ACCOUNTING POLICIES AND FINANCIAL REPORTING IN TAKAFUL COMPANIES - A CASE STUDY

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ABSTRACT: *This paper attempts to compare the financial reporting of two Islamic insurance companies "takaful" in two different countries; Bahrain and Sudan. Where Sudan is the first country to host takaful insurance in the year 1979. A case study methodology is applied where the financial reports of these two companies are studied over the years 2009 to 2012. The points under investigations are: Internal organizational structure, financial statements, financial policies, disclosure and notes to the financial statements, and management expenses. The results highlight that takaful companies in Bahrain are using mudharabah and wakalah models and their financial reports are prepared in accordance with IFRS are more informative and clearly understood. On the other hand takaful companies in Sudan use wakalah model and that their financial statements lacked elaborate disclosures rendering some of the information as not up to the standard. A closer look is taken by this study to investigate what could be the underlying factor for differences between these two companies in two countries*.

KEYWORDS: Takaful, Case Study, Bahrain, Sudan, Financial Reporting

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INTRODUCTION

An increasing number of Islamic states and Muslim populous countries promoted provision of financial services to their citizens and businesses. However, the product and operations of these financial services including insurance are bound to relatively unique socio-cultural Islamic fundamentals, i.e., the *Qur'an*, the *Sunnah* and the *Ijtihad* (or the *Shari'ah*), Kwon (2007).

Strictly applying the *Shari'ah*, Muslim jurists argue that there is a prohibited element whenever a difference exists in time, quantity, or amount of exchange in a contract., Ismail (1997 and 1998). *Riba* (charging predetermined interest) is also forbidden, as a result Islamic finance transactions are, at least in principle, are interest free, Ahmad (1967). The application of *riba* principle, however, does not mean that capital is costless. Islam permits making a predetermined claim on surplus from using capital for production, Ariff (1998).

Muslim jurists generally agree that *takaful* insurance is accordant with the *Shari'ah*, as *halal* concept of *tabarru* (meaning "donation" or "contribution") and *takaful* (meaning "joint venture" or "shared responsibility") are deeply imbedded in it, Syarikat *Takaful*, Malysia, (1999). *Takaful* is an Arabic word which means guaranteeing each other. This word is used for the Islamic version of conventional insurance. The basic idea of *takaful* existed since the time of Prophet Mohammad (*pbuh*), i.e. 1400 years back. Arab tribes used *takaful* as a pooled liability that indebted those who committed offences against members of a different tribe to pay compensation to the victims or their heirs. Over the time it spreads to sea trade, where participants made contributions to a fund to cover any group member who went through mishap on sea voyages, Cheikh (2013). As a result, Islamic Insurance Company emerged as the first *takaful* company in Sudan in 1979, Mohamed (1997). In 1985 the Grand Council of Islamic Scholars of the Organization of the Islamic Conference formally gave the required permission for *takaful* as the Islamic alternative to conventional insurance. *Takaful* grew in the Middle East, Europe and America and other parts of Africa. Multinationals like Chartis, Hannover, HSBC among others have accepted and adopted the *takaful* concept as a way of conducting insurance business.

It was a long debate and disagreements among Islamic jurists since 1976 that insurance is not accepted '*haram*' in Islam. Gradually, they come into an agreement and insurance got acceptance under the Islamic Law, as "*takaful*". But, Mughal (2008) argued that if insurance is covering these three things: bearing the risk/threat, protecting others and sharing the loss then there is no reason to be considered unlawful or '*haram*'. He supports his conclusion on the Prophet Mohammad's saying: "Whosoever removes a worldly hardship from a believer, Allah will remove from him one of the hardships on the Day of Judgment." *Takaful* is accepted for several reasons: First, it is considered not as contract of exchange but as contract of mutual gratuity "*hiba*". Second, non-existence of the three main elements of which Islamic finance strongly rejects in conventional financing: Usury *'riba'*, high risk and uncertainty *'gharar'* and gambling '*mayser*'. Consequently, there is no requirement of hand-to-hand and equal value exchange as required for money exchange. Conventional insurance is *riba*-based, as it is a contract of exchange of money in the future subject to the occurrence of the risks and at different value.

One of the differences between *takaful* and conventional insurance is that *takaful* company does not have policyholders. It has 'contributors' or 'participants' since they are participating collectively in the fund for everyone's mutual benefit. Moreover, insurance policy is defined by Billah (2003) as a contract of mutual financing between two parties, where one party is expected to be protected against an unexpected loss by the other party for the payment of an amount of premium. In another word, the insured party buys protection for a premium against risk.

Takaful considers the insurer and the insured person mutually guarantee each other against the risk. It is based on mutual help and solidarity, which eliminates the element of *riba* in the contract. All the participants are bound by the contract of partnership and '*hiba*', where the contribution of funds by the insurers are considered as collective ownership by all the providers of the funds who are considered as *'rab-ul-mal'*. Similar to '*mudharabah*' concept in Islamic finance, *'rab-ul-mal'* provide the funds and the company, as an agent, manages these funds and acts on their behalf. The fund management is not free of charge, but a fee will be provided to the management for this agency services. Furthermore, profits and loss generated are shared on a pre-determined ratio.

As in conventional insurance, *takaful* provides both 'General' and 'Life' insurance. General *takaful* includes schemes such as Motor Private and Commercial, Personal Accident, Marine, Fire Domestic, Fire Industrial, and Medical. Family *takaful*, which is the life insurance in the conventional, includes Whole Life, Endowment, Annuities, Deposit Administration and all types of Investment policies among others. For *takaful* to be *Shari'ah* compliance, it must be from the principles of Islam, i.e. *Qur'an* and *Sunnah.* These principles are considered as '*muamalat*' i.e. relationship between man-to-man and '*worship*' i.e. relationship between man-to-*Alla*. Annuar and Abu Bakar (2010) argued that since in Islam there are different '*mathhabs*' i.e. schools, so the '*muamalat*' principles must go through the process of *Ijtihad* before they can be utilized, the process can take more than one method to understand the *Qur'an* and *Sunnah*. The differences in schools and beliefs are the cause for the possibility of *Ijtihad* leading to disagreements among the Sharia scholars. As a result, Karim (1990a) addressed that the interpretations of the different schools influence the differences and similarities of the accounting policies adopted by different Islamic banks of different countries.

Takaful company should apply Islamic *Shari'ah* in all of its activities. The company's Memorandum and Articles of Association underlines this approach. The company normally has a committee of prominent *Shari'ah* scholars to provide guidance and advice at all stages of operations. The advice is provided at the point of sale, payment of benefits, accounting, investing the funds, public dealing, and serving the community in supporting charitable work. All contracts are performed to ensure the elimination of element of speculation, uncertainty and gambling. In addition, the company ensures that interests of the participants are based on mutual co-operation and solidarity. In the event of loss, the contributor is paid an amount from *takaful* fund in accordance with the underwriting principles of insurance. All the scientific methods that are normally used in insurance applications such as financial and medical underwriting, mortality and morbidity rates etc. are applied in *takaful* operations.

Mudharabah and *musharakah* are two modes of financing in Islam. Under *mudharabah* an owner of capital may let an entrepreneur use his or her capital within Islamic guidelines and share in the profits. However, only the owner of the capital will be responsible for all losses, Maysami (1997). *Musharakah*, on the other hand refers to two or more partners using their capital jointly for investment and share in both profits and losses.

Takaful operations in the primary insurance market can be broadly classified in one of three models; a *mudharabah* model, a *wakalah* model and a hybrid model. Under the *mudharabah* model both the policyholders and the insurer share profits from *takaful* operations. Under *wakalah* model there is a complete separation between the insurer's capital and the policyholders' fund and the insurer receives a fixed fee for managing/investing the fund on behalf of the policyholders. Finally, under the hybrid plan, the insurer may use *mudharabah* model for underwriting activities and a *wakalah* model for investment activities, Kwon (2007).

PURPOSE OF THE STUDY

Annuar and Abu baker (2010) studied two Malaysian *takaful* companies and seeks to find whether differences in jurists view have not only affected the accounting and financial reporting policy but other operational aspects. This paper is going to answer the same question and compare two *takaful* companies in two different countries and to explain underlying reasons for differences, if any. The main purpose of the paper is then to compare financial reporting of two *takaful* companies namely; Islamic Insurance Co. (IIC)-Sudan and *Takaful* International-Kingdom of Bahrain. It investigates whether there are differences in reporting based on *Shari'ah* jurists and other reporting issues. It is confined to comparing the annual reports of the two companies for the years 2009 to 2012. The main points this paper is going to look for are as such: Internal organizational structure, financial statements, financial policies, disclosure and notes to the financial statements, and management expenses.

Companies Background

Islamic Insurance Co. (IIC) was founded on 21 January 1979 in Sudan as a private company with limited liability. It was the first Islamic cooperative insurance company in the world. It operates under the principle that payment by the policyholders of the premium should be in advance with the intention to donate all or part of it to any of the other policyholders who suffered insurance claims. The cooperative insurance is considered a contract where the donor may get consideration against his donation but it is a contract not affected by the (*gharar*) as in the *Maliki Mathhab.*

Takaful International, on the other hand, founded in 1989 in the Kingdom of Bahrain is the first Islamic insurance company in the region. The company's strategies recognize that its primarily duty as a *takaful* provider is to provide support to its customers based on *Shari'ah*'*s* standards. During the year 2010, the company had implemented prudent underwriting strategies to selectively underwrite risks that would yield target profitability levels. The company had strived to implement highest standards of corporate governance to protect the interests of all the concerned parties, including those of the shareholders and policyholders.

METHODOLOGY AND DATA

The two countries under investigation are the Kingdom of Bahrain and Sudan. The reason for choosing Sudan is because it is the first country that adopted *takaful* by a company named "International Insurance Company" in 1979. Bahrain, on the other hand, is selected as being a financial center in the Gulf and due to its wide growth of Islamic financial institutions over the years. "*Takaful* International" is considered as the first Islamic insurance in the region and the only listed company in the Bahrain Bourse.

Case study is used to analyze each company in each country over the years 2009 to 2012. The analysis is for these main areas: 1) Reporting of the financial statements and the disclosure of information i.e. International Financial Standards; 2) Methods of accounting policies; 3) Models used in each country; 4) Expenses and fees charged; and 5) Consistency of reporting. Financial reports for each company are collected from the source company for the last four years.

FINDINGS

With respect to the organizational structure, inspection of the annual reports revealed a similarity between the two companies. Both companies have a Board of Director, *Shari'ah's* Supervisory Board, Executive Management, and Operational Management.Regarding the models used by the two companies; *Takaful* International uses both *mudharabah* and *wakalah* models, while Islamic Insurance Company uses *wakalah* model. Following the enactment of the Insurance Law of 1992 (revised in 2003) all insurance companies in Sudan are required to transact insurance and reinsurance businesses only in Islamic way particularly, based on *wakalah* model, Mohamed (1997). Differences are depicted though in the accounting policies adopted. *Takaful* International financial statements have been prepared in accordance with Financial Accounting and Auditing Standards (FAS) issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), International Financial Reporting

Standards (IFRS) and Interpretations issued by the International Financial Reporting Interpretations Committee (IFRIC). In addition, the accounts conform to the Central Bank of Bahrain, the Financial Institutions Law, Insurance Regulations issued by the Central Bank and the requirements of the Bahrain Commercial Companies Law.

Adherence of *Takaful* International to 'IFRS' and 'IFRIC' in addition to 'AAOIFI' is obvious throughout the annual report especially, with respect to disclosures of supplementary information and notes to the financial statements. The company follows the historical cost basis in accounting for its assets with the exception of available-for-sale investments, which are measured at their fair value. Straight-line method of depreciation is used to depreciate plant and equipment. Explicit reference was made to conformity with International Accounting Standards, such as, IAS 18 'Revenue Recognition', IAS 19 'Employee Benefits', IAS 39 'Financial Instruments: Recognition and Measurement', IAS 17 'Standard of Cash Flow' and IAS 7 'Leases'.

International Insurance Company, on the other hand, prepares its accounts in accordance with (AAOIFI), Sudan Company Act 1925 and the Insurance Advisory Authority Act 2001. The difference between the two companies could be explained by the nature of the underlying economic and political environment under which the two companies operate. Sudan has an Islamic regime and the economy as a whole is affected by Islamic rules. Kingdom of Bahrain has a more liberal regime and has a free and open economy that conforms to both national and international rules.

As for the external audit report, IIC auditors conducted their audit in accordance with International Standards on Auditing. In 2010 and subsequent years, however, external audit was conducted in accordance to 'AAOIFI'. Auditors of *Takaful* International, on the other hand, conducted their audit in accordance with both 'AAOIFI' and International Standards on Auditing. Another difference is the Insurance Supervisory Authority Certificate issued to International Insurance Company in addition to the external audit report and the *Shari'ah* Supervisory Board Report.

With respect to disclosure of additional information in notes to the financial statements, *Takaful* International has very elaborate, systematic and detailed note disclosures, while International Insurance Company has only one note disclosure regarding plant and equipment. A breakdown into different types of plant assets reported at cost, additions and disposals and the amount of depreciation thereon is displayed, no mention is made, however, of the method of depreciation employed. Although, the number of other notes are displayed beside different elements in the financial statements there has been no disclosures regarding these notes.

Finally, the study attempted to compare management fees in the two companies. International Insurance Company reported a percentage of the prescribed premiums as management fees including annual bonus and rewards for *Shari'ah's* Inspectorate Board. *Takaful* International, on the other hand, disclosed a detailed percentage for both general and family *takaful* operations for both *wakalah* and *mudharabah* together with the maximum percentages approved by the *Shari'ah* Advisory Board.

CONCLUSION

The contribution made by this paper has gone farther than previous research. Annuar and Abu Bakar, (2010) conducted a study of two Malaysian *takaful* companies in an attempt to document issues on *takaful* affecting the choice of accounting policies. Differences and similarities have been reported in a case study. The current study, however, has gone a step further by looking into accounting policies and financial reporting of two *takaful* companies across country. A case study is carried out to compare *Takaful* International-Bahrain, the first *takaful* company in the region with Islamic Insurance Company-Sudan. Not only has the study tried to compare two companies operating in two countries with different underlying backgrounds, it has also highlighted the fact that different background factors did affect the amount and quality of accounting information reported and disclosed by the two companies.

Sudan is a pioneer in Islamic insurance as such, one would expect that the country has gone a long way in making mandatory presentation of accounting information with high degree of transparency as a role model in Islamic insurance industry. However, the study revealed that the annual reports of Islamic Insurance Company was anything but in accordance with full disclosure. Although the financial statements are well presented disclosure of additional information was quite lacking. On the other hand, *Takaful* International accounts were well supported with all the necessary disclosures. These differences were attributed to the underlying economic and political differences between the two countries.

In an attempt to document reporting similarities and differences between Islamic insurance companies the study carried out a comparison of the annual reports of *Takaful* International-Bahrain and Islamic Insurance Company-Sudan over the period 2009-2012. Similarities are found in both organizational structure and compliance with Accounting and Auditing Organization for Islamic Financial Institutions 'AAOIFI'. However, differences are reported with respect to accounting policies. *Takaful* International, in addition to 'AAOIFI' prepared its accounts in accordance to International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS). The accounts of Islamic Insurance Company on the other hand are prepared in accordance with 'AAOIFI' only. This difference is mirrored in the external audit report where the audit for *Takaful* International was conducted in accordance with International Standards on Auditing in addition to 'AAOIFI' while Islamic International Company external audit was conducted in accordance with International Standards on Auditing in 2009 with a shift to 'AAOIFI' in 2010.

Moreover, an obvious difference exists in the amount and extent of additional disclosure in notes to the financial statements of *Takaful* International. The notes conveyed all the necessary disclosures in an orderly and consistent manner. On the other hand, International Insurance Company conformity to 'AAOIFI' only is noted in preparing financial statements and starting 2010 in the audit report. The only note elaborate disclosure in IIC financial statements was plant assets. Such differences are attributed to both the political and economic environment in which the companies operate. Islam and *Shari'ah* are underlying both the political and economic systems in Sudan, while Kingdom of Bahrain enjoys a more open political system and is more exposed to and affected by international environments where a high degree of transparency is required.

Finally, the study revealed that International Insurance Company explicitly reported the amount of management fee expressed as a percentage of the prescribed premiums as bonus and rewards for *Shari'ah* Inspectorate Board. *Takaful* International, however, made no explicit revelation on such fee.

We can hereby conclude that there are more similarities than differences between Islamic insurance companies in Bahrain and Sudan. The differences are a reflection of the underlying political system rather than differences of substance. Moreover, both companies have shown high consistency over the period the study is carried out with respect to the accounting policies employed as well as other disclosures.

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