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Islamic insurance under IFRS: we need to keep talking  
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**Muhammad Tariq**, Head of Insurance and Partner, KPMG in UAE, explains some of the key IFRS accounting and reporting challenges facing the Islamic insurance industry.



*Takaful*, or Sharia-compliant insurance, is a relatively young market with a potentially huge customer base. With significant growth outside their current major markets of the Middle East and Malaysia, a large number of *Takaful* businesses are reporting under International Financial Reporting Standards (IFRS), which gives rise to complex accounting and reporting issues. The reason for this complexity goes back to fundamental differences between *Takaful* and conventional insurance models.

#### How *Takaful* works

Islamic finance law abhors any kind of speculation and outlaws uncertainty (*Gharar*), gambling (*Maisir*) and usury (i.e. interest, or *Riba*). *Takaful* is structured to avoid these prohibited elements, introducing elements of mutual help (*Tawaun*) and donation (*Tabaru*).

Policyholders' premiums — which are treated as donations — make up a fund from which any insurance obligations are met. *Takaful* operators manage funds and settle obligations in return for an agency fee (*Wakala* fee), a profit

and loss share (*Mudarabah* share), or both. Any surplus in the fund belongs to the policyholders. If there is a shortfall in the fund, the operators make an interest-free loan (*Qard-e-Hasan*) to finance the deficit.

#### Why current application of IFRS is problematic for *Takaful* businesses

A *Takaful* insurance fund is co-owned by its customers, who jointly agree to take on the insurance risk, and share out any surplus or shortfall arising in the fund. This means that there is no transfer of risk: *Takaful* participants are effectively both the insurer and the insured. Since *Takaful* operators never actually own fund contributions, they are essentially in the position of an agent or fund manager.

Despite these key conceptual differences, regulations in many jurisdictions treat *Takaful* operators exactly the same as conventional insurance companies. This gives rise to accounting and reporting treatments under IFRS which can be at best a poor fit, and at worst fundamentally unsuitable to reflect *Takaful* principles.

**Alongside these and many other complex discrepancies, many Sharia scholars also feel that IFRS does not offer the level of transparency and disclosure required under Islamic law.**

For example:

- Definitions under IFRS relating to insurance contracts and insurers do not reflect the risk sharing nature of *Takaful* contracts: IFRS assume a transfer of risk.
- In order to present comparable financial information, IFRS largely ignores actual *Takaful* structures. Contributions from participants are treated as revenue, when it would be more accurate to record them as liabilities. Claims and other expenditure paid out of *Takaful* funds are recorded as expenses, when in fact they are a reduction of liability.

**It's clear that current application of IFRS for Takaful companies represents an uneasy compromise for the business, customers and Sharia scholars. Yet it is obviously important for Takaful companies to be regulated under international standards if they are to move forward as part of a global industry.**



- Some *Sharia* scholars argue that funds received by *Takaful* operators are fiduciary in nature and therefore should not even be shown on the operator's balance sheet.
- The IFRS accounting treatment of agency fees earned by the *Takaful* operator and charged to the fund can result in a confusing mismatch within the financial statement. This is because fees are deferred in the *Takaful* fund as an acquisition cost, but recognized upfront in the operator's income statement as service revenue.

Alongside these and many other complex discrepancies, many *Sharia* scholars also feel that IFRS does not offer the level of transparency and disclosure required under Islamic law. For example, *Sharia* principles require total segregation of the participants' and *Takaful* operators' assets and liabilities, and all schemes under the management of one operator must be segregated. This allows a fair share of surplus or deficit to be allocated to the participants of each scheme in a transparent way.

However, in almost all jurisdictions, *Takaful* businesses have to publish their financial statements on a combined corporate entity level, which can make it difficult for stakeholders to assess and understand results. To get around this problem, many companies reporting under IFRS present a separate revenue account for each *Takaful* fund under management along with a separate income statement for the *Takaful* operator. Some also use columnar balance sheets showing the assets and liabilities of the operator side by side with those of the fund, together with the aggregate balance.

#### **Dialogue required to enhance Takaful's potential**

It's clear that current application of IFRS for *Takaful* companies represents an uneasy compromise for the business, customers and *Sharia* scholars. Yet it is obviously important for *Takaful* companies to be regulated under international standards if they are to move forward as part of a global industry. To develop a consistent presentation and transparent disclosure that reflects the true essence of *Takaful*,

a productive dialogue between *Sharia* scholars and the wider industry should continue.

Frameworks already exist which should help provide insight and a basis for future development, including the accounting standards and guidelines for *Takaful* created by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Malaysian Accounting Standards Board (MASB) and the Central Bank of Malaysia (BNM). With a harmonized dialogue at global level, *Takaful* can reach its full potential.

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