Financial Accounting Standard No. (15)

Provisions and Reserves in Islamic Insurance Companies

Contents

Preface

This standard aims at setting out accounting rules for the recognition, measurement, presentation and disclosure of:

a) The main technical provisions which are established by Islamic insurance companies (company/companies)[1] to provide for claims related to unearned contributions, outstanding claims, and claims incurred but not reported.
b) The reserves which are set aside by the company from the surplus before it is allocated to policyholders, such as the deficit reserve which is set aside to make provisions against future losses, and the equalisation reserve which is set aside to mitigate the effect of exceptionally high loss ratios for classes of insurance operations displaying a high degree of claims volatility.

(1) Referred to hereafter as company or companies. Islamic insurance companies are also called Takaful companies.

Statement of the Standard

1. Scope of the Standard

This standard shall apply to the main technical provisions that are established by the companies for general insurance operations (property and casualty insurance).

The standard shall also apply to:

a) The deficit reserves which are set aside by the company from the surplus before it is allocated to policyholders, to make provision against future losses;
b) The equalisation reserve which is established by the company to mitigate the effect of exceptionally high loss ratios for classes of insurance operations displaying a high degree of claims volatility.

The standard shall not apply to the reserves within owners' equity that are set aside by the company from its earnings to comply with legal requirements or to meet general requirements. The standard also shall not apply to the depreciation provision, which is an adjustment to the book value of assets.

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

2. Technical Provisions

2/1 Types of technical provisions

The company shall set aside the following technical provisions for general insurance:

a) Unearned contributions provision

This is an amount set aside to meet claims related to unearned contributions which may arise in the current or future financial periods. (para. 2)

b) **Outstanding claims**

This is an amount set aside to make provision against claims expected to be paid in future financial periods that were incurred and reported up to the end of the financial period. This provision shall include claims handling expenses less the settled claims. (para. 3)

c) **Claims incurred but not reported**

This is an amount set aside to make provision against claims that were incurred but not reported until after the end of the current financial period. (para. 4)

2/2 Recognition of technical provisions

All technical provisions shall be recognised when set up at the end of the financial period, and shall be recorded as an expense in the "Statement of Policyholders' Revenue and Expenses". (para. 5)

2/3 Measurement of technical provisions

2/3/1 Unearned contributions provision

The unearned contributions provision shall be measured by the amount calculated as a percentage of the total amount of unearned contributions using one of the four methods, (a) to (d) below, after deducting the reinsurance share. The four methods are as follows:

a) The method of 40% non-marine, 25% marine or any other percentage.
b) The 24-month method.
c) The 360-day method.
d) Any other method.

Details of the method used shall be disclosed. (para. 6)

2/3/2 Outstanding claims

The outstanding claims provision shall be measured as equal to the amount of outstanding claims estimated by the company. The estimated amount shall be enough to enable the company to cover the claims incurred and reported up to the end of the financial period, after deducting the reinsurance share and the settled claims. (para. 7)

2/3/3 Claims incurred but not reported

The provision for claims incurred but not reported shall be measured as equal to the amount of such claims estimated by the company, based on the company's past experience related to the most recent reported claims and the various statistical methods to arrive at the value expected to be paid at the date of the statement of financial position. (para. 8)

2/4 Presentation requirements

2/4/1 All technical provisions shall be presented separately, at the end of the financial period, under "technical provisions" on the liabilities side in the statement of financial position. (para. 9)

2/4/2 The amount expected to be recovered from reinsurance, which is related to all types of technical provisions, shall be presented on the assets side under "amount expected to be recovered from reinsurance" in the statement of financial position. (para. 10)

2/5 Disclosure in the notes to the financial statements

2/5/1 The company shall disclose, for each type of technical provision and for each type of insurance business, the balance of the provision at the beginning of the financial period, the amounts added and the amounts used up during the financial period, and the balance at the end of the financial period. (para. 11)

2/5/2 The company shall disclose the basis applied in determining the amount of each type of technical provisions. Disclosure shall also be made if any changes were made in the applied basis. (para. 12)

2/5/3 The disclosure requirements stated in Financial Accounting Standard No. (12): General Presentation and Disclosure in the Financial Statements of Islamic Insurance Companies should be observed. (para. 13)

3. Reserves

3/1 Types of reserves

a) Deficit reserve

This is an amount set aside from the surplus before it is allocated to policyholders to provide a cushion against any deficit which may occur in future financial periods. (para. 14)

b) Equalization reserve

This is an amount set aside from the surplus before allocation to policyholders in order to mitigate the effect of exceptionally high loss ratios which may take place in future financial periods for classes of insurance operations displaying a high degree of claims volatility. (para. 15)

3/2 Recognition of reserves

The deficit reserve and equalization reserve shall be recognized when the management of the company decides to set up these reserves. (para. 16)

3/3 Measurement of reserves

The deficit reserve and equalization reserve shall be measured as the amount deemed prudent by the management of the company in order to achieve the objectives stated in 3/1 (a) and (b) above. At the end of the financial period, the amount needed to bring the balance of the deficit reserve and equalisation reserve to the required level shall be treated as an appropriation of the surplus. If the balance of both reserves exceeds the amount considered prudent then the excess amount shall be deducted from reserves and added to the surplus of the policyholders for the current financial period. (para. 17)

3/4 Presentation requirements

3/4/1 The deficit reserve shall be presented separately, under the policyholders' equity in the statement of financial position. (para. 18)

3/4/2 The equalization reserve shall be presented separately, under the policyholders' equity in the statement of financial position. (para. 19)

3/5 Disclosure in the notes to the financial statements

3/5/1 The company shall disclose the bases applied in determining and measuring the deficit reserve and the equalisation reserve. (para. 20)

3/5/2 The company shall disclose the changes that have occurred during the financial period in the deficit reserve and the equalisation reserve, separately. The disclosure shall include the balance of each type of reserve at the beginning of the financial period, the amounts added and used up during the financial period, and the balance at the end of the financial period. (para. 21)

3/5/3 The company shall disclose the party that shall receive, in case of liquidation, the remaining balances in the deficit reserve and the equalization reserve. (para. 22)

4. Effective Date

This Standard shall be effective for financial periods beginning 1 Muharram 1423 A.H. or 1 January 2002 A.D. (para. 23)

Adoption of the Standard

The standard of Provisions and Reserves in Islamic Insurance Companies was adopted by the Accounting and Auditing Standards Board in its meeting No. (21) held on 8 Safar, 1422 A.H., corresponding to 2 May, 2001 A.D.

Members of the Board

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

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

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

On 23 Rabi' I, 1420 A.H., corresponding to 6 July 1999 A.D., a consultant was commissioned to prepare a preliminary study on the accounting aspects of the standard. Another consultant was commissioned to prepare a preliminary study on the juristic aspects of the standard.

In its meeting No. (22) held in Jordan on 7-8 Muharram 1421 A.H., corresponding to 11-12 April 2000 A.D., the Accounting Standards Committee discussed the preliminary study and necessary amendments were made. The Committee also discussed the revised accounting study and the exposure draft of the standard in its meeting No. (23) held in Bahrain on 3-4 Safar, 1421 A.H., corresponding to 7-8 May, 2000 A.D., and asked the consultants to make the necessary amendments in the light of the comments made by the members.

The revised exposure draft of the standard was discussed by the Accounting Standards Committee meeting No. (24) held in Bahrain on 15 Rabi' I, 1421 A.H., corresponding to 17 July 2000 A.D., and necessary amendments were made.

The exposure draft of the standard was discussed by the Shari'a Committee for Standards in its meeting No. (4) held in Bahrain on 2-3 Sha'ban 1421 A.H., corresponding to 30-31 October 2000 A.D., and some further amendments were made.

The amended exposure draft was discussed in the Accounting and Auditing Standards Board meeting No. (20) held in Bahrain on 24 Sha'ban, 1421 A.H., corresponding to 20 November, 2000 A.D. The Accounting and Auditing Standards Board made further amendments to the exposure draft and decided that it should be distributed to specialists and interested parties to obtain their comments on the exposure draft in order to discuss them in a listening session.

A listening session was held in Bahrain on 2-3 Dhul-Hajjah 1421 A.H., corresponding to 25-26 February 2001 A.D. The listening session was attended by more than 40 participants representing central banks, Islamic banks, accounting firms, Shari'a scholars, academics and others who are interested in this field. Members of the Accounting Standards Committee responded in the listening session to the written comments as well as to the oral comments that were expressed in the listening session.

The Accounting Standards Committee held a meeting on 3 Dhul-Hajjah 1421 A.H., corresponding to 26 February 2001 A.D., in Bahrain to discuss the comments made on the exposure draft. The Committee made the necessary amendments, which it deemed necessary in light of the discussions that took place in the listening session.

The revised exposure draft was reviewed and approved by the Shari'a Committee for Standards in its meeting No. (5) held in Bahrain on 13-14 Muharram, 1422 A.H., corresponding to 7-8 April 2001 A.D., after making some changes to the draft.

The Accounting and Auditing Standards Board adopted the proposed standard in its meeting No. (21) held in Bahrain on 8 Safar 1422 A.H., corresponding to 2 May 2001 A.D.

Appendix (B)
Juristic Rules for Provisions and Reserves in Islamic Insurance Companies

The setting up of provisions and reserves is an essential requirement for the soundness of Islamic insurance companies. The importance of this requirement lies in the need to meet the indemnity undertakings, which are unforeseen and undeterminable future events, from the insurance fund. Hence, for anything in which absolute certainty is unattainable, a reasonable degree of certainty serves as an acceptable rule. This includes reasonable degree of certainty as to cases established by circumstantial evidence, tested experience and actuarial calculation, the results of which are based on circumstantial scientific evidence and presumption of continuity. The formulation of these provisions and reserves does not encroach on the existing rights of parties involved, because the surplus from which these provisions and reserves are set aside is determined in accordance with the consent of policyholders, either implicitly or explicitly.

The rights of policyholders and shareholders with regard to the reserves which are set aside out of their funds are in line with the principle of separation between the rights and obligations of the policyholders and shareholders. This is because of the differences in the principles on which the rights of both parties are based, namely the principle of donation for the policyholders and the principle of participation for the shareholders. The latter involves the contract of exchange. Many fatwas have been issued on the principle of separation and its implications, including the Fatwa of Al-Baraka Fiqh Seminar which states, inter alia:

"The insurance company shall maintain two separate accounts, one for investing the equity of the company and the other for the insurance fund, and the underwriting surplus belongs solely to the policyholders".[(2)]

(2) Fatwas of Al-Baraka Seminar (12), 12/11 para. (c) and others.

The use of any of the known methods to measure the unearned contribution provision is a matter of professional judgement which is based on experience and prevailing customs. Customs, whether general or specific, are taken into consideration provided they do not contradict any explicit source or general principle of Shari'a.

The estimation of claims incurred but not reported on the basis of past experience is an acceptable principle in Shari'a. In this process, a reasonable degree of certainty based on the opinion of experts is acceptable because this is a field which depends largely on expert opinion. Moreover, dependence on the opinion of experts in these matters is a Shari'a requirement which is based on the Quranic verse : ***{"...So ask of those who know the Scripture [learned men of the Tawrah (Torah) and the Injil (Gospel)], if you know not"}***.[3] The knowledgeable people here comprise experts in all human sciences and professions.

The authorisation of the company's management to set aside reserves is based on the fact that this process is among the activities that are carried out in the interests of those whose affairs are managed. This activity falls within the authority of management because it results in a benefit that is consistent with Shari'a, namely with the principle that says an act of a state authority is tied up with Maslahah (consideration of the public good or common need) which applies to any person entrusted with an activity on behalf of others. Before deducting reserves, it is imperative to secure the consent of policyholders, either implicitly by incorporating such a stipulation in the articles and memorandum of association of the company, or explicitly by any other means.

Disclosure will be made of the party that will receive, in case of liquidation, the remaining balances of reserves in order to give reassurance to the parties from whose funds the deductions were made and to bring the allocation of reserves under Shari'a supervision.

(3) [An-Nahl (The Bee): 43].

Appendix (C)
Reasons for the Standard

Provisions and reserves set aside by companies are one of the most important items in the statement of financial position because they affect the company's continuity as a going concern.

The results of a field study, comprising ten Islamic insurance companies, revealed that there are major differences among Islamic insurance companies in the methods used to recognize, measure and present provisions and reserves. These differences are summarised below:

1. There was a degree of confusion in the use of the terminology of "provision" and "reserve" which in turn affected their measurement, presentation and disclosure. Some companies used the term "reserve" for the same items for which other companies used the term "provision". Such confusion needed to be cleared up.
2. Some companies present provisions (or what they call "reserves") as part of liabilities in their statements of financial position, while other companies present the same item as part of shareholders' equity. Yet, other companies present these provisions after shareholders' equity as a separate item.
3. Most companies fail to disclose the methods used to determine the amounts of provisions and reserves. Other companies do not give adequate disclosure of the changes in the balances of provisions and reserves.

Such differences have several effects. It may be difficult to compare the surplus realised by one Islamic insurance company with that of another company or to compare the statements of financial position of Islamic insurance companies. This is likely to render the financial statements prepared by Islamic insurance company less useful to the users of their financial statements. Such differences may also affect the surplus generated by the companies and hence affect the rights of policyholders.

The field study also indicated that most companies do not establish a deficit reserve or an equalisation reserve. This highlights differences in the treatments both of any deficit from insurance operations and of the effects of claims volatility. In addition, the confusion in the use of the terminology of "provision" and "reserve" seems to have resulted in an increase in the differences, confusion and overlaps in the accounting treatments of these two items.

Appendix (D)
Basis for Conclusions

This appendix shows the alternatives which the Accounting Standard Committee found relevant in order to fulfil the objectives stated in the previous Financial Accounting Statement No. (1): Objectives of the Financial accounting standards for the Islamic Financial Institutions (Statement of Objectives) and the concepts stated in the previous Financial Accounting Statement No. (2): Concepts of Financial Accounting standards for the Islamic Financial Institutions (Statement of Concepts).

Need to Establish Technical Provisions

The establishment of technical provisions helps companies to meet their undertakings of indemnity and claims of both policyholders and others. This would contribute to the financial statements of the company giving a faithful representation of the reality which they purport to represent. This complies with the previous Statement of Concepts which states that the financial statements should provide a faithful representation of what they purport to represent. Moreover, the setting aside of technical provisions would provide relevant information to users of financial statements to assist them to make appropriate decisions in their dealings.

Recognition of Technical Provisions

The standard requires that technical provisions should be recognized when they are established at the end of the financial period and recorded as expenses in the "Statement of Policyholders' Revenues and Expenses". This treatment complies with the definition of expense recognition in the previous Statement of Concepts, which states that "one of the basic principles for expense recognition is its realization, either because the expense relates directly to the earning of revenues (earned contributions) that have been realized and recognized or because it relates to a certain period".

Measurement of Technical Provisions

The standard requires that the unearned contribution provision should be measured by the highest amount determined as a percentage of the total amount of unearned contributions, in order to make provision against the claims related to unearned contributions which might arise in future financial periods. This complies with the previous Statement of Concepts, which states that the basis of the matching concept is supported by the Islamic concept of assigning the responsibility for the cost to the recipient of the benefit. The measurement of the other types of provisions depends on the estimation and experience of the company in this field. This complies with the previous Statement of Concepts, which states that the information should provide a faithful representation of that which it purports to represent, and that the reliability of the measurement method selected to produce and present the information should be appropriate to the circumstances.

Presentation of Technical Provisions

The standard treats technical provisions as liabilities of the company, to make provision for unforeseen future risks and losses related to unearned contributions. This treatment complies with the definition of liabilities and their characteristics in the previous Statement of Concepts.

Reserves Set Aside from the Underwriting Surplus

Transfers to the deficit reserve and the equalization reserve, which should be set aside subject to the consent of the policyholders, are treated as appropriations of surplus. This treatment complies with the previous Statement of Concepts, which states "The transfer to other owners' [or policyholders'] equity accounts is a decrease in the retained earnings [or surplus] resulting from their transfer to legal or other reserves or to the owners' capital accounts". This definition of transfers to reserves differs crucially from the definition of expenses or their characteristics as stated in the previous Statement of Concepts, which states that "expenses are gross decreases in assets or increases in liabilities or a combination of both during the period". The characteristics of expenses include, among others, that "the gross decreases in assets or the gross increases in liabilities should not be the result of distribution to or investment by owners' equity" (or policyholders).

The presentation of the deficit reserve and the equalization reserve as a separate item under policyholders' equity and the disclosure made in the notes to the financial statement of the party that will receive, in case of liquidation, the remaining balances on both reserves, complies with the previous Statement of Objectives, which requires, among others, the determination of "the rights and obligations of all interested parties". Since these reserves are rightfully attributed to policyholders, their presentation under the policyholders' equity will give a faithful representation in the financial statements of the rights and obligations of each party and assist in the determination of these rights and obligations.

Appendix (E)
Definitions

Unearned Contributions

This represents the part of contributions paid to the company for the issued insurance contracts in the current financial period, but the insurance period extends to one or more future financial periods and hence this part of contribution shall not be realized in the current financial period.

Unearned Contributions Provision

This is an expense amount set aside by the company to meet claims related to unearned contributions which may arise in the current or future financial periods for outstanding insurance contracts.

Outstanding Claims

This is an expense amount set aside by the company to make provision against claims expected to be paid in future financial periods that were incurred and reported up to the end of the financial period. This provision shall include claims handling expenses less the settled claims.

Claims Incurred But Not Reported

This is an expense amount set aside by the company to make provision against claims that were incurred but not reported until after the end of the current financial period.

Deficit Reserve

This is an amount set aside from the surplus, before it is allocated to policyholders, to provide a cushion against any deficit which may take place in future financial periods.

Equalization Reserve

This is an amount set aside from the surplus, before it is allocated to policyholders, to mitigate the effect of exceptionally high loss ratios which may take place in future financial periods for classes of insurance operations displaying a high degree of claims volatility.