Fiancial Accounting Standard No. (13)

Disclosure of Bases for Determining and Allocating Surplus or Deficit in Islamic Insurance Companies

Contents

Preface

The purpose of this standard is to establish the rules that regulate the disclosure of bases for determining and allocating surplus or deficit in Islamic insurance companies[1] in order to present reliable and relevant information to assist users of financial statements in their economic decision making.

(1) Referred to hereafter as company or companies to represent Islamic insurance companies and Takaful companies.

Statement of the Standard

1. Scope of the Standard

This standard is applicable to all financial statements prepared by the companies in order to meet the common information needs of the main users of such statements. The standard is applicable to all companies regardless of their legal forms, countries of incorporation or sizes.

Should the requirements of this standard be in conflict with a company's charter or the laws and regulations of the country in which it operates, a disclosure should be made to that effect. (para. 1)

2. Disclosure of Significant Accounting Policies

2/1 Disclosure should be made of the party that meets the general and administrative expenses, and whether this party meets all or only part of these expenses. In case the party meets only part of these expenses, a disclosure should be made of the basis applied in determining this part and the body that approved it. (para. 2)

2/2 Disclosure should be made of the basis applied by the company in calculating the following items which affect the policyholders' funds:

a) Pre-operations expenditures
b) Reserves
c) Cost of assets used in operations
d) Claims and compensations
e) Treatment of commissions from non-Islamic reinsurance companies
f) Outstanding claims retained for reinsurance companies. (para. 3)

2/3 Disclosure should be made of the cash or accrual basis applied by the company in determining the policyholders' premium contributions, and the policy adopted in case a policyholder withdraws or defers settlement of his premium contribution during the financial period. (para. 4)

2/4 Disclosure should be made of the basis applied by the company in treating any current deficit and/or cumulative deficit from previous financial periods, and how such a deficit is to be accounted for in the current and subsequent financial periods. (para. 5)

3. General Disclosure in the Notes to the Financial Statements

3/1 Disclosure should be made of the bases that govern the contractual relationship between policyholders and shareholders in the following:

a) Management of insurance operations.
b) Investment of policyholders' funds.
c) Investment of shareholders' funds and the body that approved these bases. (para. 6)

3/2 Disclosure should be made of the party that manages the insurance operations and the remuneration it receives (a specified fee on the basis of agency, a share of underwriting surplus on the basis of Mudaraba or the remuneration received on other bases). (para. 7)

3/3 Disclosure should be made of the party that manages the investment of policyholders' funds and shareholders' funds, and the remuneration it receives (a percentage of investment profit in case of Mudaraba or a specified fee in case of agency). (para. 8)

3/4 Disclosure should be made of the basis applied by the company in determining the remuneration of the party that manages the company's investments on the basis of Mudaraba or agency. (para. 9)

3/5 Disclosure should be made of the basis applied by the company in allocating the profit generated from investing policyholders' funds and shareholders' funds. (para. 10)

3/6 Disclosure should be made of whether the party that manages the insurance operations or the investments of the policyholders' funds have amended during the current financial period its Mudarib share or management fees. Disclosure should be made also of the Shari'a procedures followed in implementing the amendment. (para. 11)

3/7 Disclosure should be made of:

a) Any deductions, either as a percentage or an amount, from the remuneration paid to the party that manages the investments or the insurance operations; and/or
b) Any expenses borne by the party that manages the investment funds;

As a contribution to increase the income of the party whose funds are invested or to increase the underwriting surplus, if such contribution was material. (para. 12)

3/8 In case the party that manages the investments is unable to utilize all the available funds for income-producing investments, disclosure should be made if priority has been given to policyholders or shareholders in making the allocation of income-producing investments. Disclosure should also be made of the basis on which this priority has been applied. (para. 13)

3/9 Disclosure should be made of whether the company calculates the underwriting surplus attributable to the policyholders on the basis of segregation between the different types of insurance or calculates the underwriting surplus on the basis of considering all types of insurance as one unit. (para. 14)

3/10 Disclosure should be made of which of the following methods the company has applied in allocating the underwriting surplus, and the Shari'a basis applied:

a) Allocation to all policyholders according to their pro rata share of the premium contribution without distinguishing between those who have made claims or not during the financial year.
b) Allocation only among policyholders who did not make claims during the financial year.
c) Allocation to policyholders after deducting the claims paid to them during the financial period.
d) Allocation between policyholders and shareholders.
e) Allocation by using other methods (in which case, details of the method used should be disclosed). (para. 15)

3/11 Disclosure should be made of the basis used in accounting for any underwriting surplus declared but not collected by some or all of the policyholders. (para. 16)

3/12 Disclosure should be made of the allocation that would be met of any undistributed underwriting surplus, should the company be liquidated. (para. 17)

3/13 Disclosure should be made of the basis applied by the company in determining the Zakah base and its calculation, if the company meets the criteria according to which it is obliged to pay Zakah according to Financial Accounting Standard No. (9): Zakah. (para. 18)

4. General Disclosure Requirements

The disclosure requirements stated in Financial Accounting Standard No. (12): General Presentation and Disclosure in the Financial Statements of Islamic Insurance Companies should be observed. (para. 19)

5. Effective Date

This Standard shall be effective for financial periods beginning 1 Muharram 1423 A.H. or 1 January 2002 A.D. (para. 20)

Adoption of the Standard

The Disclosure of Bases for Determining and Allocating Surplus or Deficit in Islamic Insurance Companies standard was adopted by the Accounting and Auditing Standards Board in its meeting No. (19) held on 17 Safar 1421 A.H., corresponding to 21 May 2000 A.D.

Members of the Board

1. Abdul-Malik Yousef Al-Hamar	Chairman
2. Noorur-Rahman Abid	Deputy Chairman
3. Dr. Abdul-Sattar Abu Ghoddah	
4. Musa Abdel-Aziz Shehadeh	
5. Anwar Khalifa Sadah	
6. Dr. Khalid Mohammed Boudi	
7. Mohammed Alawi Thiban	
8. Jamal Ali Al-Hazeem	
9. Jamil Darras	
10. Dr. Abdul-Samad Bin Hj. Alias	
11. Dr. Sayed Musa Al-Habshi	
12. Ibrahim Adam Habib	
13. Dr. Yousif Mohammed Mahmood Qassim	

Appendix (A)
Brief History of the Preparation of the Standard

In its meeting No. (16) held in Jeddah, Saudi Arabia on 8-9 Ramadan 1419 A.H., corresponding to 26-27 December 1998 A.D., the Accounting and Auditing Standards Board decided to give priority to the preparation of a standard on the disclosure of bases for determining and allocating surplus or deficit in Islamic insurance companies.

On 29 Ramadan 1419 A.H., corresponding to 16 January 1999 A.D., two consultants were commissioned to prepare a preliminary study of the accounting aspects of the standard. The study of the juristic aspects of the standard was carried out during the preparation of the standard on General Presentation and Disclosure in the Financial Statements of Islamic Insurance Companies.

In its meeting No. (19) held in Bahrain on 18-19 Muharram 1420 A.H., corresponding to 4-5 May 1999 A.D., the Accounting Standards Committee discussed the initial accounting study and made the amendments it deemed necessary. The Committee also took note of the summary of the juristic aspects of the standard. The Committee also discussed the revised accounting study and the exposure draft of the standard in its meeting No. (20) held in Bahrain on 21 Rabi' I, 1420 A.H., corresponding to 4 July 1999 A.D., and asked the consultants to make the necessary amendments in light of the comments made by the members.

The revised exposure draft of the standard was discussed by the Committee meeting No. (21) held in Bahrain on 25-26 Jumada I, 1420 A.H., corresponding to 5-6 September 1999 A.D., and the amendments which were considered necessary were made. The Committee also discussed the exposure draft of the standard in its meeting No. (22) held in Bahrain on

25-26 Jumada II, 1420 A.H., corresponding to 5-6 October 1999 A.D., and amendments considered necessary were made.

The exposure draft of the standard was discussed by the Shari'a Committee for Standards in its meeting No. (2) held in Bahrain on 16-17 Rajab 1420 A.H., corresponding to 25-26 October 1999 A.D., and some further amendments were made.

The amended exposure draft was discussed in the Accounting and Auditing Standards Board meeting No. (18) held in Bahrain on 14-15 Sha'ban 1420 A.H., corresponding to 22-23 November 1999 A.D. The Standards Board made further amendments to the exposure draft and decided that it should be distributed to specialists and interested parties to obtain their comments on the exposure draft in order to discuss them in a listening session.

A listening session was held in Bahrain on 27-28 Dhul-Hajjah 1420 A.H., corresponding to 2-3 April 2000 A.D. The listening session was attended by more than forty six participants representing central banks, Islamic banks, accounting firms, Shari'a scholars, academics and others who are interested in this field. Members of the Accounting Standards Committee responded to the written comments that were sent prior to the listening session as well as to the oral comments that were expressed in the listening session.

The Accounting Standards Committee held a meeting on 6-7 Muharram 1421 A.H., corresponding to 11-12 April 2000 A.D., in Jordan to discuss the comments made on the exposure draft. The Committee made the necessary amendments, which it deemed necessary in light of the discussions that took place in the listening session.

The revised exposure draft was reviewed and approved by the Shari'a Committee for Standards in its meeting No. (3) which was held on 19-20 Muharram 1421 A.H., corresponding to 24-25 April 2000 A.D., after making some changes to the draft.

The Accounting and Auditing Standards Board adopted the proposed standard in its meeting No. (19) held on 17 Safar 1421 A.H., corresponding to 21 May 2000 A.D.

Appendix (B)
Juristic Rules for Disclosure of Bases for Determining and Allocating Surplus or Deficit in Islamic Insurance Companies

Insurance or underwriting surplus is the excess of the total premium contributions paid by policyholders during the financial period over the total indemnities paid in respect of claims incurred during the period, net of reinsurance and after deducting expenses and changes in technical provisions.

The Shari'a ruling on the surplus is derived from the ruling made on the origin of that surplus, i.e. the premium contributions. The ruling states that these contributions are amounts wholly or partially donated in accordance with the Islamic insurance system in which participation is considered to be an implicit acceptance of the conditions set out in the insurance policies or the by-laws relating to the disposition of the insurance surplus in the various cases, the most important of which are mentioned below. These conditions do not conflict with the Shari'a provisions, and Muslims are bound by their agreements, except when such agreements render the impermissible lawful or render the lawful unlawful, according to the Prophetic hadith.(2)

Shari'a allows that donations may be restricted by conditions and allocated for a specific purpose. They may also be made contingent upon certain conditions, according to some Fuqaha. Gharar (uncertainty) in Islamic insurance is forgiven in the case of donations because according to the Maliki school of thought Gharar does not invalidate the contracts of donations.

The shareholders in an insurance company may invest the insurance surplus for the account of the policyholders, if there is an express provision to

(2) Related by Al-Tirmidhi, who deemed it good hadith. It was also related by Al-Tabarani in *"Al-Mu'jam Al-Kabir"*, *"Fath Al-Qadir"*, Al-Manawi, [6: 272].

this effect in the insurance policy or in the by-laws, provided that the Shari'a provisions regulating such investment are observed. The consideration payable to the party undertaking such investment (i.e., percentage of investment profit in the case of Mudaraba or amount of fee in the case of agency) should be specified in the insurance policy, by-laws or the notices sent to policyholders. The policy should also specify a deadline for policyholders to express any objection they may have regarding the consideration payable. Otherwise, the company will assume that policyholders have no objections.

Several Fatwas and Shari'a rulings have been issued confirming that the policyholders have the exclusive right to the insurance surplus.[3] The shareholders do not share in this surplus, because it belongs to policyholders collectively, as defined by the insurance agreement. The party undertaking the investment is entitled only to the consideration specified for this purpose, and should not appropriate any amount from the insurance surplus which is a residual from the premium contributions, and as such should be returned only to the policyholders. However, there are some Fatwas issued by Shari'a boards that permit shareholders to share in the underwriting surplus with the policyholders.

Methods of Allocating the Insurance Surplus

There are a number of methods to allocate the insurance surplus. These include:

a) Allocation of surplus to all policyholders, regardless of whether or not they have made claims on the policy during the financial period.
b) Allocation of surplus only among policyholders who have not made any claims during the financial period.
c) Allocation of surplus among those who have not made any claims and among those who have made claims of amounts less than their insurance contributions, provided that the latter category of policyholders should receive only the difference between their insurance contributions and their claims during the financial period.

(3) See resolution of Al-Baraka Symposium (12/2T), Fatwa issued by the Shari'a Supervisory Board of Faisal Islamic Bank of Sudan 3/3, (P. 22), the Common Shari'a Supervisory Board of Dallah Albaraka (514) and the Fatwas of Sheikh Mustafa Al-Zarqa (P. 420).

d) Allocation of surplus between policyholders and shareholders.
e) Allocation of surplus by using other methods.

Method (a) is the one which should be followed when the insurance policy or by-laws are silent on the specification of allocation methods.(4)

In case another method is used, the insurance company should state this in the insurance policy or in its by-laws.

After liquidation, the insurance surplus and any remaining reserves related to it should be donated to charitable causes. This is based on the ruling that if it is not possible to return something to its original owners, then it should be given to charity. Such a provision should preferably be provided for in the insurance policy or the by-laws. However, in case of life insurance, these funds may also be allocated among the remaining policyholders.

Policyholders should pay Zakah on the insurance surplus which is allocated among them. This is achieved by including their share of surplus in their Zakah funds. If there is a statutory text obliging the company to pay Zakah, or if this is provided for in the statutes or in the policies or by-laws, then the company must pay Zakah on the surplus. However, if there is no provision to this effect, the company should pay Zakah on behalf of the policyholders who authorize it to do so.(5)

Methods of Covering the Insurance Deficit

There are a number of methods to cover the insurance deficit. These include:

a) To settle the deficit from the reserves of policyholders, if any.
b) To borrow from the shareholders' funds or from others the amount of deficit, which should be paid back from future surpluses.
c) To ask the policyholders to meet the deficit pro rata.
d) To increase the future premium contribution of policyholders on a pro rata basis.

(4) Fatwa of the Shari'a Supervisory Board of the Islamic Arabic Insurance Company (P. 34).
(5) International Islamic Fiqh Academy resolution No. (28) 3/4; Financial Accounting Standard No. (9): Zakah issued by Accounting and Auditing Organization for Islamic Financial Institutions.

Appendix (C)
Reasons for the Standard

The reasons for preparing the standard include, among others, the following:

a) The importance of determining the relationship between policyholders and shareholders, and the consequences of the full segregation between the assets, obligations and results of operations of policyholders and shareholders in order to determine the rights and obligations of each party.
b) The importance of the issue of determining and allocating the insurance surplus among policyholders, which is a matter of fairness between the various parties involved in an Islamic insurance company.
c) Differences in the bases applied by companies in allocating the insurance surplus and the different degree of disclosure of such bases from one company to another. This does not help in comparing the performance of companies.
d) The importance of disclosing information that assists users of financial statements of the companies in their economic decision making. Disclosing such information helps in determining the rights of the concerned parties and the concept of fairness between the policyholders and shareholders on the one hand, and among the policyholders themselves on the other hand.

Appendix (D)
Basis for Conclusions

The provisions of this standard emanate mainly from the objectives of financial reports as specified in the previous Statement of Financial Accounting No. (1): Objectives of Financial Accounting for Islamic Banks and Financial Institutions (Statement of Objectives) and the concepts of financial accounting for Islamic banks and financial institutions as specified in the previous Statement of Financial Accounting No. (2): Concepts of Financial Accounting for Islamic Banks and Financial Institutions (Statement of Concepts). Such objectives and concepts reflect the needs of the categories of the users of such reports.

The previous Statement of Objectives sets out, among others, the following objectives:

a) Determination of the rights and obligations of all interested parties and,
b) Contribution to the safeguarding of the assets and rights of the various parties.

Accordingly, the standard requires disclosure of:

a) A party that meets the general and administrative expenses, and whether this party meets all or only part of these expenses. In case the party meets only part of these expenses, disclosure should be made of the basis applied in determining this part and the body that approved it.
b) The bases that govern the contractual relationship between the policyholders and the shareholders in the following:
   - Management of insurance operations,
   - Investment of policyholders' assets,
   - Investment of shareholders' assets, and
   - The body that approved these bases.

c) The bases applied in allocating the underwriting surplus:
   - Among the policyholders, and
   - Between policyholders and shareholders.

d) Whether the policyholders or the shareholders are responsible for managing the insurance operations, and the remuneration received for carrying out this function;

e) The party which is responsible for managing the investment of the policyholders' and shareholders' funds, and the bases on which:
   - The remuneration for this function is determined, and
   - Allocation of investment profits or losses is made between the parties.

f) Whether the party that manages the insurance operations or the investments of the policyholders' funds have amended its management fees or mudarib share and the Shari'a bases that were followed in implementing these amendments.

g) In the case where there is an excess of funds for the investment and part of these funds must be held in the form of non-income producing assets, the standard requires disclosure of the manner in which the investment in income-producing assets is allocated between the policyholders and the shareholders, and if any priority accorded to one party over the other.

The previous Statement of Objectives requires that financial reports should provide information on the company's economic resources and the related obligations, and the effect of transactions, other events and circumstances on the company's economic resources and obligations. This information should assist users of the financial statements in assessing the inherent risk of their investment. Accordingly, the standard requires that the financial statements should disclose whether the company calculates the insurance surplus for each type of insurance separately or on the basis of considering all types of insurance as one unit.

The previous Statement of Objectives requires that financial reports should provide information that assists in estimating cash flows that might be realized from dealing with the company. Accordingly, the standard requires that the financial statements should disclose whether the premium contributions are determined on a cash or an accrual basis, the policy adopted in case a policyholder withdraws or defers settlement of his premium contribution, and the bases applied in treating the current and cumulative underwriting deficit.

The previous Statement of Objectives requires that financial reports should provide information to assist in the determination of the amount of Zakah that should be levied on the company's funds and the parties to whom it will be paid. Accordingly, if the company satisfies any of the cases that obliges it to pay Zakah, the standard requires the disclosure of the methods applied in determining the Zakah base and its calculation.

The disclosure of such information should enhance confidence of the users of the financial statements of the company, assist them in their economic decision making, and help in achieving the company's *Takaful* objectives of mutual support.