus distribution from the participant's fund to the shareholder.
Preferred partnership fee	This is in relation to banca takaful arrangement between the takaful operator and a third-party Islamic bank whereby the former pays an upfront fee to the latter as part of a preferred partnership agreement.
Property, plant and equipment	Tangible items that: (a) are held for use in the production or supply of goods or services, for rental to others, or for administrative purposes; and (b) are expected to be used during more than one period.
Prospectus	A notice, circular, advertisement or document inviting applications or offers to subscribe for or purchase securities or offering any securities for subscription or purchase.
Provision of risk margin for adverse deviation (PRAD)	A component of the value of liabilities that relates to the uncertainty inherent in the best estimate.
Q	
***Qard* receivables**	The takaful operator rectify any deficit in the participants' risk fund by providing an equal amount as *qard* (i.e. interest-free loan) from the shareholders' fund.
Qard	A contract where the borrower is to pay the full amount to the lender.
R	
Rabbul Mal	Capital provider in *Mudarabah* arrangement.
Recognition	Process of capturing for inclusion in the statement of financial position or the statement(s) of financial performance an item that meets the definition of one of the elements of financial statements—an asset, a liability, equity, income or expenses.
Restricted investment accounts (RIA)	An investment account where the investment account holder provides a specific investment mandate to the Islamic financial institution such as purpose, asset class, economic sector and period for investment.
Retained earnings	Accumulated net profit of the company that is retained by the company at a particular period.
Retakaful assets	Balances receivable and recoverable by the takaful operator from the retakaful operators.
Retakaful commission income	Fee paid by the retakaful operator to the ceding company (i.e. takaful operator) in obtaining retakaful business from the takaful operator.
Riba	Usury or unjust, exploitative gains made in trade or business.

S	
***Shariah* advisor**	A person or a company approved and registered by the SC as a *Shariah* advisor.
Shariah Advisory Council (SAC)	The Shariah Advisory Council established by the SC under section 18 of the Securities Commission Act 1993.
Sukuk	Certificate of equal value which evidence undivided ownership or investment in the assets using Shariah principles and concepts endorsed by SAC.
T	
Tabarru'	Donation or gifts.
Takaful certificate	A contract specifying all the terms and conditions of takaful cover and issued upon completion of the underwriting process.
Takaful claim	A demand for payment of an amount due under a takaful certificate.
Takaful contribution	Amount payable by a takaful participant to a takaful operator under a takaful certificate.
Takaful receivable	Contributions receivable from the agents and brokers that they collected as an intermediary between the takaful operator (which itself is an agent of takaful funds) and participants.
Takaful	An arrangement based on mutual assistance under which takaful participants agree to contribute to a common fund providing for mutual financial benefits payable to the takaful participants or their beneficiaries on the occurrence of pre-agreed events.
Tawarruq	A contract where the bank will purchase the from a broker, on behalf of the customer. The customer will, subsequently, sell the commodity to the bank on deferred payment (including profit margin). Once the ownership of the commodity has been transferred, the bank will then sell the commodity on a spot basis for cash through another broker.
U	
Unearned contribution	The portion of contribution that relates to the unexpired period of the takaful contract.
Unrestricted investment accounts (URIA)	An investment account where the investment account holder provides the Islamic financial institution with the mandate to make the ultimate investment decision without specifying any particular restrictions or conditions.
W	
Wa'd	A unilateral promise of commitment given by one party to another to perform certain action(s) in the future.
***Wakalah* fees**	Fees charged by the shareholder's fund to manage takaful certificate issued by the general and family takaful funds under the principle of *wakalah* .
Wakalah	A contract where a principle authorizes an agent to perform a particular task on matters that may be delegated, with or without the imposition of a fee.
Z	
Zakatable assets	Assets that are subject to *zakat* .

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