


# **SIDAT HYDER**



## **Takaful Accounting**

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## **1. Introduction and Some Basic Principles**

- 1.1 The subject assigned to me is essentially Accounting and Auditing relating to Takaful. Prior to actually addressing the subject itself I wish to define the scope of this paper, i.e., what is to be covered and what is not.
- 1.2 Accounting is essentially the recording and presentation of economic transactions relating to defined business operations, usually a legal entity. It does not seek to deal with the legality, in Shariah or otherwise, of the business conducted and the transactions undertaken by the entity, but simply to record and report on these.
- 1.3 Takaful (meaning literally mutual cooperation) is a word which it has become synonymous with Islamic Insurance. A number of Takaful models are in use in different parts of the world, some of which are, in my view, not compliant with the essence of the Shariah but based simply on artificial transactions created in order to achieve results as close to conventional insurance as possible. It is not within the scope of this paper to seek to comment on these. Instead I have included these models within the scope of dealing with issues relating to Accounting. I am also not dealing with a description of the various models as these are likely to be covered by other speakers.
- 1.4 The nature of Takaful operations, in terms of detailed accounting, is largely similar to that of conventional insurance operations. Both receive premiums/contributions, investment income, pay claims, maintain reserves, have assets and liabilities, etc. Differences exist in certain limited areas, the basic ones being as follows:
  - The method used to remunerate the takaful operator. In conventional insurance the insurer bears the risk, the underwriting profit or loss therefore being a substantial portion of the total profit, the other portion being investment income. In takaful operations there is strictly no profit or loss to be made from underwriting, although in some models this is allowed. This has a bearing in terms of reserving as well as in the treatment of underwriting surpluses or deficits.
  - The nature of mitigating risks (retakaful vs reinsurance).
  - The nature of investments, which, by their very nature, excludes fixed income investments.
- 1.5 Given similarities with conventional insurance with respect to most economic transactions, it stands to reason that accounting methods for these transactions should be similar. It is therefore, in my view, not necessary to define all-encompassing accounting standards for takaful operators separately (as has been done by the AAOIFI), but instead to deal with issues where the nature of takaful operations is different from conventional insurance. This would enable efforts to be more focused and would help the takaful “industry” to benefit from innovations in accounting in conventional insurance. An accounting

standard for insurance accounting is one of the subjects being focused on by IFAC currently, with an exposure draft (ED5) having recently been circulated for comment. The AAOIFI standards would almost certainly need major modification once IFAC produces an International Accounting Standard for Insurance contracts.

- 1.6 One other area which is likely to affect accounting for takaful operators is that of regulation. In some cases (like in most countries in the Middle East, Africa and parts of South Asia), regulation of insurance is weak and does not always deal with accounting, providing at best broad formats for producing financial statements. In other jurisdictions, including Pakistan in the post Insurance Ordinance 2000 environment, both the Ordinance and subsequent subsidiary regulations provide detailed guidance on issues such as the maintenance of separate statutory funds (in the case of life insurers) as well as a framework for accounting. Although this paper deals with takaful accounting in generic terms, it does focus on the Pakistani regulatory environment.
- 1.7 The rest of this paper deals with the following issues which I consider to be the major differences between conventional insurance and takaful:
  - a) Underwriting surplus or deficit to be borne by the participants (policyholders) in the case of Takaful.
  - b) Similarly, retakaful to be done strictly on a risk pooling basis and not on a risk cession basis.
  - c) Investments to be either in equity or in other Shariah compliant savings instruments. Fixed income not allowed.
- 1.8 Each of the above topics is dealt with in turn below with respect to accounting issues which arise as a result of these differences from conventional insurance.

## 2. Underwriting Surplus/Deficit

- 2.1 The distribution of underwriting surplus or deficit either partially or wholly to policyholders is something which has been in vogue in conventional insurance for some time, especially in the case of health insurance (where even pure Administrative Services contracts are common) and life insurance (where large “profit commission” payments are common in some countries).
- 2.2 Takaful is operated through two models:
- a) **Al Mudharaba Model**, whereby cooperative risk-sharing occurs among Participants yet the Takaful Operator shares also in any operating surplus as a reward for its careful underwriting on behalf of Participants. Examples of this Model include Takaful Malaysia (STM - Malaysia), Takaful Nasional (Malaysia) and Takaful International (Bahrain).
  - b) **Al Wakala Model**, whereby cooperative risk-sharing occurs among participants with a Takaful Operator earns a fee for services {as a Wakeel or Agent} and does not participate or a share in any underwriting results as these belong to Participants as Surplus or Deficit, under the Al Wakala Model, the operator may also charge a funds management fee and a performance incentive fee (as Bank Aljazira does).
- 2.3 A graphical depiction of both models are set out in Annexes 1 and 2.
- 2.4 Although the three models involve certain major differences in approach, the accounting issues which arise are common. These include the following:
- a) Segregation of assets, liabilities, income and expenditure between the Takaful Operator, the various Mudharibahs and (if separately maintained) the various takaful funds (risk-pools) [these various “funds” being referred to hereafter as “Accounting Entities]
  - b) Setting aside reserves for meeting outstanding claims, future claims (from accepted risks) and contingencies in the process of ascertaining surplus/deficit.
  - c) Definition of bases for recognition of revenue and expenditure (cash vs accrual), this having an impact on determination of surplus/deficit.
  - d) Accounting for Qard-e-Hasana

### *Segregation of Assets, Liabilities, Income and Expenditure*

- 2.5 The essential need for implementation of the takaful models is segregation of income and expenditure, as this would be needed to:
- Determine the surplus or deficit which would impact the distribution to participants; or, where a Mudharibah model prescribes sharing by the takaful operator in the surplus/deficit, determination of the amount payable to the operator.
  - Determine the solvency position of the takaful fund and, therefore, the possible determination of a need for qard-e-hasana or a repayment thereof.

- 2.6 The accounting model can provide for segregation of income and expenditure without necessarily segregating assets and liabilities, this system being in vogue in most cost accounting systems. Direct transactions (contributions, claims, payment of medical fees, etc.) can be debited or credited to the concerned Accounting Entity, whereas others (such as investment income, bank charges, etc.) may be apportioned on some equitable basis.
- 2.7 It is my considered opinion, however, that, in order to be totally equitable, approximations should be kept to a minimum, and, as far as is possible, all income and expenditure should be allocated as close to reality as possible. For this purpose the segregation of assets and liabilities becomes a requirement, as this would allow the separation of actual liquid funds (which would be invested and would yield income).
- 2.8 Interestingly the Insurance Ordinance 2000 of the Government of Pakistan introduced a concept of statutory funds for life insurers, there also being a requirement for total separation of assets, liabilities, income and expenditure between each statutory fund and the shareholders' fund (S17 of the Ordinance). The Ordinance also contains strict provisions to ensure that allocation of any common expenses between statutory funds is equitably carried out. The framework contained in the Ordinance is, in my view, highly suitable for implementation for Family Takaful products. As an aside, I would suggest, that the Ordinance provides a framework for allowing life insurers to set up "Takaful windows", as the accounting safeguards required to ensure the equitable determination of surplus is already built into the system.
- 2.9 Interestingly, a framework for segregation of even income and expenditure (even if not assets and liabilities) for various major classes of business (or even between underwriting operations and other operations) does not exist on the non-life side. Such a framework should, in my opinion, be defined when defining regulations under which non-life Takaful operations could be conducted, so as to ensure equity in surplus determination.
- 2.10 Ideally, therefore, when assets and liabilities are also segregated, there is effectively a need for maintaining separate self-balancing trial balances for each Accounting Entity, with inter-entity accounts being maintained. Again, for the sake of equity, any inter-entity balances needs to be kept to a minimum and frequently settled (preferably not longer than monthly).

### ***Reserving***

- 2.11 Reserves required to be set up by takaful operators (within the takaful funds), consist of the following:
- a) Unearned revenue reserves, generally relating to risk premiums (tabarru) received for periods which extend beyond the financial reporting date.
  - b) Estimated amounts to be paid out relating to claims already incurred before the reporting date, including those which have been reported as well as those which have not been reported.

- c) Deficiency reserves, where there is an expectation (based on statistical experience) that contributions charged are not adequate to cover expected claims.
  - d) Contingency reserves set aside for possible adverse variations in claims in the future, i.e., to smooth the emergence of surpluses and deficits.
- 2.12 Reserving is, by its very nature, a process of estimation. Estimation has certain drawbacks. Two professionals, for example, may, with the purest of intentions, end up with different determination of reserves on exactly the same portfolio, simply due to different assumptions or different reserving methods. It may not also be wise to necessarily prescribe standard assumptions or methods, as different ones may be suitable for different portfolios.
- 2.13 In a perfect system, surpluses and deficits should be measured in actual terms. This is actually done in the case of some reinsurance pools, whereby separate accounts are run for various years and the resulting underwriting surpluses or deficits shared by those who participate in those pools. Whereas this may be practicable for reinsurance pools, these may not be practical for takaful pools catering to consumers, who would not wish to wait for years for final determination of the claims position of a pool.
- 2.14 Reserving based on estimates is, therefore, a necessary compromise which has to be made for the sake of pragmatism. Of the elements set out in 2.11 above, the first three are clearly reserves which need to be set aside in the determination of surplus. The fourth, however, may be viewed not as a provision to be accounted for in the determination of surplus but as an appropriation of surplus. This needs to be discussed further.
- 2.15 An essential feature of all takaful models is the sharing of underwriting surpluses/ deficits by participants. Accurate determination of the surplus/deficit is, therefore, fundamental to the accounting process. The setting aside of a reserve for contingencies, however, raises the questions as to who this reserve belongs to. This is relevant as the impact of the reserve in the initial years of takaful operations is likely to be substantially greater than in subsequent years. This will effectively result in participants in earlier years paying for stabilization of underwriting results for participants in later years.
- 2.16 Despite the possible inequity in a pure sense, the building up of contingency reserves is desirable in order to enable stability in underwriting results and make it practical to expand the size of the risk pool (as there will be limits to what amounts the takaful operator will be able to provide as qard-e-hasana in case of deficits). This balancing of the rights of current participants and the stabilization of underwriting results is similar to the balancing of rights of different generation of with profits policyholders that has faced conventional insurance companies for many decades.

- 2.17 It is recommended that contingency reserves set aside are disclosed separately from other reserves. Given alternative treatments possible, however, it is only possible to treat this as a reserve within the takaful fund in which it has been set up. It has, therefore, to be treated as a long term liability in much the same way as other reserves.

#### ***Basis for Recognition of Revenue and Expenditure***

- 2.18 Many takaful organizations recommend the recognition of revenues on a cash basis, on the premise that surpluses determined for distribution should be based on “actual” and not “accrued” revenue. The standard produced by the AAOIFI does not, however, apparently agree with this point of view, as the format for the balance sheet prescribed in it included contributions receivable (i.e., accrued revenue).
- 2.19 I share the AAOIFI’s view. The issue of cash vs accrual is one which is generic to all entities required to produce accounts. What is important with respect to the accounting treatment of any transaction is that the treatment reflects what is equitable between different generation of participants. If, for example, an ordinary share in which the mudhariba fund has invested has gone ex-dividend, it would seem to me that it is equitable to treat the dividend as receivable for accounting purposes, whether or not it has been received or not.
- 2.20 I am therefore strongly of the view that normal accrual concepts should be followed in accounting for takaful.

#### ***Accounting for Qard-e-Hasana***

- 2.21 Qard-e-Hasana, in a Takaful concept, is a loan made to the takaful fund in order to cover a deficit in that fund after exhausting any contingency reserves. While discussing the accounting treatment of amounts so transferred, both in the period of transfer as well as amounts due, at the balance sheet date, from the takaful fund to the takaful operator, one can draw a parallel with capital contributions from the shareholders’ fund to a statutory fund which is envisaged under the Insurance Ordinance 2000.
- 2.22 It is, in my view, not appropriate to treat the amount outstanding as a liability of the takaful fund and an asset of the takaful operator. From a point of view of determining the extent to which the qard is receivable by the takaful operator, it is clear that this is contingent upon future surpluses arising in the takaful fund. In accordance with the prudence concept, therefore, this should not be recognized as an asset. As a corollary, therefore, the qard should not be recognized as a liability in the takaful fund.

- 2.23 There are two possible ways of treating the qard from an accounting perspective:
- a) As a revenue transfer from the takaful operator to the takaful fund, any repayment then being treated as a revenue transfer the other way.
  - b) As an appropriation of profits in the P&L Account of the takaful operator, and a capital transfer in the accounts of the takaful fund.
- 2.24 I would recommend the treatment set out in 2.23 (b) above.
- 2.25 For regulatory purposes it is clear that the capital available should be reduced by the amount of any qard-e-hasana outstanding, as effectively either treatment would reduce shareholders' equity.

### **3. Accounting for Re-Takaful**

- 3.1 Accounting for re-takaful should, in theory, be similar to accounting for re-insurance. There is, however, a significant difference, in that re-takaful, if undertaken in a purely Shariah compliant sense, is essentially a risk pooling mechanism and, therefore, the takaful operator has to share in any surplus or deficit arising in the pool, thereby necessitating the recognition of such surplus or deficit in preparing the accounts of the takaful fund.
- 3.2 In practice, currently, the vast majority of takaful funds reinsure in a conventional way under dispensations granted under the doctrine of necessity, on the basis that adequate capacity is not available with re-takaful operators. Even where risks are ceded under conventional reinsurance contracts, however, there are often profit commission terms whereby a proportion of any surplus which arises is paid back to the ceding entity.
- 3.3 Interestingly I have seen a re-takaful treaty issued by one prominent re-takaful entity which, for all intents and purposes, was exactly the same as that issued by conventional reinsurers. Such treaties would, in my view, need to be treated as conventional treaties for the purpose of accounting.
- 3.4 Where re-takaful is undertaken in a pure sense, it is clear that the takaful fund must take into account any surplus or deficit in the re-takaful pool needs to be taken into account in preparing its financial statements. Where the re-takaful operator has extended a qard-e-hasana to the re-takaful pool, it is my view that such a qard needs to be reserved for separately by all ceding takaful funds, as this is effectively going to be recouped from future surpluses. The only event in which a reserve to reflect the qard-e-hasana need not be created is if the takaful fund withdraws from that re-takaful pool for future years.
- 3.5 Where conventional reinsurance is undertaken, any vested profit commission must certainly be accounted for fully. There are two views on the treatment of any unvested “accrued” profit commission, one stating that it should be recognized and the other that it should not be (until it vests). My own preference is for the former, as this is more equitable. In any case any accrued profit commission may be used as an asset when determining any contingent reserve to be set up.

#### **4. Accounting for Investments**

- 4.1 Accounting for investments in takaful could generally follow the same principles in other Islamic financial institutions. I am not, therefore, undertaking any detailed discussion on recognition of income from Shariah compliant financial instruments, but limiting myself to two issues:
- a) The recognition of dividends declared on equity investments.
  - b) The recognition of unrealized capital gains
- 4.2 In my view the underlying principle for any accounting, especially where this affects the actual value paid out, must be equity. Confusion is often caused because recommendations on accounting principles is made at the level of a continuing entity. In my experience a useful way to look at any issue relating to which period any revenue or expenditure should fall, is to hypothesize a single participant takaful entity, with the single participant exiting at a point in time to be replaced by another single participant entering at that very point in time.
- 4.3 If the above exercise is carried out it is clear that the following will emerge as the proper treatment of investment income while preparing takaful fund or mudhariba fund accounts:
- a) All dividends from ordinary shares which have gone ex-dividend before the balance sheet date should be recognized as accrued investment income.
  - b) Investments should be marked to market for the purpose of computing capital gains, so that even unrealized gains are recognized.
- 4.4 It goes without saying, however, that tax which will eventually be due needs to be separately provided for.

**5. Conclusion**

- 5.1 As indicated in the opening paragraphs, takaful accounting is only a recording and presentation of transactions emanating from the basic takaful business model. Much work is yet being done on the model itself, and therefore, as a consequence, much work still needs to be done on accounting concepts.
- 5.2 Experience has also taught us that, whatever the theoretical concepts be, when these are actually implemented in practice new issues arise which need to be dealt with. Takaful accounting is yet to benefit from a period of such experience, and will, no doubt, need to develop further.

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