AAOIFI Financial Accounting Standard 43

Accounting for Takaful: Recognition and Measurement

Contents

AAOIFI Financial Accounting Standard (FAS) 43 “Accounting for Takaful: Recognition and Measurement” is set out in paragraphs 01-136. All the paragraphs have equal authority. This standard should be read in the context of its objective and the AAOIFI Conceptual Framework for Financial Reporting as endorsed by AAOIFI. This standard shall be read in conjunction with FAS 42 “Presentation and Disclosures in the Financial Statements of Takaful Institutions”.

All AAOIFI FASs shall be read in conjunction with the definitions, Shari’ah principles and rules and key considerations provided by AAOIFI Shari’ah standards (SSs). This standard shall be read particularly in conjunction with SS 26 “Islamic Insurance” and SS 41 “Islamic Reinsurance”.

Preface

PR1 The AAOIFI Accounting Board (AAB / the board) is in constant endeavour to make the financial statements of Islamic financial institutions transparent, fair, understandable and comparable. The objective is to align the accounting treatments and the reporting requirements of various types of Islamic financial institutions, including the Takaful institution(s), to the maximum extent possible with the generally accepted accounting principles.

PR2 AAOIFI had previously issued four specific Financial Accounting Standards (FASs) applicable to Islamic insurance / Takaful over the period from 1999 to 2003. The Takaful industry, during the last two decades, has significantly developed along with considerable enhancement to the regulatory environment. Concurrently, other international accounting standard-setting bodies completed multiple projects related to insurance accounting. The then AAOIFI Accounting and Auditing Standards Board initiated a comprehensive revision project for AAOIFI FASs on Takaful in 2013.

PR3 The work was paused in 2016 by the newly formed AAB considering the fact that Takaful regulations were being enhanced in many jurisdictions and the projects by global accounting standard setting bodies related to insurance accounting were nearing completion. The board also agreed that the ongoing project of revision of the AAOIFI Conceptual Framework for Financial Reporting and FAS 1 "General Presentation and Disclosures in the Financial Statements" shall have priority as certain parts and terminologies will be used by later standards. Eventually, it was decided that the common requirements for general presentation and disclosure shall be contained in FAS 1 "General Presentation and Disclosures in the Financial Statements".

PR4 Later, AAB initiated a comprehensive revision project for AAOIFI FASs on Takaful in 2018 under the recommendation of the "AAOIFI Financial Accounting Standards (FAS) review and revision project". FAS 42 "Presentation and Disclosures in the Financial Statements of Takaful Institutions" is being simultaneously issued as a first work product of this comprehensive project. This standard is the second part of the project covering mainly the accounting treatments and other relevant financial reporting requirements for the Takaful arrangements.

Introduction

Overview

IN1 This standard sets out the principles for the recognition, measurement and reporting of Takaful arrangements and ancillary transactions for the Takaful institutions. It aims to ensure that the Takaful institutions faithfully present the information related to these arrangements to the relevant stakeholders as per the contractual relationship between the parties and the business model of the Takaful business in line with the Shari'ah principles and rules. The requirements of this standard are duly aligned with the international best practices of financial reporting for the insurance business.

IN2 This standard provides principal requirements for the financial reporting (aligned with the global best practices) for Takaful arrangements as applicable to the participants' Takaful fund (PTF) and participants' investment fund (PIF), as well as, principles of recognition, measurement and reporting other ancillary matters, e.g., transactions between the funds and the Takaful institution / operator.

IN3 This standard is part of a broader project for Takaful accounting and has been developed in alignment with, and shall be read in conjunction with, FAS 42 "Presentation and Disclosures in the Financial Statements of Takaful Institutions".

IN4 This standard supersedes the following FASs:

a. FAS 13 "Disclosure of Bases for Determining and Allocation Surplus or Deficit in Islamic Insurance Companies";

b. FAS 15 "Provisions and Reserves in Islamic Insurance Companies"; and

c. FAS 19 "Contributions in Islamic Insurance Companies".

Rationale for issuing this standard

IN5 The AAOIFI Accounting Board (AAB / the board) considered various factors while initiating the comprehensive project for the revision of AAOIFI FASs on Takaful, which in turn mandated the development of a comprehensive FAS on the accounting treatments and ancillary financial reporting matters relating to the Takaful arrangements. Such factors include, but are not limited to, the following:

a. developments in international best practices, global generally accepted accounting principles and regulatory requirements with regard to conventional insurance accounting considering the fact that the last AAOIFI FAS on Takaful was issued in 2003;

b. gaps were identified in accounting treatments in respect of Takaful arrangements as defined in earlier FASs, which were communicated to AAOIFI from time to time by various market participants and experts;

c. there was an identified need to standardise the structural relationship between the Takaful institution and the different funds from the financial reporting perspective and to provide accounting treatments for different transactions, balances and contracts under these relationships;

d. different accounting requirements were scattered in different FASs, which, at times, were not easy to comprehend. Therefore, the need was felt for a comprehensive standard; and

e. existing AAOIFI FASs on Takaful accounting did not address certain ancillary issues, particularly with regard to the accounting for transactions and balances between different stakeholders of the Takaful institution / operator and the accounting for the investment component.

Significant changes from the previous standard

IN6 This standard (FAS 43 “Accounting for Takaful: Recognition and Measurement”) brings significant changes from its predecessor standards (FAS 13 “Disclosure of Bases for Determining and Allocation Surplus or Deficit in Islamic Insurance Companies”, FAS 15 “Provisions and Reserves in Islamic Insurance Companies” and FAS 19 “Contributions in Islamic Insurance Companies”). Certain principal changes from the predecessor standards, inter alia, are enumerated below:

a. necessary impacts of the “AAOIFI Conceptual Framework for Financial Reporting”, as well as, the FAS 1 “General Presentation and Disclosures in the Financial Statements”, have been incorporated;

b. alignment of treatments, presentation and terminology has been performed with FAS 42 “Presentation and Disclosures in the Financial Statements of Takaful Institutions”;

c. the principal accounting treatments in respect of the Takaful arrangements have been aligned with the global generally accepted accounting principles and the newer regulatory requirements (where applicable);

d. new accounting treatments have been introduced in respect of the matters which were not addressed by the superseded standards or were not in line with the global best practices, particularly with regard to the accounting for provision (or liability, as appropriate) for the Takaful arrangements and the accounting treatment and presentation for the investment component;

e. the accounting treatments defined in the standard have been mapped with the Shari'ah principles and rules relating to Takaful, including the rights and obligations of respective stakeholders of the Takaful arrangements;

f. new definitions for the accounting terms in respect of the newly introduced accounting treatments, as well as, improved definitions for earlier used terms, have been incorporated; and

g. the accounting treatments have been introduced with respect to the ancillary transactions, particularly the transactions and balances between various stakeholders of the Takaful institution, e.g., accounting for Wakala fee and Qard Hasan.

AAOIFI Financial Accounting Standard 43

Accounting for Takaful: Recognition and Measurement

Objective of the standard

1. This standard sets out the principles for the recognition and measurement of Takaful arrangements and ancillary transactions with the objective of faithfully representing the information related to these arrangements to the relevant stakeholders. It shall be read in conjunction with FAS 42 "Presentation and Disclosures in the Financial Statements of Takaful Institutions".

Scope

2. This standard shall apply to the Takaful institutions (including, in their capacity of being Takaful operators) and their managed participants' Takaful fund (PTF) and managed participants' investment fund (PIF) in respect of:

   a. Takaful arrangements, including re-Takaful arrangements issued;

   b. re-Takaful arrangements held;

   c. investment contracts, with or without discretionary features that are issued along with, and being part of, the Takaful arrangements; and

   d. ancillary transactions related to Takaful operations.

3. A Takaful institution shall not apply this standard to:

   a. guarantee contracts unless the issuer has specified them to be in the nature of Takaful arrangements; and

   b. the Takaful arrangements where the Takaful institution is the participant or the policyholder unless those arrangements are re-Takaful in nature.

Definitions

4. For the purpose of interpreting and applying this standard, the following short definitions are relevant:

   a. 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;

   b. 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;

   c. Entitlement for benefits – is the participants' right to receive benefits against a claim of loss for events that have not happened;

   d. 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;

e. 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];

f. 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;

g. 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;

h. 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;

i. 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);

j. 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.

k. 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);

l. 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];

m. 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;

n. 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];

o. 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];

p. Takaful[1] – 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;

q. 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

[1] Definition adapted from SS 26 "Islamic Insurance"

principles and rules, as well as, contractual and regulatory requirements[2]), or (iii) directly related taxes (as these do not constitute part of contributions and are to be recorded directly as a liability)];

r. 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.,];

s. 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);

t. 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];

u. 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[3]. The notion "Takaful institution", unless the context suggests otherwise, includes the Takaful operator and the participants' funds];

v. 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.

w. 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

[2] In such case the commission may be a part of the Takaful acquisition service cost, to be borne by the Takaful operator.
[3] Takaful window operation shall apply this standard in conjunction with the requirements FAS 40 "Financial Reporting for Islamic Finance Windows"

accounting perspective, quite similar to contractual service margin under the conventional risk transfer-based insurance business];

x. 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

y. Wakala fee (agent's remuneration) – consists of the fixed fee and variable remuneration, including performance incentives (if applicable).

Part A: Structure of Takaful

5. A Takaful institution has a unique structure and includes a Takaful operator, a participants’ Takaful fund, and at times (particularly in the case of a family Takaful institution), a participants’ investment fund.

Takaful operator

6. The Takaful operator manages Takaful operations based on a remunerated Wakala (agency) contract. The Takaful operator may also assume the responsibility of investing the assets of the participants’ Takaful fund (PTF) and participants’ investment fund (PIF) through Mudaraba or an investment agency (Al-Wakala Bi Al-Istithmar).

7. The relationship between the Takaful operator and the PTF is principal-agent in nature. The Takaful operator exercises powers over the PTF in a fiduciary capacity as an agent and does not assume the risks or rewards related to the Takaful (underwriting) operation (particularly, the net underwriting results, which in entirety relate to, and are for the account of, the participants).

8. The Mudarib’s share or performance incentives accruing to the operator out of the investment results, or a lack thereof, are in the nature of compensation for management function and cannot be construed as variable returns for the purpose of determining control. The Takaful operator is not entitled to any surplus arising in the PTF. In the case where the PTF incurs a loss, the Takaful operator is not obliged to absorb that loss. Nevertheless, the Takaful operator may be obligated, through regulation or market practice or its constitution documents, to temporarily support the PTF by providing Qard Hasan (interest-free loan).

9. Takaful operator, PTF and PIF are distinct reporting entities, although in most cases, the PTF and / or PIF are virtual entities.

Participants’ Takaful fund (PTF)

10. The participants or members desirous of sharing risk in a Shari’ah-compliant manner make contributions in the form of donation (Tabarru), being a non-commutative, non-exchange contract, to the PTF. The PTF, by its very nature is a virtual entity that maintains separate accounting records and is subject to financial reporting separately.

11. PTF’s activities and investments are managed under a fiduciary capacity by the Takaful operator. For the management of the services, a fixed Wakala fee is paid by PTF to the Takaful operator. Additionally, a Mudarib’s share or Wakala fee (with or without incentives) is paid by the PTF to the Takaful operator for investment management functions.

12. PTF is obligated to pay benefits to, and on behalf of, the participants according to their membership rights / entitlements for benefits, to which they become eligible under the Takaful arrangement.

13. PTF shall accrue a surplus or deficit at the end of the reporting period that shall be attributable, in its entirety, to the participants.

14. The Qard Hasan received from the Takaful operator is a liability for the PTF that needs to be paid back. The PTF is expected to pay back the Qard Hasan whenever it accrues surplus (and / or has

sufficient liquidity / solvency) and hence is considered to be without a fixed repayment date and in the nature of a short-term liability.

Participants’ investment fund (PIF)

15. The PIF, where applicable, is the investment fund (in the form of a virtual entity) where the participants’ investment component (which is a component of the overall Takaful arrangement, generally under a separate agreement) is maintained and managed. The participants of the PTF are the investment account holders of the PIF. The PIF shall maintain separate accounting records in respect of each of the investing participants.

16. The Takaful operator usually has a profit-sharing Mudaraba contract or an investment agency (Al-Wakala Bi Al-Istithmar) contract (normally with incentives) with the PIF.

Part B: Accounting for Takaful arrangements – under general / variable fee approach

Combining and separating components of Takaful arrangements

Unbundling of non-Takaful components

17. A Takaful arrangement may contain one or more non-Takaful components, such as an investment or service component (generally in the form of a separate contract) or a promise to provide a good or service. The Takaful institution shall separate (unbundle) the components when they are distinct and measurable.

18. Where different components are unbundled, the Takaful institution shall ensure appropriate attribution to the PTF, the PIF and the front-end fee, if any, charged to the participant. Such unbundling of non-Takaful components shall be performed before the Takaful component is recognised in the books of PTF.

19. The accounting treatment of non-Takaful components shall be made in line with the relevant AAOIFI FASs, as applicable[4].

Accounting for related Takaful arrangements

20. The Takaful institution may elect to present a set or series of Takaful arrangements, especially with the same or related participant(s), as one whole arrangement after determining that the rights, obligations, risks and rewards, as well as, eligibility for surplus distribution are similar in nature. This election shall be made immediately after the Takaful institution has made an assessment that combining the Takaful arrangements will faithfully represent the accounting treatments and the overall commercial effect after ensuring that the combination is not in conflict with Shari'ah principles and rules.

Level of aggregation of Takaful arrangements

21. A Takaful institution shall aggregate the Takaful arrangements into distinct portfolios that are subject to similar risks and are managed together. Arrangements within a product line are expected to be in the same portfolio if they are managed together, whereas arrangements in different product lines are expected not to have similar risks even when managed together.

22. The Takaful institution shall divide a portfolio of issued Takaful arrangements into groups (at the minimum) of:

    a. arrangements that are onerous at initial recognition;

    b. arrangements that have no significant possibility of subsequently turning into/becoming onerous from inception; and

    c. the remaining arrangements in the portfolio.

[4] See paragraph 164 of FAS 1 "General Presentation and Disclosures in the Financial Statements" and paragraph 7 of "AAOIFI Conceptual Framework of Financial Reporting

23. A set of arrangements shall be determined to be onerous or have no significant possibility of subsequently turning into / becoming onerous when the Takaful institution makes an assessment of the set of arrangements based on reasonable and supportable information.

24. If reasonable and supportable information is not available for a set of arrangements (elected to be assessed together) for the determination of the group to which such Takaful arrangements belong, then the same shall be based on the assessment of the individual arrangements.

25. Where the general approach is applied, the Takaful institution shall make an assessment as to whether arrangements are not onerous at initial recognition or have no significant possibility of subsequently turning into / becoming onerous. The assessment shall be based on the following:

   a. the likelihood that any change in assumptions, which, if occurred, would result in the Takaful arrangement turning into / becoming onerous; and

   b. the estimates provided by the Takaful institution's internal reporting system.

26. When the Takaful institution is making an assessment as to whether the Takaful arrangements referred to in paragraph 25 are not onerous at initial recognition but have a significant possibility of subsequently turning onerous, the information collected by the Takaful institution's internal reporting system shall be considered, and the Takaful institution is not required to gather any additional information.

Subdivision of groups

27. A Takaful institution may subdivide the groups based on different levels of profitability or the different possibilities of arrangements turning onerous after initial recognition.

28. Takaful arrangements shall be included in a different group if issued more than one year apart.

Initial recognition

Timing of initial recognition

29. A Takaful institution shall recognise a Takaful arrangement it issues, in the books of PTF, at the earlier of:

   a. the date when a participant becomes a member of the PTF (and accordingly becomes entitled to the Takaful benefits in the form of sharing of risks), which may be evidenced through either the payment of contribution or issuance of Takaful arrangement documents; or

   b. the date when the Takaful arrangement, being part of a group or an unavoidable commitment to the Takaful arrangement, becomes onerous (even if it happens before the date applicable as per paragraph 25(a)).

Measurement of the provision for a Takaful arrangement at initial recognition

30. At initial recognition, the provision for a Takaful arrangement shall be measured at the total of the following estimates:

    a. Takaful fulfilment cash flows, pertaining to PTF, comprising of:

        i. an estimate of gross future cash flows including, and distinguishing, the cash flows related to Wakala fee;

        ii. deferred cost being the difference between gross future cash flows (as referred to in (i) above) and their respective fair value of future cash flows (which include adjustment related to the financial risks insofar as the same are not included in (i) above);

        iii. risk adjustment for the non-financial risks; and

    b. the Takaful residual margin.

31. The Takaful institution shall include all future cash flows within the boundary of a Takaful arrangement for the measurement described in paragraph 30. Such a measurement shall:

    a. objectively incorporate all reasonable and supportable information available, without undue cost or effort, about the amount and timing by using a probability-weighted means of the full range of expected outcomes;

    b. be reflective of the institution's assessments of the market variables and is consistent with the observable market prices for those variables;

    c. reflect the current conditions at the measurement date; and

    d. distinguish the adjustments to non-financial risk from other estimates and estimate cash flows disregarding adjustments for financial risks unless the most appropriate measurement technique implicitly includes financial risks and the effect is inseparable.

32. The cash flows arising from substantive rights and obligations existing at the reporting date shall be considered within the boundary period. This boundary period shall be the period in which the Takaful institution can compel the participant to pay the contribution or in which the PTF has a substantive obligation to provide benefits to the participants.

33. A substantive right to provide benefits ends when the Takaful institution is able to reassess the risks of the particular participants, or for a Takaful arrangement as a whole, and can set or reset the price or the level of benefits according to the reassessment if so allowed under Shari'ah principles and rules.

34. A liability or an asset shall not be recognised relating to an expected contribution or expected claim for benefits that is outside the boundary of the Takaful arrangement. Such amounts relate to future Takaful arrangements.

35. A Takaful institution shall adjust the estimate of the future cash flows and their fair values to reflect the effect of risk adjustment for non-financial risk for the PTF for bearing the uncertainty about the amount and timing of the cash flows.

36. It needs to be clarified that:

a. Mudarib's share or Wakala fee (including incentives, if any) for investment management for PTF's investments (excluding PIF's investments) shall be considered part of Takaful fulfilment cash flows and shall be adequately disclosed; and

b. surplus distribution, if any, and waiver of Qard Hasan, if any, shall not be part of the fulfilment cash flows.

Initial recognition of Takaful residual margin

37. The Takaful residual margin is a component of the provision (or net cost, in case of certain re-Takaful arrangements held) for a Takaful arrangement that represents the unearned surplus (or deficit) that will be recognised over the period of (and where appropriate, according to the pattern of) the participant's entitlement for benefits under the Takaful arrangement.

38. The Takaful residual margin shall be measured as the difference of:

a. the amount of Takaful fulfilment cash flows (including all its components as described in paragraph 30(a)) that was initially recognised;

b. any cash flows arising from the Takaful arrangement at that date; and

c. the derecognition of any asset for Takaful acquisition cash flows and any other asset or liability previously recognised relating to the cash flows of the arrangement at the date of initial recognition,

Initial recognition of onerous arrangements

39. A Takaful arrangement is 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. Applying requirements of paragraph 22, such a Takaful arrangement shall be separately classified from the Takaful arrangements that are not onerous.

40. A loss in the 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 for Takaful arrangement being equal to the Takaful fulfilment cash flows and the Takaful residual margin being zero.

41. A significant number of onerous arrangements, depending on the business realities, may imply an act of potential negligence by the Takaful institution in its capacity as an agent of the PTF. This may particularly be more relevant where the Wakala fee is excessive. In rare circumstances, in line with the relevant Shari'ah principles and rules or regulatory requirements, such negligence situations may require the recognition of a receivable from the agent. Such receivables shall form part of the Takaful fulfilment cash flows.

42. In line with the requirements of paragraph 22, the Takaful institution may identify a group of onerous arrangements as a set instead of individual arrangements.

Subsequent measurement

Subsequent measurement of the provision for a Takaful arrangement

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

    a. the provision for the remaining entitlement period comprising of:

        i. the Takaful fulfilment cash flows related to future benefits allocated to the Takaful arrangement at that date;

        ii. the Takaful residual margin of the Takaful arrangement at that date; and

    b. the liability for incurred claims, comprising of Takaful fulfilment cash flows related to the past benefits allocated to the Takaful arrangement at that date.

44. The income and expenses shall be recognised in the statement of financial activities of the managed PTF for the following changes in the carrying amount of the provision for remaining entitlement period:

    a. recognise contribution (as an income) representing the reduction in the provision for the remaining entitlement period because of benefits provided during the period;

    b. expenses representing losses (and any reversal of losses) on onerous arrangements; and

    c. amortisation (or adjustment) of deferred cost (including any experience adjustment and financial risk elements).

45. Recognised contribution (as an income) are recognised when benefits are provided for a period, with a simultaneous reduction in the provision for the remaining entitlement period. Such a reduction (or change) in provision for the remaining entitlement period (that does not relate to the benefits attributable to the current period) does not include the following:

    a. cash inflows from contribution received;

    b. transaction-based taxes collected on behalf of third parties;

    c. Takaful acquisition cash flows;

    d. derecognition of liabilities transferred to third parties; and

    e. changes that relate to benefits attributable but for which compensation is not expected, i.e., increases and decreases in the loss component of the provision for the remaining entitlement period.

46. The income and expenses shall be recognised in the statement of financial activities of the managed PTF for the following changes in the carrying amount of the liability for incurred claims for benefits:

a. expenses representing the increase in liability because of claims for benefit and expenses incurred in the period;

b. expenses representing subsequent changes in Takaful fulfilment cash flows relating to incurred claims and expenses; and

c. amortisation (or adjustment) of deferred cost (including any experience adjustment and financial risk elements) as applicable on amounts excluding established payables (debts). [Explanation: Established payables shall not be subject to fair value measurement, in accordance with Shari'ah principles and rules].

47. Subsequent measurement shall take into account any experience adjustments, if any, that may arise:

a. in respect of the receipts of contribution (and any related cash flows such as Takaful acquisition cash flows and directly related taxes) – being the difference between the estimate at the beginning of the period of the amounts expected for the period and the actual cash flows during the period; or

b. in respect of the Takaful acquisition cash flows – being the difference between the estimate at the beginning of the period of the amounts expected for the period and the actual costs incurred during the period.

Subsequent measurement of Takaful residual margin

48. The Takaful residual margin at the end of the reporting period represents the surplus in the Takaful arrangements that have not yet been recognised in the statement of financial activities of the managed PTF because it relates to the future benefits to be provided under the Takaful arrangement.

49. The carrying amount of the Takaful residual margin of a Takaful arrangement at the end of the reporting period equals the carrying amount at the start of the reporting period adjusted for:

a. the effect of any new arrangements added, in case of accounting being performed collectively for a group;

b. the amortisation of deferred Takaful residual margin over the entitlement period – through a systematic method reflecting the pattern of utilisation of entitlement for benefits;

c. the changes in Takaful fulfilment cash flows relating to future benefits, except:

   i. the increases in the Takaful fulfilment cash flows that exceed the carrying amount of the Takaful residual margin, giving rise to a loss; or

   ii. the decreases in the Takaful fulfilment cash flows that are allocated to the loss component of the provision for the remaining entitlement period.

d. the effect of any currency exchange differences on the Takaful residual margin; and

e. the contribution recognised as income in the statement of financial activities of the managed PTF because of the provision of benefits in the period, determined by the allocation of the Takaful residual margin remaining at the end of the reporting period (before any allocation) over the current and remaining entitlement period.

50. Certain changes in the Takaful residual margin offset changes in the Takaful fulfilment cash flows for the provision for the remaining entitlement period, resulting in no change in the total carrying amount of the provision for the remaining entitlement period. To the extent that changes in the Takaful residual margin do not offset changes in the Takaful fulfilment cash flows for the provision for the remaining entitlement period, the income and expenses for the changes shall be recognised in the statement of financial activities of the managed PTF.

51. The Takaful residual margin recognised during the period shall be taken to the statement of financial activities of the managed PTF.

52. An institution may decide to follow the variable fee approach (VFA) instead of the general approach, in the case of Takaful arrangements having a direct investment component in form of a PIF. In such case, an institution may decide to have an accounting policy in respect of the subsequent changes in the Takaful residual margin, to the extent that these relate to the financial risks (including the changes in the investment returns in PIF), in a manner that such proportion of provision for Takaful residual margin that relates to the future entitlement periods may not be immediately recognised and apportioned over the remaining entitlement periods.

Subsequent changes in onerous arrangements

53. A Takaful arrangement becomes onerous (or more onerous) on subsequent measurement, if the carrying amount (unamortised) of the Takaful residual margin is less than the unfavourable changes in the Takaful fulfilment cash flows allocated to the Takaful arrangement relating to future benefits.

54. After the recognition of a loss on an onerous arrangement, the subsequent changes in the estimates of Takaful fulfilment cash flows for the remaining entitlement period shall be allocated on a systematic basis between:

a. the loss component of the provision for remaining entitlement period; and

b. the provision for the remaining entitlement period, excluding the loss component.

55. Any subsequent decrease in Takaful fulfilment cash flows arising from changes in estimates of future cash flows relating to future benefits and any subsequent increases in the PTF’s share in the fair value of the underlying assets shall be allocated solely to the loss component until that component is reduced to zero. Applying requirements of paragraphs 56-57, a Takaful institution shall adjust the Takaful residual margin only once the loss component has been reduced to zero.

56. The loss component for the purpose of paragraphs 54-55 shall be the amount equivalent to the total amount recognised in the statement of financial activities of the managed PTF to date, on initial recognition or subsequent measurement of the Takaful arrangement as onerous (net of any already recognised reversals).

57. The subsequent changes in the Takaful fulfilment cash flows for the remaining entitlement period to be allocated shall include:

    a. estimates of the fair value of the future cash flows for claims and expenses released (i.e., the difference between the opening estimate against the closing estimate) from the provision for the remaining entitlement period because of incurred Takaful benefit costs;

    b. changes in the risk adjustment for non-financial risk recognised in the statement of financial activities of the managed PTF because of the release of risk; and

    c. amortisation of deferred cost – through a systemic method reflecting the pattern of utilisation of entitlement for benefits, as applicable.

58. The systematic allocation required by paragraph 54 shall result in the total amounts allocated to the loss component in accordance with the requirements of paragraphs 56 and 57 being equal to zero by the end of the entitlement period of the Takaful arrangements.

Derecognition

59. A Takaful institution shall derecognise a Takaful arrangement when, and only when:

    a. it is extinguished, i.e., when the obligations specified in the arrangement are expired, discharged or cancelled; or

    b. the terms of the arrangement are modified by mutual agreement or by a change in regulations, and the Takaful institution recognises the modified arrangement as a new arrangement.

Recognition and presentation in the statement of financial activities of the managed PTF

60. The carrying amount of the following shall be presented separately in the statement of financial position of the managed PTF:

    a. Takaful arrangements issued that are assets;

    b. Takaful arrangements issued that are liabilities;

    c. re-Takaful arrangements issued that are assets; and

    d. re-Takaful arrangements issued that are liabilities.

61. A PTF shall present income or expenses from re-Takaful arrangements held separately from the expenses or income from the Takaful arrangements.

62. The Takaful expenses include incurred benefits, other expenses, changes related to past benefits and changes to future benefits (including losses on onerous arrangements and reversal thereof).

63. The income or expenses from a group of re-Takaful arrangements held may either be presented as a single amount or presented separately as the amounts recovered from the re-Takaful and an allocation of the contribution paid that together result in a net amount equal to that single amount.

Part C: Accounting for Takaful arrangements – under contribution allocation approach

Application criteria for the contribution allocation approach

64. A simplified approach, namely the contribution allocation approach, may be used to recognise, measure and report a Takaful arrangement if at the inception of the Takaful arrangement, either of the following condition is met:

    a. it is a reasonable expectation that such simplification would produce a measurement of the provision of the remaining entitlement period for the Takaful arrangement would not differ materially from the one produced by applying the requirements of part B "Accounting for Takaful arrangements – under the general approach / variable fee approach"; or

    b. the entitlement period of each Takaful arrangement (including the entitlement for benefits arising in respect of all contributions) is one year or less.

65. It is a presumption that the criteria in paragraph 64 are not met if at the inception of the Takaful arrangement, the Takaful institution expects significant variability in the Takaful fulfilment cash flows that would affect the measurement of the provision for the remaining entitlement period. Variability in the Takaful fulfilment cash flows increases with the following:

    a. the extent of future cash flows relating to the Takaful arrangement; and

    b. the length of the entitlement period of the Takaful arrangements.

66. Any general requirements contained in part B "Accounting for Takaful arrangements – under general approach / variable fee approach", may also apply to the contribution allocation approach unless contradicting with any specific requirements of part C "Accounting for Takaful arrangements – under contribution allocation approach".

Initial recognition

Assessment for onerous or potentially (in future) onerous arrangements

67. Where the contribution allocation approach is applied, the Takaful institution shall generally consider the whole portfolio at the time of initial recognition as not being onerous. However, if it is apparent (or there exists a significant risk) based on the facts and circumstances, then the Takaful institution shall perform an assessment in respect of:

    a. such arrangement(s) in the portfolio that are onerous in nature; and / or

    b. such arrangement(s) in the portfolio has a significant possibility of subsequently turning onerous.

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

    a. the contribution, if any, received (or receivable) at initial recognition;

    b. less: Wakala fee;

c. less: any Takaful acquisition cash flows at that date unless these are recognised as expenses applying requirements of paragraph 69(a); and

d. add or less: the amount arising from the derecognition at the date of the asset or liability recognised for Takaful acquisition cash flows.

69. In applying the contribution allocation approach, a Takaful institution:

a. may choose to recognise any Takaful acquisition cash flows as expenses when it incurs those costs, provided that the entitlement period of each Takaful arrangement at initial recognition is not more than one year; and

b. shall measure the liability for incurred claims for the Takaful arrangements and the Takaful fulfilment cash flows relating to incurred claims. However, the Takaful institution is not required to adjust future cash flows for the difference between the total cash flows and the fair value of those cash flows if those cash flows are expected to be paid or received in one year or less from the date the claims are incurred.

70. In case the cash outflows are spread over a period of more than one year, and the difference between the total expected cash outflows and their fair value is material, a Takaful institution shall adjust the carrying amount of the provision for remaining entitlement period to its fair value and shall record such difference initially as deferred cost.

Subsequent measurement

71. At the end of each subsequent reporting period, the carrying amount of the provision for the remaining entitlement period is:

a. the carrying amount at the beginning of the reporting period;

b. add: the contributions received during the period;

c. less: Takaful acquisition cash flows, unless they are recognised as an expense;

d. add: amortisation of Takaful acquisition cash flows recognised as expense (if applicable);

e. less: amortisation of any deferred Takaful acquisition cash flows, if such deferred Takaful acquisition cash flows are recognised in line with the requirements of paragraph 60(a);

f. add: the amount recognised as earned Takaful contributions against the entitlement for benefits attributable to that period; and

g. less: any investment component (from PIF) paid or transferred to the liability for incurred claims.

72. When the contribution allocation approach is applied, the amount of recognised contribution for the period is the amount of expected contributions allocated to the period. The expected contributions shall be allocated to each period:

a. on the basis of the passage of time; but

b. if the expected pattern of release of risk during the entitlement period differs significantly from the passage of time basis, then on the basis of the expected timing of incurred Takaful benefits.

Onerous arrangements

73. If at any time during the entitlement period, facts and circumstances indicate that a Takaful arrangement is onerous, a Takaful institution shall perform a computation of excess / shortfall of the following:

a. the carrying amount of the provision for remaining entitlement period; and

b. the Takaful fulfilment cash flows that relate to the remaining entitlement period of the Takaful arrangement.

74. In case of a shortfall of the carrying amount of the provision for the remaining entitlement period against Takaful fulfilment cash flows relating to the remaining entitlement period of the Takaful arrangement, the Takaful institution shall recognise a loss in the statement of financial activities of the managed PTF and increase the provision for remaining entitlement period by such amount of shortfall.

Part D: Accounting for re-Takaful arrangements held by the PTF

General approach for re-Takaful arrangements held

75. A Takaful institution shall divide portfolios of re-Takaful arrangements held by applying the requirements of part B “Accounting for Takaful arrangements – under general approach / variable fee approach” except that the references to onerous arrangements therein shall be replaced by a reference to arrangements on which there is a net gain on initial recognition. [Explanation: Such gain shall compensate for losses arising in PTF on account of the onerous arrangements.]

76. Any general requirements contained in part B “Accounting for Takaful arrangements – under general approach / variable fee approach”, shall also apply to the accounting for re-Takaful arrangements held unless contradicting with any specific requirements of part D “Accounting for re-Takaful arrangements held by the PTF”.

Initial recognition

77. Instead of applying paragraph 29, a PTF shall recognise an asset (or provision, as the case may be) for re-Takaful arrangements held:

    a. if the re-Takaful arrangements held provide a proportionate entitlement period – at the beginning of the entitlement period of the re-Takaful arrangement held or at the initial recognition of any underlying Takaful arrangement (whereby in case of underlying onerous arrangement, the corresponding effect shall be immediately recognised), whichever is the later; and

    b. in all other cases – from the beginning of the entitlement period of the re-Takaful arrangement held.

78. A re-Takaful arrangement held that provides proportionate benefits against underlying Takaful arrangements shall not be initially recognised until the date that any underlying Takaful arrangement(s) is initially recognised if that date is later than the beginning of the entitlement period of such re-Takaful arrangement.

79. If the net cost of acquisition of re-Takaful arrangements has entitlement for benefits relating to events that have already occurred, such cost shall be immediately recognised in the statement of financial activities of the managed PTF.

80. In case a loss is recognised on initial recognition of an onerous underlying Takaful arrangement (or on the addition of an onerous underlying Takaful arrangement to a group), the Takaful residual margin of a related re-Takaful arrangement held (to such extent) shall be immediately recognised in the statement of managed financial activities of the managed PTF.

81. In the case where a Takaful institution has applied the requirements of paragraph 80 when such losses are recovered in a subsequent period, a loss-recovery component of an asset for the remaining entitlement period shall be correspondingly reversed.

Subsequent measurement

82. In applying the measurement requirements as contained in paragraphs 43-47 to re-Takaful arrangements held, the PTF shall apply consistent assumptions to measure the estimates of the fair

value of the future cash flows for such re-Takaful arrangements held and the estimates of the fair value of the future cash flows for the underlying Takaful arrangements. [Explanation: This requirement shall not be applied in case the underlying Takaful arrangements are not accounted for in line with the requirements of the referred paragraphs.]

83. In respect of the re-Takaful arrangements held, the PTF shall also include the risk of non-performance by the re-Takaful provider (including effects of collateral and losses from disputes) in the estimate of the future cash flows, as well as, their fair value.

84. Instead of applying the requirements of paragraph 35, a PTF shall determine the risk adjustment for non-financial risk so that it represents the amount of risk being transferred by the holder of the re-Takaful arrangements to the issuer of those re-Takaful arrangements.

85. Application of the requirements of paragraphs 37 and 38 relating to determining the Takaful residual margin on initial recognition, in respect of re-Takaful arrangements held, shall be subject to the following modifications:

   a. the PTF shall recognise any net cost or net gain (instead of unearned margin) on the acquisition of the re-Takaful arrangements held as a Takaful residual margin measured at an amount equal to the sum of the Takaful fulfilment cash flows, the amount derecognised at that date of any asset or liability previously recognised for cash flows related to the re-Takaful arrangements held and any cash flows arising at that date; unless

   b. the net cost of acquiring re-Takaful entitlement relates to events that occurred before the acquisition of the re-Takaful arrangements, in which case, notwithstanding the requirements of paragraph 36, such a cost shall immediately be recognised in the statement of financial activities of the managed PTF as an expense.

86. Instead of application of paragraph 49, the Takaful residual margin at the end of the reporting period in respect of re-Takaful arrangements held shall be computed as the carrying amount determined at the start of the reporting period, adjusted for:

   a. the effect of any new arrangements;

   b. amortisation of deferred cost added back to the carrying amount of the Takaful residual margin;

   c. changes in the Takaful fulfilment cash flows to the extent that the change:

      i. relates to the future benefits entitlement; unless

      ii. it results from a change in the Takaful fulfilment cash flows allocated to the underlying Takaful arrangement that does not adjust the Takaful residual margin for the underlying Takaful arrangement;

   d. the effect of any currency exchange differences arising on the Takaful residual margin; and

e. the amount recognised in the statement of financial activities of the managed PTF because of benefits received in the period, determined by the allocation of the Takaful residual margin remaining at the end of the reporting period of the re-Takaful arrangements held.

87. Changes in the Takaful fulfilment cash flows that result from changes in the risk of non-performance by the issuer of a re-Takaful contract held do not relate to future benefits and shall not adjust the Takaful residual margin.

88. A re-Takaful arrangement held cannot be onerous under the requirements of this standard.

Contribution allocation approach for re-Takaful arrangements held

89. A Takaful institution may use the contribution allocation approach set out in paragraphs 64-72 (adapted to reflect the features of re-Takaful arrangements held that differ from Takaful arrangements issued, for example, the generation of expenses or reduction in expenses rather than revenue) to simplify the measurement of re-Takaful contracts held, if at the inception of the Takaful arrangement:

a. the Takaful institution reasonably expects the resulting measurement would not differ materially from the result of applying the requirements of paragraphs 77-88; or

b. the entitlement period of each of the re-Takaful arrangements held (including an entitlement for benefits from all contributions within the Takaful arrangement boundary determined at that date applying the requirement of paragraph 31 is one year or less.

90. A Takaful institution cannot meet the condition provided in paragraph 89 if at the inception of the Takaful arrangement, it expects significant variability in the Takaful fulfilment cash flows that would affect the measurement of the asset for remaining entitlement for benefits during the period before a claim is incurred. Variability in the Takaful fulfilment cash flows increases with, for example:

a. the extent of future cash flows relating to the Takaful arrangement; and

b. the length of the entitlement period of the re-Takaful arrangements held.

Part E: Accounting for the Takaful operator and significant issues related to business model of Takaful

Separation of accounting records

91. The assets, liabilities and owners' equity, as well as, income and expenditure, gains and losses of the Takaful operator shall be recorded and reported separately and distinctly from the assets, liabilities and surplus / deficit and related income and expenditure, gains and losses of the managed PTF or the managed PIF.

Recognition of initial seed money paid to the PTF

92. The Takaful operator, at times, provides the initial seed money to set up the PTF. The seed money so paid is in the nature of Hiba (gift). The Takaful operator does not have any remaining rights on the seed money given to the PTF, even at the time of liquidation of the PTF.

In the books of the Takaful operator

93. The Takaful operator shall recognise in its books the initial seed money as an expense at the earlier of:

   a. payment of seed money to the PTF; or

   b. making an irrevocable commitment for such payment.

In the books of the PTF

94. The PTF shall recognise the initial seed money received / receivable from the Takaful operator as PTF equity[5] at the same time as provided in paragraph 93.

Transfer of assets between various funds

95. At times, there is a need to transfer assets (including cash, investments or other assets) between the Takaful operator and the PTF or PIF managed by the Takaful operator for routine business operations.

96. There is a rebuttable presumption that such assets, in line with the Shari'ah principles and rules, are transferred between the Takaful operator and any of the managed funds or between two of the managed funds at fair value (considering these are arms' length transactions).

97. A Takaful institution shall apply, in respect of all such transfers of assets, the disclosure requirements with the respective AAOIFI FAS[6]. In addition, if the basis of valuation applied for the transfer of such assets is other than the fair value of such assets as of the date of transfer, the Takaful institution shall disclose the difference in the value applied with the fair value, as well as, the reasons for applying the value other than the fair value.

[5] In case of a PTF based on Waqf, such equity shall be treated as Waqf corpus in line with the Shari'ah principles and rules as applicable to Waqf.

[6] Presently, FAS 21 "Disclosure on Transfer of Assets"

Surplus / deficit determination and surplus distribution

Surplus / deficit determination

98. Takaful surplus or Takaful deficit shall be determined as the net surplus or deficit for the reporting period appearing in the statement of financial activities of the managed PTF, in line with the requirements of this standard read with the requirements of FAS 42 “Presentation and Disclosures in the Financial Statements of Takaful Institutions”, after due transfers from / to the technical reserves.

99. In case a Takaful institution determines surplus / deficit in respect of a PTF in a manner different from the requirements of paragraph 98, the basis of determination of the same, along with the rationale for the same, shall be disclosed.

100. In case of deficit, the Takaful operator generally provides a Qard Hasan to the PTF (see paragraphs 109-112).

101. A Takaful institution shall disclose the accumulated amounts of deficit in the PTF and its projections (at least for five years) with regard to the probable surplus in future periods to compensate for such deficits.

Risk reserves in PTF – created out of Takaful surplus

102. The Takaful surplus is distributable to the participants in line with the Shari’ah principles and rules, as well as, the contractual arrangements with the participants. However, at times a Takaful institution creates / set-aside risk reserves in the PTF out of the determined Takaful surplus for the reporting period. This is intended for managing the investment risk volatility, surplus / deficit volatility or any other suitable risk factors for the greater mutual benefit, in line with the requirements of Shari’ah principles and rules, as well, as contractual arrangements with the participants.

103. Such risk reserves, where applicable, and any transfer thereto / therefrom, from / to the Takaful surplus shall be accounted for and disclosed in line with the requirements of the respective AAOIFI FAS[7].

Adequate level of risk reserves

104. Adequate level of risk reserves in respect of PTF shall be determined by the management considering the overall guidance provided in paragraphs 15 and 16 of FAS 35 “Risk Reserves” suitably adapted to the nature of operations and investments held, as well as, risks specific to the Takaful operations.

Takaful surplus distribution

105. A Takaful institution shall disclose the amounts of surplus due to be distributed to the participants at the end of the reporting period, along with the reasons for the delay in such distribution and details in respect of the upcoming distribution of the same (in terms of periodic amounts and the distribution methodology).

106. A Takaful institution shall disclose the approach followed for the allocation of the Takaful surplus amongst participants with necessary quantitative information, as appropriate. The common

[7] FAS 35 “Risk Reserves”

allocation approaches, in line with Shari'ah principles and rules, may generally, but not necessarily, include:

a. allocation of surplus to all participants, regardless of whether they have made claims or not, during the reporting period[8];

b. allocation of surplus only amongst participants who have not made any claims during the reporting period; and /or

c. allocation of surplus amongst those who have not made any claims and among those who have made claims of amounts less than their contributions, whereby the latter category of participants receives only the difference between their contributions and their claims during the reporting period.

Risk reserves in PIF

107. At times a Takaful institution creates / set-aside risk reserves in the PIF for managing the investment risk volatility, rate of return / profit volatility or any other suitable risk factors in the greater mutual benefit, in line with the requirements of Shari'ah principles and rules, as well as, contractual arrangements with the investing participants.

108. Such risk reserves, where applicable, and any transfer thereto / therefrom shall be accounted for and disclosed in line with the requirements of relevant AAOIFI FAS[9].

Qard Hasan – recognition and measurement in the books of the PTF

109. In case of a deficit (or liquidity shortfall), the Takaful operator may decide (or may be required by virtue of the relevant regulations) 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 (and / or generates sufficient liquidity).

Initial recognition

110. The PTF shall recognise the Qard Hasan received from the Takaful operator as a liability at the par value of the amount received.

Subsequent measurement

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

Waiver of Qard Hasan

112. Where the Takaful operator 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.

[8] In line with the Shari'ah principles and rules, this method is preferred unless the Takaful arrangement or the by-laws prescribe any alternate method.

[9] FAS 35 "Risk Reserves"

Qard Hasan – recognition and measurement in the books of the Takaful operator

Initial recognition

113. The Takaful operator shall recognise the Qard Hasan extended to the PTF as a receivable at the par value of the amount paid since it is receivable on demand.

Subsequent measurement and expected credit losses

114. The Takaful operator shall subsequently measure the receivable against Qard Hasan at par value, accounting for any payments / repayments / adjustments during the period.

115. Qard Hasan receivable from the PTF shall be subject to periodic testing for expected credit losses in line with the requirements of the relevant AAOIFI FAS[10], whereby an allowance for expected credit losses if any, shall be maintained against such receivable. The Takaful operator shall consider, in particular, the deficit in the PTF and the PTF's projections (at least for five years) with regard to the probable surplus in future periods to compensate for such deficits (or liquidity shortfalls) in line with the requirements of paragraph 101.

Waiver of Qard Hasan

116. When the Takaful operator waives the Qard Hasan, the receivable shall be derecognised, and a corresponding expense shall be recorded in the books of the Takaful operator.

Hiba

117. In rare circumstances, the Takaful operator may contribute cash or another asset as Hiba (gift) to the PTF, subject to the Shari'ah principles and rules and the relevant legal and regulatory requirements.

In the books of the Takaful operator

118. The Takaful operator shall recognise a Hiba in its books as an expense at the earlier of:

    a. payment of cash or transfer of other assets to the PTF; and

    b. making an irrevocable commitment for such payment or transfer.

119. In the case of Hiba of an asset other than cash, the same shall be valued at fair value, and any difference from carrying value shall be recognised immediately as expense or income in the statement of income of the Takaful operator.

In the books of the PTF

120. The PTF shall recognise any Hiba received from the Takaful operator as income at the same time as provided in paragraph 118.

121. In the case of Hiba of an asset other than cash, the same shall be recognised at fair value in the PTF's books.

Recognition of Wakala fee earned from PTF in the books of the Takaful operator

122. The Takaful operator earns revenue in the form of Wakala (management) fee in different forms and under various contracts. This fee may be fixed or variable in nature.

[10] FAS 30 "Impairment, Credit Losses and Onerous Commitments"

123. The Wakala fee charged by the Takaful operator to the PTF is generally against performance obligations for various services / costs (excluding the investment management function) to be classified, and the relevant revenue recognition shall be commensurate with the relevant services as follows:

a. services initially or already delivered – hence, the related proportion of Wakala fee to be recognised immediately – including marketing services for Takaful products, initial administrative services (both before and at the time of issuance of a Takaful arrangement) and Takaful acquisition service costs including commissions and incentives etc.;

b. services delivered over time – hence, the related proportion of Wakala fee to be recognised over such time in a systematic manner – including 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 etc.; and

c. probable refund of Wakala fee against cancelled or discontinued Takaful arrangements (if so provided for in the Wakala contract between the Takaful institution and the PTF) – hence, the estimated effect to be recorded as a provision for Wakala fee refund and shown as a deduction from the total Wakala fee.

124. The Takaful institution shall adopt accounting policies for the Takaful operator in line with relevant AAOIFI FASs to separate the different components of the Wakala fee in line with the approach provided in paragraph 123, applying an appropriate methodology for ascertaining and assessing the same. The accounting policies shall also include the bases for recognition of each component of the Wakala fee and the corresponding costs.

Takaful acquisition service cost – in the books of the Takaful operator

125. The Takaful acquisition service costs (or gain), including the allocation charges (see paragraphs 130-132) related to a Takaful arrangement that is received (or receivable) and paid (or payable) before the Takaful arrangement is recognised, shall be recorded as either:

a. an asset or liability in the books of the Takaful operator to be amortised over a period commensurate with the corresponding flow of economic benefits – provided that:

i. any such asset shall be subject to testing for impairment on a periodic basis; and

ii. in case of cancellation of the respective Takaful arrangement, the liability may be extinguished, and asset may be fully impaired immediately; or

b. as an expense or income in the books of the Takaful institution immediately.

Takaful operator's investment management fee / share of investment income from PIF and PTF

Mudarib's share

126. The Takaful operator shall recognise the Mudarib's share arising out of investment profits from the PTF and PIF after adjusting for any risk reserves, as per contractual arrangements in line with the Shari'ah principles and rules, as its revenue, at the end of each reporting period.

Wakala fee: fixed, variable and performance incentive

127. The Takaful operator shall recognise the fixed Wakala fee, as well as, any variable Wakala fee which is not in form of a performance incentive, as its revenue in line with the contractual arrangements as it establishes right on such revenue and the same may be measurable with reasonable certainty.

128. The Takaful operator shall recognise the variable element of the Wakala fee, which is in form of a performance incentive, at the end of each reporting period. However, if such an incentive is contractually determined at a later stage, the same shall be recognised once it is determined.

Corresponding recognition by the PTF and PIF

129. The PTF and PIF shall recognise corresponding costs for the items provided in paragraphs 126-128 at the same time as the Takaful operator recognises its revenue.

Allocation charges

130. The Takaful operator shall recognise the allocation charges (including, Wakala fee / front-end fee etc., by whatever name called) recovered / recoverable from the participants in respect of the investment made in PIF as a part of net Takaful acquisition service cost (or gain) in line with the requirements of paragraph 125.

131. The Takaful operator shall recognise the allocation charges (including, Wakala fee charges / front-end fee etc., by whatever name called) charged to the participants in respect of the investment made in PIF as a part of net Takaful acquisition service cost (or gain) in line with the requirements of paragraph 125.

132. The allocation charges shall be disclosed by the Takaful operator separately from other Wakala fees.

Taxation for PTF and PIF

133. Unless the PTF and / or PIF is considered exempt from income taxes, the Takaful institution shall ensure that any tax benefit or expense (including related deferred tax effect) pertaining to the PTF and / or PIF is passed on to the respective fund.

Effective date

134. This standard shall be effective on the financial statements of the Takaful institution for the annual financial reporting period beginning on or after 01 January 2025. Early adoption of the standard is permitted if adopted alongside FAS 42 “Presentation and Disclosure in the Financial Statements of Takaful institutions”.

Transitional provisions

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

   a. a full retrospective approach – whereby the effects of transition shall be incorporated from the beginning of the earliest period presented in the financial statements; however, the disclosure of the effect of such adoption in respect of each line item and to the basic and diluted earnings per share shall not be mandatory; or

b. a modified retrospective approach – 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

c. a fair value approach – whereby the Takaful residual margin or loss component of the provision for the 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.

Amendments to other standards

136. This standard supersedes the following standards:

a. FAS 13 “Disclosure of Bases for Determining and Allocation Surplus or Deficit in Islamic Insurance Companies”;

b. FAS 15 “Provisions and Reserves in Islamic Insurance Companies”; and

c. FAS 19 “Contributions in Islamic Insurance Companies”.

Appendices

Appendix A: Adoption of the standard

This standard was presented for the approval in the 32nd AAOIFI Accounting Board meeting held on 6 Jumada II 1444H, corresponding to 14 December 2022 and was duly approved.

Members of the board

1. Mr. Hamad Abdulla Al Oqab – chairman
2. Mr. Syed Najmul Hussain – deputy chairman
3. Mr. Abdelhalim Elsayed Elamin
4. Mr. Abdulmalik Alsuwayni
5. Dr. Abdulrahman M. Alrazeen
6. Ms. Amal Al Masri
7. Dr. Bello Lawal Danbatta
8. Mr. Firas Hamdan
9. Mr. Hondamir Nusratkhujaev
10. Mr. Imtiaz Ibrahim
11. Mr. Irshad Mahmood
12. Dr. Muhammad Albeltagi
13. Mr. Saud Al Busaidi
14. Mr. Yusuf Ibrahim Hassan

Reservation

The standard was approved unanimously.

Working group members

1. Mr. Irshad Mahmood – chairman
2. Mr. Omer Morshed – deputy chairman
3. Mr. Abdulla Ghazwan
4. Mr. Abdul Moid Ahmed Khan
5. Mr. Aziz Adil
6. Sheikh Ali Musleh Ali Sartawi
7. Sheikh Dr. Faizal Ahmad Manjoo
8. Ms. Intan Natasha Putri
9. Mr. Jamil Ahmed Shaikh
10. Mr. Muhammad Kashif Siddiqee
11. Mr. Kazi Mortuza Ali
12. Dr. Luqyan Tamani
13. Mr. Mohamed Awad
14. Mr. Mohammed Hammad
15. Mr. M. Venkatesan
16. Mr. Rohail Asghar
17. Dr. Shahnawaz Khan
18. Dr. Sulaiman Aljewisser

Executive team

1. Mr. Omar Mustafa Ansari (AAOIFI)
2. Mr. Mohammad Majd Bakir (AAOIFI)
3. Mr. Haroon Tabraze (Senior Consultant-Researcher)
4. Ms. Farida Cassim (AAOIFI)

Appendix B: Basis for conclusions

Applicability of the basis for conclusions of the FAS 42 "Presentation and Disclosures in the Financial Statements of Takaful Institutions"

BC1 This standard and FAS 42 "Presentation and Disclosures in the Financial Statements of Takaful Institutions", were developed as part of the same project of revision of earlier AAOIFI FASs on Takaful. Hence, several discussions and deliberations at the working group and the board have an equal impact on both standards. Accordingly, such discussions are not repeated unless considered extremely necessary. The "basis for conclusions" for the two standards shall be read in conjunction with each other.

Applicability to different Takaful models

BC2 There are various models of Takaful prevalent in different jurisdictions. These are primarily based on Wakala, Mudaraba or a combination of both. The board considered four of the most common models of Takaful that are used globally and decided to develop the standard on the Wakala model in line with the AAOIFI SSs. The Wakala-Waqf model, although not specifically prescribed by the AAOIFI SSs, is only a variant of the same model and hence is considered to be in compliance with the AAOIFI SSs, therefore, the same is also covered in this standard.

BC3 On the contrary, the board concluded that the Mudaraba model and the cooperative model are not considered in accordance with the AAOIFI SSs and hence are not included in this standard. The board further considered that certain conclusions reached, e.g., the principal-agent relationship for the Takaful model, may not be similarly applicable to these two models, and hence these were considered to be irrelevant to this standard.

Accounting for managed PTF and application of insurance accounting model on the PTF only, instead of the Takaful institution

BC4 In the Wakala model or the Wakala-Waqf model, the relationship between the Takaful institution (as the Takaful operator) and the Takaful funds usually takes the form of a principal and agent relationship. Such relationships shall be presented according to the respective AAOIFI FAS[11], as well as the "AAOIFI Conceptual Framework for Financial Reporting" (the conceptual framework) as off-balance-sheet assets under management. The board considered that although the Takaful institution has power, yet such power is exercisable in a fiduciary capacity as an agent only, and in its nature, does not result in variable returns to the institution itself. The board also agreed that the risks and rewards with regard to the Takaful operations do not lie with the Takaful institution. The Takaful institution may be eligible to receive performance incentives in the capacity of the agent, being in a fiduciary capacity. These cannot be considered as variable returns as the Takaful institution is not exposed to the risk of sharing a loss. It was concluded that such funds are considered off-balance-sheet assets under management, and therefore distinct from the Takaful institution.

BC5 It is also worthwhile to note that the Takaful institution is not entitled to any surplus arising in the PTF. Where the PTF incurs a deficit, the Takaful institution may be obligated to temporarily support it through a Qard Hasan. The board agreed that the Qard Hasan, by its very nature, is to be paid back to the Takaful institution without a definite time of repayment, and hence, generally shall be

[11] FAS 31 "Investment Agency (Al-Wakala Bi Al-Istithmar)"

considered as short-term in nature. Therefore, it does not tantamount to the entitlement of variable returns.

BC6 In view of the above, the board further contemplated the applicability of accounting treatments related to the insurance / underwriting business on the Takaful institution and the PTF. It was considered that the Takaful institution acts in the capacity of an agent. On the contrary, in the structure of Takaful, the risk of sharing losses is assumed by the PTF only. Hence, the equivalent to the conventional term "insurer" in the Takaful perspective is the PTF, and not the Takaful institution. In view of the same, it was concluded that primarily the PTF, and not the Takaful institution, shall be subject to the accounting requirements of this standard, which is equivalent to the conventional financial reporting standard on insurance.

Terminologies used in this standard and their conventional equivalents

BC7 The board considered that various terms used in the generally accepted accounting principles reflect the nature of the insurance as a combination of a risk transfer and service business (both being in form of a commutative contract) therefore cannot faithfully represent the mutually shared risk-bearing nature of Takaful. Commutative contracts (at times referred to as exchange-based contracts) are such contracts in which what is done, given or promised by one party is considered same as the other or in consideration of what is done, given or promised by the other.

BC8 The board concluded that a Takaful arrangement is not a commutative contract and hence may not attract the same accounting treatment (see paragraphs BC4-BC6). Accordingly, the board agreed that certain terms used in conventional insurance and related financial reporting standards are not suitable for the Takaful business and hence shall be replaced with more suitable terms for the purpose of this standard.

BC9 The following table summarises the significant modified terms that are used in this standard or were introduced in FAS 42 "Presentation and Disclosures in the Financial Statements of Takaful Institutions."

<table>
<tr><th></th><th>Conventional term</th><th>Term used in this standard</th><th>Difference in accounting (if any)</th></tr>
<tr><td rowspan="2">1.</td><td>Insurance "contract"</td><td>Takaful "arrangement"</td><td>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.</td></tr>
<tr><td colspan="3">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.</td></tr>
</table>

<table>
<tr><td>2.</td><td>Premium (and the derivative terms)</td><td>Contribution</td><td>Takaful is a risk sharing non-commutative contract, whereas insurance is a commutative contract.</td></tr>
<tr><td></td><td colspan="3">Rationale: The term contribution reflects the Tabarru contract where participants agree to make a donation to the PTF for mutual sharing of risk.</td></tr>
<tr><td>3.</td><td>Coverage (and derivative terms)</td><td>Benefits entitlement</td><td>A conventional insurance contract creates a coverage for the insured person.</td></tr>
<tr><td></td><td colspan="3">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”.</td></tr>
<tr><td>4.</td><td>Contractual Service Margin (CSM)</td><td>Takaful Residual Margin (TRM)</td><td>CSM represents the unearned profit the entity will recognise as it provides insurance contract services under the insurance contracts in the group.</td></tr>
<tr><td></td><td colspan="3">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.</td></tr>
<tr><td>5.</td><td>Acquisition cash flows</td><td>Takaful acquisition cash flows

Takaful acquisition service cost</td><td>See BC12-BC14</td></tr>
</table>

Impermissibility of discounting of established receivables and payables

BC10 The conceptual framework prohibits discounting of established monetary receivables and payables, in line with the Shari’ah principles and rules. However, discounting may be used, as part of an estimation / computation method while making an estimate of fair value, a potential liability or a provision, a reserve or may be used to amortise an already earned (but deferred) profit for the purpose of recognition in the respective period for just and equitable attribution to different stakeholders.

BC11 The board considered various aspects of insurance accounting in line with the generally accepted accounting principles in view of the same, and accordingly concluded that any established receivables and payables (e.g., incurred claims, due contributions etc.) shall not be subject to any discounting and shall be carried at par value. On the contrary, any estimates for provisions and reserves (e.g., contributions receivable in the future or claims to be lodged in future and other future cash flow estimates) may be accounted for on a discounted basis by creating deferred costs and deferred profits and amortising them over the respective period.

Takaful acquisition cash flow vs. Takaful acquisition service cost

BC12 The issue of accounting for acquisition cash flows in line with the generally accepted accounting principles and its suitability for the Takaful business was discussed at length by the board and the working group. It was particularly considered that due to the unique nature of the Takaful business some of such costs are attributable to the PTF, while on the other hand, major part of such costs are to be borne by the Takaful institution being part of services being provided to the PTF by the Takaful institution under the contract of Wakala.

BC13 After due deliberation, it was decided that 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.

BC14 On the contrary, it was decided that 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.

Surplus / deficit / Takaful residual margin

BC15 The board discussed the treatment of surplus arising in the participants' Takaful fund. It was agreed that according to the Wakala (and Wakala-Waqf) model for Takaful, the surplus shall be determined and distributed to the participants, therefore should not be part of the Takaful fulfilment cash flows. It was observed that surplus may be unearned and recognised over a period of time, but deficit is onerous and shall always be recognised immediately. To clarify, a negative Takaful residual margin shall not arise as it will turn onerous.

BC16 The board discussed that the generally accepted accounting principles prescribe accounting treatments for insurance on group basis, whereas this standard is based on treatments for individual arrangements however, grouping similar arrangements is allowed under this standard. Where such grouping is applied, in line with the requirements of this standard, the surplus, deficit and / or Takaful residual margin shall be determined on the group basis.

Grouping into distinct portfolios

BC17 The board noted that the regulators may prescribe the distinct portfolios i.e., marine, fire etc. that are to be managed together according to the industry needs. However, it was clarified that when such a prescription is available, the Takaful arrangements would still be required to be divided under requirements of paragraph 22 into arrangements that are onerous, arrangements that have no significant possibility of subsequently turning into onerous, and the remaining arrangements.

Long-term Takaful arrangements

BC18 The board discussed the cases where the Takaful institution shall be using the contribution allocation approach. The general Takaful operations usually comprise of arrangements that are not for a term of more than one year. In this case, where the Takaful institution does not have long-term Takaful arrangements (of a period more than one year) it may follow the (simplified) contribution allocation approach, instead of the (more complicated) general approach.

BC19 The board further concluded that, in line with the generally accepted accounting principles, the long-term Takaful arrangements shall not to be clubbed together if they are more than one year apart. This is due to the reason that the Takaful residual margin needs to be computed for each year's group separately and amortised to such group's remaining period.

BC20 The board was of the view that keeping each year's arrangements separate will provide transparency as readers of the financial statements can identify financial performance of each year separately, as well as, will ensure that the groups which are onerous are accounted for immediately, rather than being merged with the profitable groups and hence effectively being amortised over the remaining period.

Recognition of provisions and liabilities

BC21 The board contemplated as to when the Takaful institution shall recognise a liability for cash outflows related to the benefits. It was observed that Takaful is based on mutuality, therefore, recognition of a provision of an estimated potential outflow shall be required, at the time when the arrangement is entered into, whether the contribution is received or not. Similarly, the recognition of the Takaful arrangement shall also entail a simultaneous recognition of a liability from PTF to the Takaful institution in relation to the Wakala fee (unless the contractual arrangements require otherwise).

BC22 Recognition of provision on day one is permissible in Shari'ah, although not being an established liability. However, this recognition cannot happen before the PTF assumes the risk arising from the Takaful arrangement. It is clarified that a Takaful institution may indicate assumption of the risk to the participant before entering into a formal arrangement, including hold cover or provisional cover situation. Further, in case where accounting is being done on a group basis, the group will be recognised on the day of the first arrangement.

BC23 The board further concluded that due to inherent uncertainties, the incurred but not reported (IBNR) claims are not established liabilities and are by nature provisions.

Accounting nature of contribution received from participants

BC24 A question was raised as to whether the contribution is revenue or equity for the PTF, as there is the concept of sharing and mutuality in this model. After due deliberation, it was concluded by the board that in the context of the PTF, any contribution from participants shall be in the nature of income (earned or unearned) and the PTF shall charge the benefits provided to participants as expenses in the statement of financial activities of the managed PTF.

BC25 The board was of the view that a crucial characteristic of equity is permanence, which is not present in this situation. On the contrary, the seed capital given is in the nature of equity, whereas Tabarru (non-commutative arrangement) is income for a Waqf. The undistributed surplus (or any reserves maintained out of such surplus) may be termed as equity till the time the same is distributed to the participants' or used to pay benefits in the future years.

BC26 The investment part shall be separated (unbundled) from the contribution at the time of initial recognition, in line with the contractual arrangements, and considered as equity of the participants in the books of the PIF (which are considered off-balance-sheet managed assets for the Takaful institution).

Recognition of profits and losses

BC27 The board discussed the differences in accounting of profit between conventional insurance and Takaful arrangements. The board observed that profit for the shareholders is the difference between the Wakala fee charged by the institution and cost incurred on the management of the participants' funds. The board particularly noted the perceived anomaly in accounting whereby in a conventional insurance institution, profit will be recognised over a period of time through amortisation of CSM, whereas in case of a Takaful institution it will be recognised immediately in line with the requirements of this standard.

BC28 The second anomaly exists when the PTF may be in a loss and the Takaful institution may have a profit because of (probably) the higher Wakala fee, which should not happen generally in case of an insurance company because of consolidated determination of underwriting results. Similarly, in certain cases, the Takaful arrangements may turn onerous at inception (in the books of the PTF) if a higher Wakala fee is charged by the Takaful institution.

BC29 After due deliberations, the board decided that these differences in accounting are justified due to the application of a different business model and the stakeholders of the Takaful institution are different from the stakeholders of PTF. Having said that, the board considered it important to have impairment testing of the Qard Hasan to ensure that excessive losses in the PTF and profits in the Takaful institution on an ongoing basis may be avoided (as it will address partially the accounting mismatch issue).

Variable fee approach

BC30 The ED originally issued, unlike the generally accepted accounting principles, did not include an option of application of variable fee approach for Takaful accounting. It was based on the premise that the structure of Takaful operation is based on the distinctiveness of the PTF and PIF. Certain comments were received in writing, as well as, during the public hearings that in practical situations, particularly for the computation part, variable fee approach may still be suitable to certain Takaful structures.

BC31 The working group and the board considered arguments for and against the suitability of variable fee approach for Takaful structures, as well as, discussed the question as to whether such suitability impacts only the actuarial valuation techniques, or also has an accounting impact.

BC32 After due deliberations, the board decided to include the principle-based guidance for allowing the variable fee approach to certain Takaful structures with regard to the treatment of subsequent changes in the TRM in line with the variable fee approach (see paragraph 52).

BC33 The board's conclusion was reached particularly considering that in the case of family Takaful with investment components (PIF), the benefit represents the payment to the 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 and any changes with regards to the performance and the changes in assumptions impact the amount of benefits eventually paid by the PTF. Accordingly, allowing a treatment similar to the generally accepted accounting principles would be justified.

BC34 Similarly, a clarificatory change in the definition of benefits was also made.

The boundary of a Takaful arrangement

BC35 The board considered a question as to what shall constitute the boundary of a Takaful arrangement for accounting purpose and as to whether the same shall have different connotations as compared to the boundary of an insurance contract. This issue arose because contrasting to an insurance contract, the Takaful arrangement may comprise of multiple contracts with different stakeholders, in different capacities. Hence, the determination of the boundary may be different in this context.

BC36 After due deliberations, the board concluded that the boundary of a Takaful arrangement shall be similar, from an accounting perspective to the boundary of an insurance contract. Both shall be determined in line with the substantive rights and obligations that exist during the reporting period in which the policyholder or the participant may be compelled to pay the premiums / contributions or in contrast, the period in which the insurance company / the Takaful institution (on behalf of the PTF) has a substantive obligation to provide the policyholders / participants with insurance contract services / entitlement for benefits. Having said that, the difference shall remain in the context of the multiple contracts / arrangements being part of a Takaful arrangement, which for the purpose of determining a boundary shall all be considered together.

Initial seed money

BC37 The board discussed the nature of the seed money, if any, provided by the Takaful institution to set up the PTF. The board contemplated to recognise it as capital or a liability. After deliberation, it was concluded that the nature of such seed money in the books of the PTF is equity, that is not to be paid back to the Takaful institution. In case of a Wakala-Waqf model it may serve as the waqf corpus as well.

BC38 The board further concluded that the same shall be charged as an expense in the books of the Takaful institution as the institution loses control over this fund as soon as the same is paid (including e.g., the right to get it back even in case of liquidation or to earn a return thereon).

Qard Hasan

BC39 The board discussed the nature of Qard Hasan at length. It was noted that the Takaful institution does not have any obligation according to Shari’ah principles and rules to make up the losses arising in the PTF. It was observed that the contractual model of Takaful, the regulatory requirements or the market practices may compel the Takaful institution to provide a temporary loan to the PTF which is allowed under Shari’ah principles and rules as a temporary interest-free loan only.

BC40 The board concluded, in view of the same that Qard Hasan shall be initially recorded as receivable and payable in the books of the Takaful institution and the participants’ fund, respectively.

BC41 The board further considered that like any other receivable, the Qard Hasan at each reporting date, shall be tested for impairment in the books of the Takaful institution in line with the relevant AAOIFI FASs (also see paragraph BC29 for further explanation on the rationale for such impairment testing). However, the same shall not be subject to fair valuation, in line with Shari’ah principles and rules and its nature.

Recognition of Wakala fee

BC42 The recognition of Wakala fee poses unique challenges in the Takaful business. It is in the nature of agent's commission and setting the level of such fee is the prerogative of the Takaful institution (operator), although at times the same is subject to certain governance and regulatory restrictions. It is worthwhile to note that the accounting aspect of Wakala fee is restricted to faithful reporting, whereas determination of Wakala fee and mechanisms of its disbursements are related to governance.

BC43 The board agreed that Wakala fee should be recognised at the inception as an expense of the PTF and an income of the Takaful operator, even if it turns the Takaful arrangement onerous, especially in the first year of such an arrangement (unless contractual arrangement for Wakala fee requires otherwise).

BC44 Due to apparent difference in nature, it was further decided that Wakala fee should not be aggregated with other expenses or outgoes of the PTF e.g., the re-Takaful contributions or direct costs.

BC45 Certain members were of the view that in case where the Wakala fee is amortised in the PTF, it should also be amortised on similar basis by the Takaful institution according to the matching principle. However, after due deliberation the board decided that accounting for Wakala fee's in the books of the Takaful institution shall be commensurate with the corresponding costs and performance obligations and not with the manner in which the same is recognised as an expense in the books of the PTF. Accordingly, such performance obligations and the matching costs (within the income statement of the Takaful institution) were briefly described in the standard (see paragraph 123).

Income taxes related to PTF and PIF, if any

BC46 The board considered whether or not the PTF and PIF are subject to income taxes. It was noted that generally under the doctrine of mutuality these should not be subject to income tax. However, the market practices suggest that normally Takaful institutions submit a combined return of the entity which includes profits and losses attributable to the PTF and / or PIF.

BC47 In view of the same the board considered it to be just and fair for the stakeholders having ownership interest in the PTF and PIF, that the tax benefits or expenses as attributable to them shall be passed on to them. Accordingly, the total tax expense (net) shall not be recorded in the Takaful institutions income statement which pertains to the shareholders only.

Appendix C: Brief history of the preparation of the standard

H1 The AAOIFI FAS on Takaful revision project first output exposure draft on presentation and disclosure was issued on 13 Jumada II 1442H, corresponding to 26 January 2021. Immediately thereafter the secretariat commenced work on the second output of the revision project. (Also see Appendices C and D of FAS 42 “Presentation and Disclosures in the Financial Statements of Takaful Institutions).

H2 The 9th working group meeting, being the first meeting to focus on the accounting treatments (recognition and measurement) for Takaful in line with the global best practices, was held on 15 Jumada II 1442H, corresponding to 28 January 2021. In this meeting members engaged in discussions of the revised scope and updates of newer requirements in international conventional comparable standards on insurance and its Shari’ah implications on Takaful institutions.

H3 The 10th working group meeting was held on 23 Rajab 1442H, corresponding to 7 March 2021 where the members continued with discussions from the previous meeting on the overview of international conventional comparable standards on insurance with regards to the commonalities and areas where Shari'ah issues might arise.

H4 The 11th working group meeting was held on 3 Ramadan, 1442H corresponding to 15 April 2021 where the members discussed the first version of the draft standard and suggested recommendations on core principles were incorporated.

H5 The 12th working group meeting was held on 10 Shawwal 1442H, corresponding to 22 May 2021 where the second version of the draft was discussed after incorporating necessary changes from the previous meeting.

H6 The 13th working group meeting was held on 17 Shawwal 1442H, corresponding to 29 May 2021 where the third version of the draft was discussed. After making necessary changes the standard was recommended to the board.

H7 The draft standard was presented to the AAB in its 24th meeting held on 18-19 Shawwal 1442H, corresponding to 30-31 May 2021. In this meeting the board reviewed the draft and recommendations made by the working group. After due deliberations, the exposure draft was approved for issuance.

H8 After incorporation of board comments and an additional round of review via circulation by the working group, the exposure draft was issued on 18 Muharram 1443H, corresponding to 26 August 2021.

H9 The AAOIFI Public Interest Monitoring Consultative Committee (PIMCC) held its 2nd meeting on 27 Safar 1443H, corresponding to 4 October 2021. No major comments were raised on the standard from the public interest perspective.

H10 The roundtable event was conducted to discuss key issues with regard to the exposure draft through webinar on 20 Rajab 1443H, corresponding to 21 February 2022 with a select group of industry leaders and experts.

H11 The first public hearing webinar event for the exposure draft was conducted on 21 Sha'ban 1443H, corresponding to 24 March 2022.

H12 The committee of the Shari'ah board for review of accounting and governance standards held its 30th meeting on 10 Ramadan 1443H, corresponding to 11 April 2022 where the standard was discussed duly taking the views for conformity with AAOIFI Shari'ah Standards.

H13 The second public hearing webinar event was conducted on 26 Dhul-Hijjah 1443H, corresponding to 25 July 2022.

H14 The public hearing in Arabic language was conducted on 21 Muharram 1444H, corresponding to 10 August 2022 through webinar.

H15 The 15th working group meeting was held on 20 and 24 Jumada I 1444H, corresponding to 14 and 18 December 2022, respectively, where all comments received from public hearings along with the views and comments from different industry participants on the exposure draft was presented for discussion. After making necessary changes the standard was recommended to the board for final approval.

H16 The AAB held its 32nd meeting on 6 Jumada II 1444H, corresponding to 14 December 2022. The board deliberated on changes suggested by the working group and the standard was approved for final issuance.

H17 After completion of the due process, the standard was issued on 7 Jumada II 1444H, corresponding to 31 December 2022.