Takaful accounting under AAOIFI FAS 42 and FAS 43

For the joint session of:

- The Institute of Chartered Accountants of Pakistan
- The Insurance Association of Pakistan

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AAOIFI
هيئة المحاسبة والمراجعة للمؤسسات المالية الإسلامية
ACCOUNTING AND AUDITING ORGANIZATION FOR ISLAMIC FINANCIAL INSTITUTIONS

بسم الله الرحمن الرحيم

Presentation agenda / main areas of discussion

1. Preamble
2. About AAOIFI
3. Takaful – an introduction
4. FAS 42 and FAS 43 – an overview
5. Core differences between FASs and IFRS 17

01

Preamble

Islam is a complete Deen / way of life

Islam, in contrast to the interpretation about other major religions on earth, is a complete Deen.

Deen, for that purpose, means a complete way of life, rather than only a combination of beliefs and rituals.

Islam provides its own economic, social and political systems.

Islamic economic system, inter alia, provides principles of taxes, government spending, trade and commerce and commercial dealings.

Accounting teachings derived from the Holy Quran

	References from the Holy Quran	Accounting teachings derived from the revelation
1	*“O you who believe, when you transact a debt payable at a specified time, put it in writing, and let a scribe write it between you with fairness. A scribe should not refuse to write as Allah has educated him. He, therefore, should write. The one who owes something should get it written, but he must fear Allah, his Lord, and he should not omit anything from it.”* [2:282]	- Proper documentation and record-keeping is essential for maintaining financial transparency and accountability - All financial transactions must be recorded accurately and transparently, and those responsible must be held accountable for their actions
2	*“…and do not curtail (decrease) the measure and the weight..”* [11:84] *“Give full measure, and do not be among those who bring loss to others. Weigh with an even balance, and do not make people short of their things…”* [26:181-183] *“Woe to the curtailers who, when they measure something to receive from people, take it in full, and when they measure or weigh something to give it to them, give less than due.”* [83:01-03]	- Emphasises the importance of proper recognition, measurement, and reporting of assets, liabilities, equity, revenue and expense, to stakeholders - Highlights the importance of honesty and integrity in accounting and the need to prevent fraud and deception in financial reporting

Accounting teachings derived from the Holy Quran (contd.)

	References from the Holy Quran	Accounting teachings derived from the revelation
3	*"Do not eat up each other's property by false means…"* [2:188 and 04:29] *"…do not eat up their (orphans) property along with your own…"* [04:02]	- Warns against fraudulent business / accounting practises - Emphasises requirement for accurate and truthful financial reporting
4	*"…Allah commands you to deliver trusts to those entitled to them…"* [04:58]	- Emphasises the need to refer to the experts and to adhere to accounting standards established by the experts and relevant ethical principles to ensure the accuracy and transparency of financial matters.
5	*"…So, ask the people (having the knowledge) of the Zikr (reminder / guidance), if you do not know."* [16:43]	- Highlights the importance of professional judgment and expertise in accounting

These differences and underlying principles of Islamic finance necessitates dedicated and specialised standards

Prohibition of Riba	Prohibition of Gharar	Prohibition of Maysir / Qimar	Equitable distribution of risk-reward	Time value of economic resources / no time value of money	Integration of moral and ethical values
No predetermined return on loans	Avoidance of excessive unnecessary risks	Prohibition of all forms gambling	Capital alone has no right of earning	Money cannot be traded for profit against time / rented	No financing of unethical goods: alcohol, porn, harmful goods etc.
No debt rescheduling and credit rollover	Prohibition of exploiting ignorance (Jahl)	Prohibition of speculative transactions	No concept of risk-free rate of return	Mostly asset backed transactions	Social responsibility and social finance to be integrated
No additional charges for late payment	No short-selling / forwards and futures			Time value of assets / goods, services and entrepreneur-ship	Ethical values to be integrated
No sale of debts and receivables					

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Standardisation secures integrity of Islamic finance

Standardisation is important to secure the integrity of Islamic finance where integrity is characterised by the following:

1.	2.	3.	4.	5.
industry moving in one direction towards realisation of Maqasid Al Shari’ah;	industry not compromising on the minimum level of Shari’ah-compliance in all areas of operations;	industry adopting the best practices;	industry enjoying the trust and confidence of its stakeholders; and	industry is stable, sustainable and competitive.

Standardisation benefits all Islamic finance stakeholders

Standardisation and harmonisation of best practices in Islamic finance

Leads to

Higher levels of trust because of higher:

- Comparability
- Transparency
- Reliability
- Understandability
- Accountability
- Timeliness

Islamic finance stakeholders

Benefits to economy
- Attracts foreign investment
- Better resource allocation
- Increased wealth
- Improved intl. reputation
- Attracts foreign talent
- Attracts foreign technology

Benefits to regulator
- No need to reinvent the wheel and develop the standards from scratch
- Secure adequate capacity in the market
- Increased focus on supervision
- Internal capacity shortage does not become a challenge

Benefits to investor
- Better forecasting
- Better decision-making

Benefits to IFIs
- Better governance
- Lower cost of capital
- Reduced costs
- Higher productivity
- Higher legal security
- Higher adaptability
- Interoperability of products
- Better HR availability
- Uniformity of processes
- Appropriate risk management

Need for Islamic finance accounting: quick arguments

Yes

- To deal the specific information needs
- What is the real true and fair view
- Transaction trail – and compliance
- Risk profile of the transactions, balances
- Profit and loss and balances determination in line with Shari'ah
- Reputation risk

No

- In dealings – all is permissible, unless specifically impermissible
- Accounting is neutral
- Accounting is secular
- Accounting is post facto so no impact

How AAOIFI accounting principles are derived from Shari'ah principles and rules: few examples

Timing of recognition of revenue	True sale as per Shari'ah
	Sale is recorded when risks and rewards transfer (usually in the shape of ownership and possession)
	Recognition of revenue only on transfer of control (including risks and rewards)
Possession by agent	Possession includes physical or constructive possession
	Possession by the agent does not create sale or profit for the principal
Combination of contracts	Combining two transactions in one is prohibited
	Two contracts, or a contract with a promise must remain independent and executed separately
	Accounting recognition and measurement for both contracts shall be separate
Discounting prohibition	Debt cannot be sold against cash or receivables
	In some situations, it may be transferred at par value
	Monetary receivable or payable must not be discounted; they are to be accounted for at par value
Quasi-equity	Quasi-equity holders are partners and have proportionate ownership in residual underlying assets
	A guarantee relating to principal or return on the investment is not permissible
	These accounts are not considered liability and treated separately

What goes wrong when proper accounting is not done?

- Rights and responsibilities of the stakeholders in line with the Shari'ah principles and rules are not established
- Profit and loss distribution between the relevant parties is not carried out in a Shari'ah-compliant manner
- Improper recognition of revenue results in illegitimate profits
- Incorrect timing of revenue recognition results in improper recognition and derecognition of assets
- Transaction trail as per Shari'ah principles and rules is lost and hence Shari'ah-compliance becomes weak and Shari'ah audit difficult
- Financial statements will not show true and fair presentation of the financial position and performance of the institution
- Risk profiles of respective assets, liabilities, equity and quasi-equity are not reflected properly

Can accounting disclosures be sufficient?

- Fundamental accounting rule is that disclosures cannot remedy a wrong / inappropriate accounting treatment

Are mere disclosures to demonstrate compliance with Shari’ah are sufficient, irrespective of accounting treatments?

Yes?

No?

02

About AAOIFI

About AAOIFI: the standard-setting organisation of the global Islamic finance industry

Legal status

- AAOIFI stands for 'Accounting and Auditing Organization for Islamic Financial Institutions'
- AAOIFI is a not-for-profit organisation
- Founding members include: IsDB, Al Rajhi Bank, KFH, Albaraka, Albukhary Foundation and Al-Faisal Group

History and organisational structure

- Set up in 1991 by key industry stakeholders
- **166 active institutional members in 37 countries**
- Organisational structure: General Assembly, BOT, PIMCC, Technical Boards, and Secretariat

Primary objectives

Standards-setting

- **117 standards and technical pronouncements in issue – 5 areas**
- Standards issued
  - Shari'ah [59]
  - Accounting [36]
  - Auditing [08]
  - Governance [15]
  - Ethics [01]
- 3 Technical Board
  - Shari'ah Board
  - Accounting Board
  - Governance & Ethics Board

Geographical footprint*

- Adopted or adapted or used as guidance in more than 40 jurisdictions
- Standards available in multiple language

Secondary objectives

Other services

- Capacity building
- Advocacy and awareness
- Technical bulletin – JOIFA
- Advisory and assurance services

Note:
AAOIFI also has AAOIFI Education Board to oversee the capacity building activities
AAOIFI also set up the Public Interest Monitoring Consultative Committee (PIMCC)

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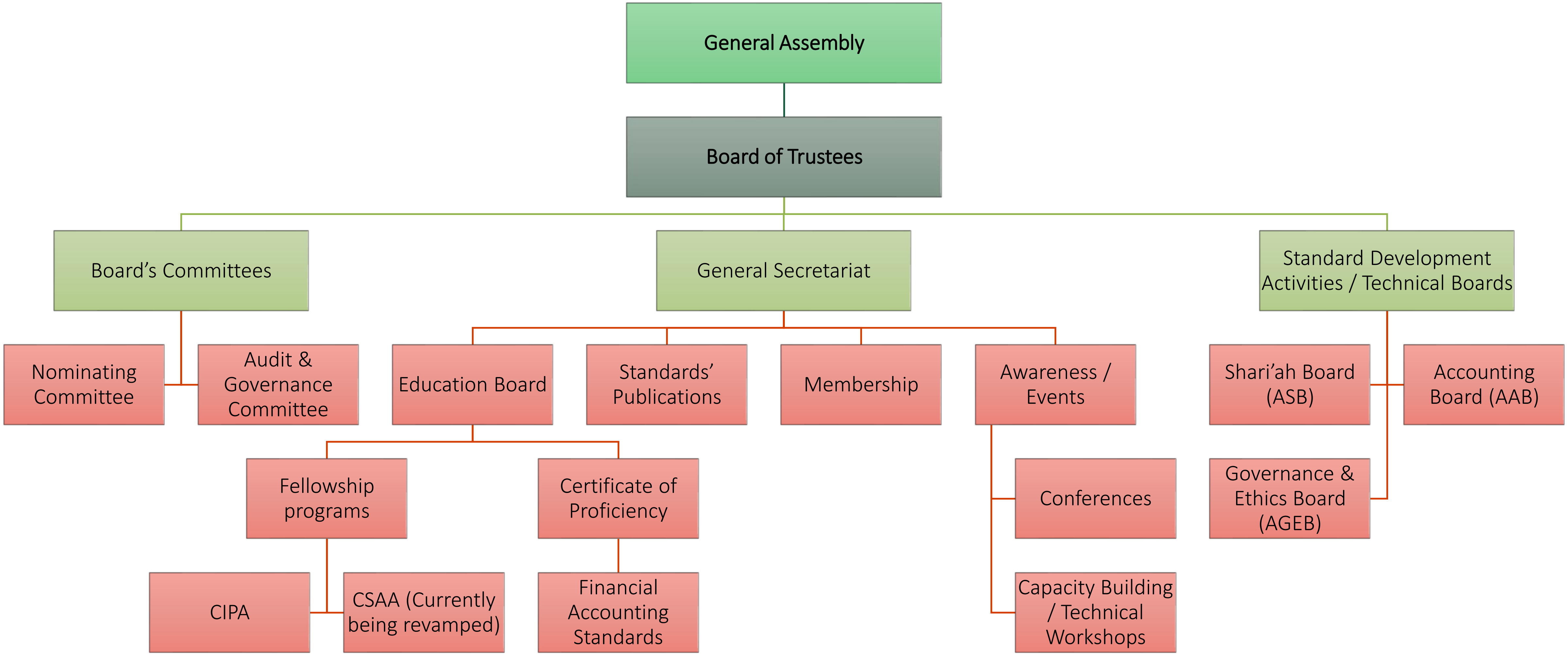
as of March 2023

AAOIFI's organisational structure and independence of technical boards



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AAOIFI offers an integrated solution to global Islamic finance industry

Shari’ah

[Providing core Shari’ah principles and rules applicable to IF transactions]

Accounting

[Ensuring that the products and services are executed, recorded and presented in the right manner and reflect the right characteristics]

Governance

[Systems to ensure that Shariah principles and rules are implemented]

Ethics

[Ensuring that the spirit of Shari’ah in terms of values and behaviour is applied, in addition to the legal rules]

Auditing

[Ensuring that the Shari'ah principles and rules, as well as, their implementation, recording and reporting is appropriate]

Geographical footprint of AAOIFI

Levels of AAOIFI standards adoption	No. of regulatory jurisdictions			No. of countries		
Levels of adoption	**Shari'ah**	**FAS***	**Governance**	**Shari'ah**	**FAS***	**Governance**
Adoption of AAOIFI standards as part of law	1	-	-	1	-	-
Full adoption	17	23	13	13	16	12
Partial adoption	8	11	10	6	9	9
Guidance / reference material	10	5	9	15	10	14
Local standards based on AAOIFI standards	4	5	3	4	5	3
Guidance & local standards based on AAOIFI standards	1	3	5	1	2	4
Supplementary reporting	-	3	-	-	3	-
Total	**41**	**47**	**41**	**38**	**36**	**41**

*FAS – Financial Accounting Standards

Note: Some countries and regulatory jurisdictions may have varied levels of adoption at the same time, hence the total number may have certain overlapping. This has been reduced and hence the total number may not add up.

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03

Takaful – an introduction

The business model

A Takaful institution consists of:

- Takaful operator (management)
- Participants' Takaful fund
- Participants' investment fund

Takaful operator

The Takaful operator

Has a principal-agent relationship with the PTF for underwriting operations			Has a Mudaraba / investment agency contract with PTF for investment management	Has a Mudaraba / investment agency contract with PIF for investment management
Manages the operations under a Wakala (agency) contract	Receives Wakala fee from PTF against managing the underwriting operations	Funds the PTF in the event of a deficit through Qard Hasan	Receives Wakala fee (fixed / variables / with incentive) or Mudarib's share from PTF against investment management	Receives Wakala fee (fixed / variables / with incentive) or Mudarib's share from PIF

Participants’ Takaful fund (PTF)

The participants’ Takaful fund (PTF)

- Has a principal-agent relationship with the Takaful operator
- Is a virtual entity (as per Shari’ah, is a legal entity / Waqf in Pakistan)
- Attributes entire surplus or deficit to participants of PTF
- Pays Wakala fee to the Takaful operator against management of underwriting operations
- Receives Qard Hasan from the Takaful operator and records it a liability
- Pays Wakala fee (fixed / variable / with incentive) to the Takaful operator against investment management

The participants’ investment fund (PIF):

- Maintains the investment component of the arrangement – in case of Family Takaful products with investment feature
- Is a virtual entity
- Maintains separate accounting records
- Has a Wakala (fixed / variable / with incentive) or Mudaraba contract with the Takaful operator

Fundamental differences between Takaful and conventional insurance

Takaful	Conventional insurance
• Risk-sharing	• Risk-transfer
• PTF is the insurer / under-writer	• Insurance company is the insurer / under-writer
• Takaful operator is the manager of under-writing business	• No such (manager's) role
• Surplus is attributable to participants only	• Profits are for the shareholders of the insurance company
• Deficit is attributable to the fund and temporarily to be funded by the operator through Qard Hasan	• Losses are for the shareholders of the insurance company

Is Takaful really different from conventional insurance?

Arguments for YES

- If it is not different, then why it exist?
- Can only change of documentation justifies Shari'ah compliance?
- Fundamentally risk sharing is different from risk transfer

Arguments for NO

- In the nutshell, it is the same…
- Qard and other regulatory requirements make it the same

04

FAS 42 and FAS 43 – an overview

4a

Summary of accounting treatments under FAS 42 and FAS 43

Takaful structure

Management under fiduciary capacity as agent

Takaful Institution

Wakala Arrangement

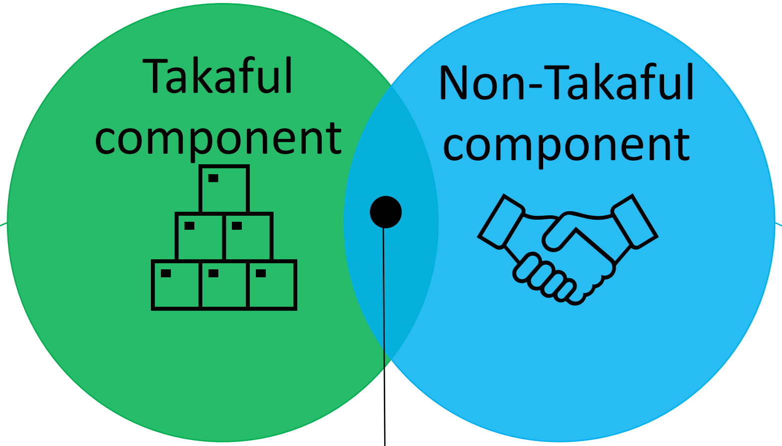
Fixed or variable (but not based on surplus) Wakala arrangement

Participants' Takaful Fund (PTF) (virtual entity) Standard shall be applicable on PTF

Participants' Investment Fund (PIF) (virtual entity)

Takaful arrangement

Recognised in books of PTF



A promise to provide a good or a service, recognised under the relevant FASs

Takaful arrangement segregated (unbundled) into

Wakala fee

Probable refund of Wakala fee against cancelled or discontinued Takaful arrangements. (if the contract is between Takaful institution & PTF)

The estimated effect **to be recorded as a provision for Wakala fee refund** and net change in provision to be shown as a deduction from the total Wakala fee.

Services initially or already delivered

The related proportion of Wakala fee to be **recognised immediately** including the marketing services, initial administration services and Takaful acquisition service costs such as commissions and incentives.

Services delivered over time

The related proportion of Wakala fee to be **recognised over such time in a systematic manner**. This includes support services during the Takaful entitlement period such as accounting and book-keeping services, administrative services related to benefits ascertainment and payment and administrative services related to re-Takaful acquisition and benefits management.

Level of aggregation

Takaful arrangements that are managed together may be segregated into distinct portfolios – based on similar risks

Determination of whether they are onerous or have no significant possibility of subsequently becoming onerous is based on reasonable and supportable information.

Takaful portfolio of arrangement should be divided into (at the minimum of)

- Arrangements that are onerous at initial recognition
- Arrangements that have no significant possibility of subsequently turning into onerous
- The remaining arrangements in the portfolio

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Income and expenses against provision for carrying amount of liability for incurred claims

Expenses representing the increase in liability because of claims and expenses incurred in the period; and

Expenses representing subsequent changes in Takaful fulfilment cash flows relating to incurred claims and expenses

Measurement at initial recognition

The **provision for a Takaful arrangement** shall be **measured** at the **total** of the following estimates:

Takaful fulfilment cash flows

- **Future cash flows related to Wakala fee – at fair value**
- **Deferred cost** being the difference between total future cash flows (including Wakala fee and other future cash flows) and the fair value of future cash flows (which includes adjustment related to the financial risks.
- **Other future cash flows – at fair value**
- **Risk adjustment for the non-financial risks**

+

Takaful residual margin

Estimate of fair value of cash flows

The estimate of the fair value of the future cash flows shall be adjusted to reflect the sustainability margin for the PTF (uncertainty about amount and timing of the cash flows arising from non-financial risk).

✔ Mudarib's share or Wakala fee (including incentives) for investment management for PTF's investments (excluding PIF's investments) shall be considered a part of Takaful fulfilment cash flows

✘ Surplus distribution and waiver of Qard Hasan shall not be part of the fulfilment cash flows.

Takaful residual margin

What is it?

Is a component of the provision (or net cost - re-Takaful) representing the unearned surplus (or deficit) that will be recognised over the period of the participant's entitlement for benefits under the Takaful arrangement

The Takaful residual margin shall be measured as

The amount of Takaful fulfilment cash flows (including all its components) that was initially recognised

−

Any cash flows arising from the Takaful arrangement at that date

=

Onerous arrangement

- **It is an onerous** at the date of initial recognition if the Takaful fulfilment cash flows, any previously recognised Takaful acquisition cash flows and any cash flows arising from the Takaful arrangement at the date of initial recognition in total are a net outflow.

- **A loss in statement of financial activities** of the managed PTF for the net outflow for onerous arrangements **shall be recognised**, resulting in the carrying amount of the provision being equal to the Takaful fulfilment cash flows and the Takaful residual margin being zero

Subsequent measurement

The carrying amount of the provision for a Takaful arrangement at the end of each reporting period shall be the sum of:

Provision for remaining entitlement period

+

Liability for incurred claims

=

A. the Takaful fulfilment cash flows related to future benefits allocated to the Takaful arrangement at that date; and
B. the Takaful residual margin of the Takaful arrangement at that date

Comprising of Takaful fulfilment cash flows related to the past benefits allocated to the Takaful arrangement at that date

Income and expenses against provision for remaining entitlement period

Revenue representing the reduction in the provision for remaining entitlement period because of benefits provided during the period;

Expenses representing losses (and any reversal of losses) on onerous arrangements.

Amortization of deferred cost (including any experience adjustment and financial risk elements).

Amortization of the Takaful residual margin over the period, and any adjustment thereon.

Simplified approach – contribution allocation

On **initial recognition**, the provision for the remaining entitlement period is measured under contribution allocation approach as follows

Contribution	−	Any takaful acquisition cashflow at the date	−	Wakala fee	− +	Derecognition amount asset/liability
if any, received (or receivable) at initial recognition		Takaful acquisition cash flows at that date, unless these are recognized as expense applying paragraph 60(a)		Amount paid to takaful institution to act as an agent to manage the participants' fund		The amount arising from the derecognition at the date of the asset or liability recognised for Takaful acquisition cash flows

Initial seed money paid to PTF

Recognition criteria

In the Takaful Institution books

Recognised as **expense**, at the earlier of:

A. payment of seed money to the PTF; and

B. making an irrevocable commitment for such payment.

In the PTF books

Recognised as **receivables** (until payment received) from the Takaful institution as PTF equity at the same time as provided.

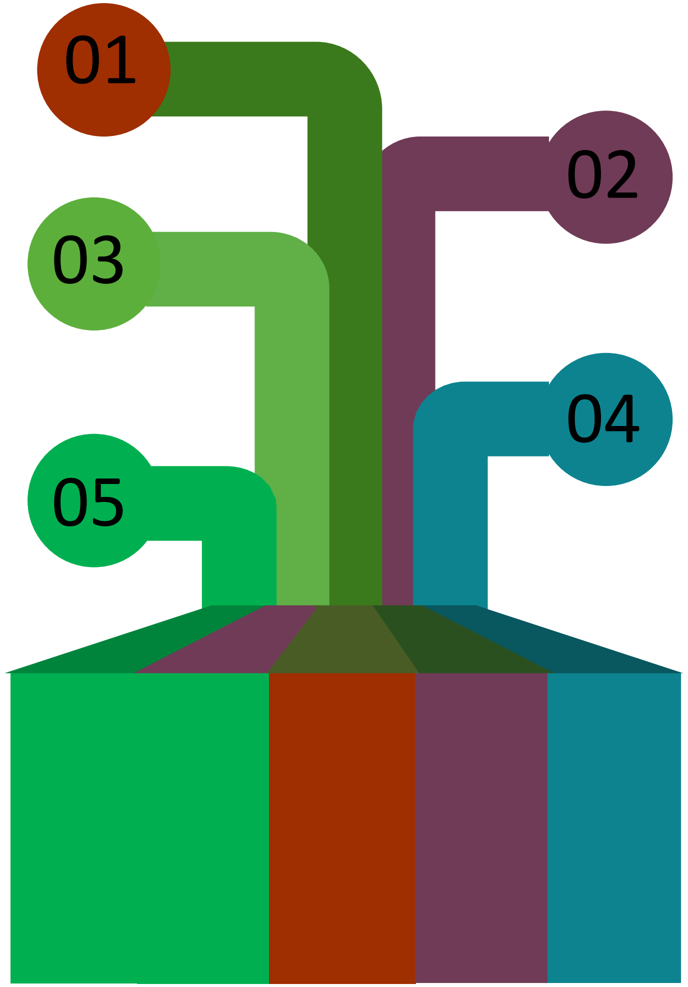
Takaful surplus / deficit

It is determined as the net surplus or deficit (after transfers from / to the technical reserves

In case of Deficit
The Takaful institution generally provides a Qard Hasan

Disclosures
The accumulated amounts of deficit and its projections shall be disclosed (at least for 5 years) with regard to the probable surplus in future periods to compensate for such deficits

Qard Hasan (in the books of PTF)



The **Takaful institution may** decide to give a **Qard Hasan** to the **PTF**

This Qard Hasan has the nature of a temporary, **interest-free loan** that shall be payable when the PTF accrues a surplus or generates sufficient liquidity.

The PTF shall **recognise** the Qard Hasan received from the Takaful institution **as a liability, at the par value of the amount received.**

The PTF shall **subsequently measure the liability** for Qard Hasan **at par value**, accounting for any payments / repayments / adjustments during the period.

Where the Takaful institution **waives off** its right to receive the Qard Hasan from the PTF, according to regulatory requirements or otherwise, the PTF **shall immediately derecognise the liability and record the amount as its income for the period.**

Transitional provisions

Transitional provisions

A Takaful institution, at the time of first-time adoption of this standard, shall follow one of the following approaches:

Full retrospective approach

Option 01

whereby the effects of transition shall be incorporated from the beginning of the earliest period presented in the financial statements.

Modified retrospective approach

Option 02

whereby the effects of transition shall be taken to the retained earnings of the Takaful institution, as well as, accumulated surplus / deficit in the respective Takaful funds at the beginning of the current financial period; or

Fair value approach

Option 03

whereby the Takaful residual margin or loss component of the provision for remaining entitlement period, at the transition date (beginning of the current period) shall be determined as the difference between the fair value of the Takaful arrangements at that date and the fair value of the fulfilment cash flows measured at that date, and the corresponding effects shall be adjusted in the retained earnings of the Takaful institution, as well as, accumulated surplus / deficit in the respective Takaful funds.

4b

Key definitions

Key definitions

- Benefit – is the payment to a participant against a claim for a loss for events that have happened, net of any balance available to the participant's credit in the PIF against such claim;
- Contribution – is the gross amount that a participant undertakes to pay in respect of a Takaful (or a re-Takaful) arrangement issued by a PTF;
- Entitlement for benefits – is the participants' right to receive benefits against a claim of loss for events that have not happened;
- Entitlement period – is the period during which the PTF provides entitlement for benefits to the participants. This period includes the entitlements for benefits that relate to all contributions and investment components, where applicable, within the boundary of the Takaful arrangement;

Key definitions

- Fair value of future cash flows – in the specific context of this standard, of an asset or provision (not being an established debt), is the estimated value equivalent to the fair value of an otherwise permissible exchange of an asset or liability, having similar cash flows, with a knowledgeable willing party on an arm's length basis [Explanation: For avoidance of doubt, it is clarified that the estimate of such value may take into account the considerations applied in similar transactions, including discounting of cash flows to arrive at the fair value acceptable to such counterparty];
- Financial risk – in the specific context of this standard, is the risk affecting the fair value of future cash flows arising through a possible future change in one or more of a specified benchmark rate, investments / assets price, commodity price, currency exchange rate, index of prices or rates, credit rating or credit index or other variables, provided that any non-financial variable amongst such factors is not specific to a party to the Takaful arrangement;

Key definitions

- Liability for incurred claims for benefits – is the obligation to investigate and pay valid claims for benefits, net of PIF balances available against such claims, against events that have already occurred and other incurred Takaful costs;
- Onerous arrangement – is a Takaful arrangement where the unavoidable costs of meeting the obligations under the Takaful arrangement exceed the economic benefits expected to be received under the Takaful arrangement;
- Participants' (also referred to as policyholders') investment fund (PIF) – is the fund managed by the Takaful institution on behalf of participants, collectively, with the objective of making investments and earning returns thereon, based on Mudaraba or Al-Wakala Bi Al-Istithmar (investment agency);
- Participants' (also referred to as policyholders') Takaful fund (PTF) – is the fund created by (or on behalf of) the participants with the objective to share risk and whose management has been undertaken by the Takaful institution. The fund is entitled to the contributions and returns (if any), subject to direct expenses, provisions and reserves related to the Takaful operations and the surplus (or deficit) arising thereon;

Key definitions

- Provision for remaining entitlement period – is the obligation to investigate and pay valid claims for benefits under existing Takaful arrangements for events that have not yet occurred (i.e., the obligation that relates to the unexpired portion of the entitlement period);
- Qard [also referred to as Qard Hasan] – is an interest-free loan intended to allow the borrower to use the loaned funds, with or without prescribing a period of time, with the understanding that the same amount of the loaned funds (in the original nature of funds e.g., same currency) would be repaid when due or when demanded (in case the period is not prescribed) [Explanation: In the specific context of this standard, it refers to the interest-free loan extended by the Takaful operator to the PTF to temporarily finance the funding deficit in the PTF];
- Reinsurance – is a “conventional” contract according to which an insurance company cedes (transfers) part of the risks of its insurance commitments to a reinsurance company. The insurance company, therefore, undertakes to pay to the reinsurance company part of the insurance premium paid by the policyholders, against the commitment of the reinsurance company to bear part of the claims as per an agreement between the two parties;

Key definitions

- Re-Takaful – refers to the arrangement among Takaful institutions, on behalf of their respective PTFs under management, to devise a mechanism for the avoidance of part of the risks which the PTFs may encounter. On the basis of such arrangement, a re-Takaful PTF, which has a distinct juristic personality and independent financial liability, is formed through making contributions out of the PTFs as a part of the contributions paid by their respective participants on the basis of Tabarru. The re-Takaful PTF, thus formed, assumes the task of covering part of the risks encountered by the PTFs [Explanation: Re-Takaful is the Shari'ah compliant alternative to the conventional reinsurance, having the distinctive characteristic of being based on the same principles of Takaful and mutuality as indicated in SS 26 "Islamic Insurance" and SS 41 "Islamic Reinsurance", instead of exchange of reinsurance premiums. The need for re-Takaful may arise in respect of a Takaful institution due to lack of sufficient capacity to take risks or because of regulatory requirements of risk sharing with regard to the magnitude of the risk in question.] [Note: For the purpose of this standard, the term re-Takaful, wherever the context suggests may include "conventional" reinsurance in line with the prevailing practices of the Takaful institution in case of dire need (subject to Shari'ah principles and rules) with adequate disclosures in respect of the same];

Key definitions

- Risk adjustment for non-financial risk – is the allowance the PTF needs to maintain for bearing the uncertainty about the amount and timing of the cash flows that arise from non-financial risk as the PTF fulfils Takaful arrangements [Explanation: Such cash flows may include, where applicable, the element of non-financial risk that may arise against the risk reserves in the PTF];
- Takaful – is a process of agreement among a group of persons (commonly referred to as participants) to handle the losses resulting from specific risks to which all of them are vulnerable. A process, thus initiated, involves payment of contributions as donations, and leads to the establishment of a Takaful fund that enjoys the status of a legal entity (from Shari'ah perspective) and has independent financial liability. The resources of this fund are used to indemnify any participant who encounters injury, subject to a specific set of rules and a given process of documentation. The fund is managed by either a select group of participants, or a joint stock company that manages the Takaful operations and invests the assets of the fund, for an agreed fee;

Key definitions

- Takaful acquisition cash flows – arise from the costs borne by the PTF directly attributable to acquisition of a Takaful arrangement [Explanation: These may include costs initially borne by the PTF e.g., surveyor's costs, initial medical costs, documentation / legal charges, tracker or other security devices costs, etc. but does not include (i) Wakala fee, or (ii) commission (in case it is borne by the Takaful institution against Wakala fee, in line with relevant Shari'ah principles and rules, as well as, contractual and regulatory requirements), or (iii) directly related taxes (as these do not constitute part of contributions and are to be recorded directly as a liability)];
- Takaful acquisition service costs – are the costs borne by the Takaful operator directly attributable to first time acquisition of a Takaful arrangement which are not part of Takaful acquisition cash flows (see paragraph 4(r)) [Explanation: These may include costs such as commissions, documentation charges (which are not recovered from the participant), etc.,];

Key definitions

- Takaful arrangement – is a combination of non-commutative (non-exchange, non-remunerative), investment and / or service contract(s) entered into mutually by the participants of a PTF of a Takaful institution in order to provide mutual Takaful entitlement for benefits and ancillary services (some of which may rest with the Takaful institution as the service provider);
- Takaful fulfilment cash flows – is an explicit, unbiased and probability-weighted estimate (i.e., an expected value) of the fair value of the future cash outflows minus the fair value of the future cash inflows that will arise as the PTF fulfils Takaful arrangements, including a risk adjustment for non-financial risk [Explanation: Wakala fee to be paid by the PTF to the Takaful institution is part of the future cash outflows for such purpose and hence is included in the Takaful fulfilment cash flows];

Key definitions

- Takaful institution – is an entity possessing a license of practicing Takaful (at times also referred to as Islamic insurance) business in line with the requirements of Shari'ah principles and rules. The institution undertakes its operation based on a remunerated Wakala (agency) contract. In addition to managing the Takaful operations, the institution also assumes the responsibility of investing the assets of the fund through Mudaraba or investment agency [Explanation: For the purpose of this standard, a Takaful institution includes a Takaful window operation . The notion "Takaful institution", unless the context suggests otherwise, includes the Takaful operator and the participants' funds];
- Takaful operator – in the specific context of this standard, represents the function of the Takaful institution whereby it manages the PTF and the PIF, and from an accounting perspective, represents the residual part of the Takaful institution duly owned by and representing the equity, rights and obligations of the shareholders (or the principal owners) of the Takaful institution, excluding the PTF and PIF.

Key definitions

- Takaful residual margin – is the component of the carrying amount of the asset or liability for Takaful arrangements (or a group of Takaful arrangements) representing the unearned surplus or, at times, unrecognised net cost (applicable in case of re-Takaful arrangement held only), the PTF shall recognise as it provides benefits under the Takaful arrangements. [Explanation: The Takaful residual margin in a risk sharing Takaful business is, from an accounting perspective, quite similar to contractual service margin under the conventional risk transfer-based insurance business];
- Wakala (agency) – is the act of one party delegating the other to act on its behalf in what can be a subject matter of delegation. Its basic elements comprise the form, the subject matter of agency, and the two parties to the contract (the principal and the agent); and
- Wakala fee (agent's remuneration) – consists of the fixed fee and variable remuneration, including performance incentives (if applicable).

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Presentation of financial statements under FAS 42

Complete set of financial statements

- Statement of financial position of the Takaful institution as at the end of the financial reporting period
- Statement of income and other comprehensive income of the Takaful institution for the financial reporting period
- Statement of changes in owners' equity of the Takaful institution for the financial reporting period
- Statement of cash flows of the Takaful institution for the financial reporting period
- Statement of financial position of managed PTF, separately for the general and family Takaful operations, as at the end of the financial reporting period
- Statement of financial activities of the managed PTF, separately for the general and family Takaful operations, for the financial reporting period
- Statement of managed PIF for the financial reporting period
- Notes, comprising significant accounting policies and other explanations

Statement of financial position of the Takaful institution

Assets

- Cash and balances with Islamic banks and other financial institutions
- Deposits with regulators
- Receivables from the managed PTF and managed PIF
- Qard Hasan receivable from the managed PTF, net of allowance for impairment thereon, if any
- Accounts receivable (including co-Takaful)
- Investment in associates and joint ventures
- Investment in real estate
- Investment in sukuk
- Investment in shares and other securities
- Property, plant and equipment with disclosure of significant types and related accumulated depreciation
- Right-of-use assets
- Intangible assets
- Income tax (distinguishing between current and deferred) asset
- Other assets with disclosure of significant types

Statement of financial position of the Takaful institution

Liabilities

- Due to the managed PTF and managed PIF
- Due to financial institutions
- Due to other counterparties
- Sukuk – liability type
- Gross ijarah liability, deferred Ijarah costs and net Ijarah liability
- Provisions, accruals and other liabilities, including;
  - declared but undistributed profits;
  - Zakah obligation, distinguishing between legal and voluntary;
  - income taxes payable, distinguishing between current and deferred; and
  - other payables

Statement of financial position of the Takaful institution

Quasi-equity

- Sukuk
- Financings based on Musharaka / Mudaraba
- Investment accounts (or similar balances) [if applicable, meeting the definition of quasi-equity]

Owners' equity

- Subscribed and paid-up capital
- Premium on issued shares
- Capital reserve, legal reserve and discretionary reserve
- Retained earnings, duly identifying the amount of retained earnings resulting from the revaluation / fair value adjustment of assets and liabilities
- Number of treasury shares held by the Takaful institution
- Any other component of owners' equity

Statement of income and other comprehensive income of the Takaful institution

- Wakala fee and share of profits from the managed PTF and the managed PIF respectively, disclosing the manner in which the Wakala fee and the share of profits is recognised
- Income and gain from participatory investments and investments in shares and other securities
- Income and gain from investments carried at fair value through statement of income
- Income from off-balance-sheet assets under management other than the PTF and the PIF
- Income from associates
- Other fee, commission and related expenses
- Other income
- General and administrative expenses, distinguishing between material expenses as separate line items
- Net income (loss) before Zakah and taxes
- Income taxes, both current and deferred, disclosed separately
- Zakah
- Net income (loss)
- Other comprehensive income

Statement of changes in owners' equity of the Takaful institution

- Capital contribution by the owners
- Net comprehensive income or loss, or alternatively net income or loss and net other comprehensive income or loss, as applicable
- Internal changes in components of equity e.g., issue of bonus shares or internal transfers between reserves and / or retained earnings
- Distribution (dividends) to owners
- Zakah paid (or recorded as payable) on behalf of the owners

Statement of cash flows of the Takaful institution

- The Takaful institution shall disclose the net increase or decrease in cash and cash equivalents during the period and the relevant balance of cash and cash equivalents at the beginning and end of the financial reporting period.
- The Takaful institution's policy with respect to the components of cash and cash equivalents used as a basis for the preparation of the statement of cash flows shall be disclosed.
- Appropriate disclosures shall be provided as a footnote the statement of cash flows, or in the notes to the financial statements, about significant cash flows pertaining to PTF and PIF.

Statement of financial position of the managed PTF

- The statement of financial position of managed PTF shall include the PTF's assets, PTFs' liabilities, and the PTF's net assets
- Participants' assets shall not be set-off against participants' liabilities and participants' liabilities shall not be set-off against participants' assets, unless there is a specific requirement of a relevant FAS or a requirement of Shari'ah principles and rules or a legally enforceable right for the set-off
- Significant items of participants' assets, participants' liabilities and participants' fund shall not be combined on the face of the statement
- The amount of any allowance established to cover expected losses or amount of impairment shall be disclosed
- Assets and liabilities shall be combined into groups, for better understanding, in accordance with their nature and shall be presented in the order of the relative liquidity of each group
- Sub-totals for participants' assets, participants' liabilities and participants' fund shall be disclosed

Statement of financial position of the managed PTF

Assets

- Cash and balances with Islamic banks and other financial institutions
- Deposits with regulators, if any
- Receivables from the Takaful operator, specifying the nature of the same
- Contributions receivable, net of allowance for impairment thereon
- Re-Takaful arrangements asset
- Other accounts receivable
- Investments in real estate
- Investment in Sukuk, shares and other similar instruments
- Income tax asset (proportion related to the PTF), distinguishing between current and deferred, if any
- Other assets, with disclosure of significant types

Statement of financial position of the managed PTF

Liabilities

- Provision for Takaful arrangements (distinguishing between, and adequately disclosing provision for remaining entitlement for benefits and liability for incurred claims for benefits)
- Re-Takaful arrangements liability
- Due to the Takaful operator
- Qard Hasan payable to the Takaful operator, and the significant terms and conditions including the expected period(s) of payment
- Due to financial institutions
- Due to other counterparties
- Provisions, accruals and other liabilities, including:
  - declared but undistributed surplus;
  - income taxes payable (proportion related to the PTF), distinguishing between current and deferred; and
  - other payables

Statement of financial activities of the managed PTF

- Recognised Takaful contributions (separately disclosing gross contributions received or receivable)
- Recognised Takaful costs (disclosing Wakala fee, benefits paid or payable and other costs etc.)
- Re-Takaful net result (gain or loss) (disclosing contributions, benefits and commission etc.)
- Takaful gross margin
- Income from investments, differentiating between:
  - Income from sukuk
  - Income from placements with Islamic banks and other financial institutions
  - Investments in shares and other securities
  - Fair value gains and losses on investments
- Impairment expense (distinguishing between investments and contributions receivable)
- Amortisation of deferred cost (related to provision of Takaful arrangements)

Statement of financial activities of the managed PTF

- Amortisation of deferred profit (related to re-Takaful arrangements held)
- Provisions for outstanding court cases and ancillary matters
- Other income
- Qard Hasan from the Takaful operator – written-off during the period by the operator, considered Hiba, hence recorded as income of the PTF
- Other expenses
- Income taxes (if any), both current and deferred, disclosed separately
- Net surplus or deficit

Statement of managed PIF

- The statement shall segregate:
  - managed assets by source
  - investment portfolios by type
- The statement shall generally include:
  - the balance of managed assets at the beginning of the period with separate disclosure of the portion of the balance resulting from the revaluation of managed assets, where applicable;
  - the number of investment units in each of the investment portfolios and the value per unit at the beginning of the period, if applicable;
  - additional investments or purchase of investment units by the participants during the period, classified by type;
  - withdrawals of investment or repurchase of investment units by the participants during the period, distinguishing between policy cancellation, maturity and payment of benefits;
  - the operator's share in investment profits as a Mudarib or its fee as an investment agent;

Statement of managed PIF

- The statement shall generally include (contd…):
  - direct expenses related to operations of the PIF e.g., acquisition costs for investment (if not considered element of the cost of investment), bank and legal charges and third-party management costs;
  - allocated overhead expenses, if any, from the Takaful operator to managed investment accounts or portfolios in line with Shari'ah principles and rules;
  - consolidated surplus or losses for managed assets during the period with separate disclosure of the amount resulting from the revaluation of managed assets, where applicable;
  - the consolidated balance of managed assets at the end of the period with separate disclosure of the portion of the balance resulting from the revaluation of managed assets, and any related impairment, where applicable;
  - movement in profit equalisation reserve and / or investment risk reserve, or any other reserves, if applicable; and
  - the balance of managed assets at the beginning of the period with separate disclosure of the portion of the balance resulting from the revaluation of managed assets, where applicable.

General disclosures

- A Takaful institution shall disclose all material information that is necessary to make the financial statements adequate, relevant and reliable for their users, including the following:
  - a description of the Takaful model and the relationship between the Takaful operator and the managed funds;
  - a description of the significant terms and conditions of the contracts / arrangements between the Takaful operator and the managed funds including, but not limited to, Qard Hasan, Wakala fee and Mudarib's share. This description is preferably to be presented after the accounting policies;
  - the nature of the activities the Takaful institution is authorized to carry out by its charter and the major Takaful services / operations it provides; and
  - the Takaful institution's responsibility towards Zakah
- Any unusual supervisory restrictions imposed by any regulatory or supervisory agency
- Additional restrictions that arise due to the Waqf model (or any other permissible structure) used by the Takaful institution, or due to regulations applicable on statutory fund model (or any other similar structure), or the relevant solvency requirements in the respective regulatory jurisdictions
- Concentration of Takaful and re-Takaful risks in geographical areas, economic sectors and location of the re-Takaful institutions

General disclosures

- Capital adequacy and solvency of the Takaful institution, both at the Takaful operator and the PTF level, indicating any difference in respect of previous assessment of the same that may arise from the regulatory reviews
- Guarantees and other similar arrangements, which are not part of PTF and rather are related to the Takaful operator, along with relevant accounting policies for accounting for any onerous commitments and income recognition therefrom
- Disclosure for trust funds and other similar assets in fiduciary capacity, if applicable, in line with the requirements of relevant FASs
- Notes to the statement of managed PIF shall disclose the following:
  - the nature of the relationship between the Takaful operator and owners of the investments either as Mudarib or as investment agent along with significant terms and conditions of such arrangement; and
  - the rights and obligations associated with each type of investment account or investment unit.

05

Core differences between FASs and IFRS 17

5a

Core differences in accounting between FAS 43 and IFRS 17: due to Shari’ah and business model

Key differences between FAS 43 and IFRS 17: Faithful representation and control issues

True nature of business of Takaful operatory – true and fair view, faithful representation

- IFRS new framework also talks about faithful representation (instead of substance over form, considering it as one of the elements mainly). FAS 43 (and FAS 42) define the whole accounting cycle in line with the faithful representation of the business model in lien with Shari’ah.

Control definition – whether PTF and PIF are controlled by the Takaful operator? What shall be the accounting in case of consolidation (consolidation of Takaful window and consolidation of subsidiary)?

- The are multiple challenges in determining control under IFRS, for stand-alone and consolidated FSs, e.g., governance rights (for self benefit, or for others’ benefit in fiduciary capacity), variable returns (gains and losses – do variable returns exist without losses) and the impact of Qard on control
- FAS 43 clarifies on these matters in line with the Shari’ah principles and business model of Takaful
- FAS 40 on windows accounting clarifies the requirement for a separate set of financial statements

Concept of quasi-equity and off-balance-sheet managed assets

- IFRS is silent on these matters and considers quasi-equity as a liability, while FAS 43 (and FAS 42) in line with Shari’ah principles and business model define it properly

Differences between IFRS 17 and FAS 43: Due to Shari’ah issues

Combining of two contracts in one – is it allowed by Shari’ah?

- FAS 43 (along with FAS 42) requires completely different accounting for each component related to different virtual entities as per Shari’ah

Time value of money – is it allowed by Shari’ah?

- FAS 43 addresses the issue by not allowing the discounting of established receivables and payables

What can be discounted, and what not, as per Shari’ah? If estimates are discounted – how to be represented (deferred cost / profit elements)?

- FAS 43 addresses the issue by using a fair value of future cash flows approach allowing a discounted accounting approach (with disclosure of deferred elements)

Reflection of rights and responsibilities of the parties as per Shari’ah

- FAS 43 (to be read with FAS 42) defines presentation of the rights and responsibilities of respective parties in accordance with Shari’ah and the business model

Differences between IFRS 17 and FAS 43: Due to Shari’ah issues

Determination of surplus / deficit as per Shari’ah

- Determination of surplus and deficit, and their respective accounting is properly defined in FAS 43. Doing this accounting directly through CSM may create multiple confusions, and different interpretations (e.g., whether surplus is payable and CSM is zero, and whether Qard is receivable and is a P&L entry, to nullify CSM, etc.?)

Determination of revenues, expenses, profits and losses for the equity of the Takaful operator

- What meets the definition of revenue, and when, has multiple confusions and interpretation issues, which are well defined by FAS 43, including accounting treatment of Wakala fee, acquisition service costs etc.

Determination of correct amounts of Mudaraba profits / investment agency fee for PTF / PIF

- Determination of these profits including incentives etc., are to be done in line with relevant FASs which ensure compliance with Shari’ah – however, it creates a challenge if different from IFRS

Key differences between FAS 43 and IFRS 17: Takaful accounting challenges addressed by FAS 43

What is a reporting entity; can a Takaful institution be considered a reporting entity?

- IFRS implementation disregards PTF as virtual entity due to control issue, while FAS 43 considers it separate as per Shari'ah and the business model

Does a Takaful institution / operator provide insurance services as per IFRS 17?

- PTF is the insurer as per FAS 43

Does IFRS 17 apply to either the entity as a whole or to PTF only (or to PIF and PTF together)?

- FAS 43 is clear about underwriting accounting only on PTF and FAS 42 requires its full financial reporting

Will the unearned profit be zero under IFRS 17, as Takaful institutions are required to distribute the surplus back to policyholders?

- FAS 43 addresses this issue appropriately by defining the surplus and deficit accounting

Key differences between FAS 43 and IFRS 17: Takaful accounting challenges addressed by FAS 43

How is Qard Hasan and Wakala fee accounted for under IFRS 17? What if Qard Hasan is not considered recoverable anymore?

- FAS 43 provides appropriate accounting treatments for these issues (along with all relevant issues) through a separate chapter

If a contract / arrangement is onerous, how will the Qard Hasan be allocated / recovered?

- This creates a confusion under IFRS 17, as in such case the Qard becomes immediately receivable and CSM may become zero, while this is not the correct Qard accounting as per Takaful business model.

Can an insurer present columns on the face of its accounts since an entity is not allowed to separate insurance components in a single contract for measurement purposes?

- Columns and their totals still may be considered as combination of two contracts / balances attributable to two entities as per Shari'ah. This issue is resolved by FAS 43 by having different financial statements.

5b

Core differences in terminologies between FAS 43 and IFRS 17

Core differences: FASs and IFRS 17

	Conventional term	Term used in this standard	Difference in accounting, if any.
1.	Insurance “contract”	Takaful “arrangement”	Takaful is a risk sharing non-commutative contract, whereas insurance is a commutative contract. Takaful arrangement, at times, refers to a combination of multiple contracts which may not be combined in one contract in line with the Shari’ah principles and rules.
	Rationale: The term contract does not faithfully present the nature of Takaful and its structural relationships. According to Shari’ah, a Takaful arrangement is established using two or three separately identified relationships / agreements / documents defining the rights and responsibilities of the parties, in different Takaful structures.		

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Core differences: FASs and IFRS 17

	Conventional term	Term used in this standard	Difference in accounting, if any.
2.	Premium (and the derivative terms)	Contribution	Takaful is a risk sharing non-commutative contract, whereas insurance is a commutative contract.
	Rationale: The term contribution reflects the Tabarru contract where participants agree to make a donation to the PTF for mutual sharing of risk.		

Core differences: FASs and IFRS 17

	Conventional term	Term used in this standard	Difference in accounting, if any.
3.	Coverage (and derivative terms)	Benefits entitlement	A conventional insurance contract creates a coverage for the insured person.
	Rationale: A Takaful arrangement entitles the participants to get benefits in the case of a loss through a mutuality arrangement, and hence, the term more suited to the same is "benefits entitlement" instead of "coverage".		

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Core differences: FASs and IFRS 17

	Conventional term	Term used in this standard	Difference in accounting, if any.
4.	Contractual Service Margin (CSM)	Takaful Residual Margin (TRM)	CSM represents the unearned profit the entity will recognise as it provides insurance contract services under the insurance contracts in the group.
	Rationale: Insurance is a for-profit business, while PTF is a not-for-profit (mostly virtual) entity. The objective of insurance business is to earn profits, while PTF surplus, if any, are distributed back to the participants, after maintaining necessary reserves. Moreover, the service provider in the context of the Takaful business is the Takaful institution which provides services to the PTF and where necessary to the participants (e.g., investment management). Furthermore, as discussed above, the term "contract" is replaced with the term "arrangement" in the context of Takaful. Considering all of these factors, it was considered more appropriate to coin a new term which reflects the true nature of Takaful business and the financial reporting model in line with the requirements of this standard.		

Core differences: FASs and IFRS 17

	Conventional term	Term used in this standard	Difference in accounting, if any.
5.	Acquisition cash flows	Takaful acquisition cash flows Takaful acquisition service cost	See BC12-BC14
	Rationale: The costs attributable to the PTF shall be termed as "Takaful acquisition cash flow" and its accounting treatment within PTF shall be similar to the accounting treatment of similar costs in the conventional insurance contracts in line with the generally accepted accounting principles. On the contrary, the costs attributable to the Takaful institution are in the nature of a service cost against the Wakala fee earned from the PTF. A new term namely, "Takaful acquisition service cost" was coined for such costs. The same shall be recognised immediately, or over a period of time in the statement of income of the Takaful institution, matching with the recognition of relevant Wakala fee		

و الحمدللّه في الأولى والآخرة

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