



30 November 2010

Sir David Tweedie  
Chairman  
International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH  
UNITED KINGDOM

**Re: AOSSG comments on IASB Exposure Draft ED/2010/8: Insurance Contracts**

Dear Sir David:

The Asian-Oceanian Standard-Setters (AOSSG) appreciates the opportunity to provide comments to the IASB on the Exposure Draft(ED) of IFRS 4.

The AOSSG currently has 24 member standard-setters from the Asian-Oceanian region: Australia, Brunei, Cambodia, China, Dubai, Hong Kong, India, Indonesia, Iraq, Japan, Kazakhstan, Korea, Macao, Malaysia, Mongolia, Nepal, New Zealand, Pakistan, Philippines, Saudi Arabia, Singapore, Sri Lanka, Thailand, and Uzbekistan.

To the extent feasible, this submission to the IASB reflects in broad terms the collective views of AOSSG members. Individual member standard setters may also choose to make separate submissions that agree or disagree with aspects of this submission.

The objective of AOSSG is to enhance the input to the IASB from the Asian-Oceanian region and not to prevent the IASB from receiving the variety of views that individual member standard setters may hold. We attach the separate comments on certain Islamic finance impacts of the proposals in the ED from the Islamic Finance Working Group of AOSSG (see Appendix B).

This submission has been reviewed by members of the AOSSG after having been initially developed through the AOSSG's Insurance Contract Working Group. The AOSSG has not received any substantive contrary views from our constituents.

The AOSSG acknowledges that the proposed measurement model in this ED simplifies the various measurement methods applied in insurance accounting and it will enhance the comparability of the financial statements.

However, the following aspects need to be considered:

- Maintaining consistency among standards
- Fluctuation in profit and loss
- Supplementary guidance for Comparability

## **Maintaining consistency among standards**

The development of discount rate application principle which can be applied consistently for all IFRSs is necessary. Currently, the IASB does not provide consistent standards for individual standard's discount rate application.

For example, there are differences between the IAS 19 (defined benefit obligations) and the ED (insurance contract). Even though the defined benefit obligations and insurance contract liability have similar characteristics, but the applied discount rates that are applied to these two standards have differences.

Therefore, it is necessary for the IASB to clearly provide the rationale for the differences between standards on discount rate application. For long-term purposes, developing discount rate application principle such as US GAAP's SFAC 7 (Statement of Financial Accounting Concept No.7) and including it in the conceptual framework are needed.

## **Fluctuation in profit and loss**

According to the proposal of this ED, recognizing all the gains and losses from subsequent measurement in current profit and loss, may increase the volatility of profit and loss, thus we express our concern on this matter. Moreover, we suggest the method to recognise the change in insurance contract liability due to the assumed change in discount rate, not directly related with the insurer's performances, in OCI to be considered as an alternative.

## **Supplementary guidance for Comparability**

Although IFRS lays emphasis on principle based approach, and prefers not to suggest a specific guidance. This may lead insurers to choose various methods to value their insurance contract liabilities, which may in turn result in a variation in the level of presentation and estimation.

Hence, this could contradict with the ED's original objective of unifying the various accounting practices applied by different insurers for the comparability of a financial statement.

The components that require specific guidelines in ED are followed below:

- **Illiquidity risk assessment** for determining the discount rate reflecting the characteristics of an insurance contract liability.
- **The range of the specific assets** of which performance affects the cash flows of an insurance contract.
- **The proximity of the components of a contract** to the insurance coverage that allows them to be unbundled since there is no close relevance.
- **The confidence level** on measuring risk adjustment.
- **The level of possible scenarios** that can take place in estimating the expected probability-weighted present value of contingent cash flows of an insurance contract.

If the individual insurers assess the aforementioned components and recognise insurance contract liability and related profit and loss, the comparability of financial information between insurers may deteriorate. Therefore, we request more detailed guidance to improve the comparability.

In addition, in order to enhance understanding of the corresponding standards, we suggest adding basic examples or presenting education material similar to the fair value measurement. These kinds of examples or education materials will increase the understandability of the insurance accounting standards.

The AOSSG views, as summarised above, are explained in more detail in Appendix A. If you have any queries regarding any matters in this submission, please contact us.

Sincerely,



Ikuo Nishikawa  
Chairman of the AOSSG



Dr. Chungwoo Suh  
Leader of the AOSSG Insurance Contract Working Group

## Appendix A

### **Question 1- Relevant information for users**

Do you think that the proposed measurement model will produce relevant information that will help users of an insurer's financial statement to make economic decisions? Why or why not? If not, what changes do you recommend and why?

AOSSG members appreciate the IASB's effort to replace the existing interim standard IFRS 4 insurance contracts which allows different local liability measurement practices across jurisdictions, with a single standard for the measurement of insurance contracts to be applied across all jurisdictions adopting the IFRS.

In addition, AOSSG members believe that the proposed measurement model will produce relevant information that will help users of an insurer's financial statement to make economic decision, because it can faithfully reflect the facts an insurer fulfils its insurance obligations, providing relevant information about the amount, timing and uncertainty of future cash flows, so that it will increase information transparency and enhance information decision-usefulness.

### **Question 2 - Fulfilment cash flows**

- (a) Do you agree that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract? Why or why not? If not, what do you recommend and why?
- (b) Is the draft application guidance in Appendix B on estimates of future cash flows at the right level of detail? Do you have any comments on the guidance?

Q2-a) AOSSG members agree that the measurement of an insurance contract should include the expected present value of the future cash outflows less future cash inflows that will arise as the insurer fulfils the insurance contract.

Generally, the insurance contract liability is not transacted in market. Measuring with fulfilment value is appropriate considering the economic substance of insurance contract.

From theoretical perspective, measuring the insurance contract liability with the current price of future cash flow enables to fully present the fulfilment values and to increase the understandability.

The rules stated above are also consistent with the proposed method of 'measuring current value of the expected cash flow' of 'Measurement of Liabilities in the IAS 37's ED and 'Financial Instruments: Amortised Cost and Impairment's ED.

Q2-b) AOSSG members note that the draft guidance in Appendix B on estimates of future cash flows is at the right level of detail.

### **Question 3 - Discount rate**

- (a) Do you agree that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of

- (b) Do you agree with the proposal to consider the effects of liquidity and with the guidance on liquidity? Why or why not?
- (c) Some have expressed concerns that the proposed discount rate may misrepresent the economic substance of some long duration insurance contracts. Are those concerns valid? Why or why not? If they are valid, what approach do you suggest and why?

Q3-a) AOSSG members believe that the discount rate used by the insurer for non-participating contracts should reflect the characteristics of the insurance contract liability and not those of the assets backing that liability because:

The cash flows occurred from the non-participating contract are not directly related with the cash flows occurred from the backing asset which are managed to fulfill the insurance contract liability. Thus, only applying the liability's intrinsic characteristics is logically consistent with the fulfillment value which is measurement purpose of the insurance contract.

As mentioned in the IAS 19.BC27, if the return rate of this kind of backing assets is used as the discount rate of insurance contract liability, there could be problem that the amount of liability is recognised lesser as invested in the high-risk assets with high expected return.

Q3-b) AOSSG members agree with the proposal of adding the liquidity premium to the discount rate of insurance contract liability.

However, AOSSG members have some concerns about how this might be done, particularly as paragraph BC 110 states that "...there is not yet a consensus on how best to measure those effects, for example how to separate liquidity effects from credit effects."

In addition, AOSSG members note that there will be great operational confusion occurred if the detailed definition and the application guidelines are not provided on the liquidity premium. When considering the fact that the measurement result may greatly change due to the differences of discount rate that are applied in insurance contract liability, if the detailed definition and application guidelines do not exist, there is risk of deteriorating the reliability of financial statements' comparability between companies.

Considering the measurement purpose of 'fulfillment value,' the liquidity premium does not measure assuming transfer of the insurance contract liability to the third party. It is measured assuming early fulfillment of insurance contract on insurers' insurance contractor. However, the IASB's clarification on this matter is not provided on the ED.

Q3-c) AOSSG members consider that those concerns are not valid.

AOSSG members believe that using the discount rate that applies to insurance contract liability as rate of return on asset management does not appropriately apply the economic substance of non-participating insurance contract. In other words, since cash flows of non-participating insurance contract is not directly influenced by the cash flows of backing assets, there will be distortion of economic substances if cash flows occurred on these contracts are discounted with the rate of return on managed assets.

If credit risk, insurers' non-performance risk, is applied to discount rate, the discount rate will

increase if insurers' credit risk increases. Thus, if insurers' insurance contract liability decreases, there will be recognition of profit. This is opposed in intuition and this may cause confusion to the users of financial statements.

On the other hand, there are some views that the concern is valid particularly in an environment where there are no (or lack of) observable rates on financial instruments with similar maturity periods to use as a benchmark to discount long-term duration insurance contracts.

Consequently, a mismatch of assets and liabilities may arise. For example, insurers would face difficulties in determining reliable discount rates as they typically have long duration insurance contracts exceeding 20 years, as there is a lack of long dated assets in certain markets.

#### **Additional review comments on the discount rate**

AOSSG members also consider that there is need to develop the discount rate application rule that can be consistently applied to all the IFRSs. The current IASB does not provide consistent standards regarding the discount rate application on individual standards.

For example, there are differences between the IAS 19 Employee benefits and the IFRS4 ED Insurance contracts. The defined benefit obligation and the insurance liability have similar characteristics but there are differences in discount rates that are applied on these two standards. Therefore, the IASB needs to clarify the reasoning behind these differences between the standards relating to the discount rate application. In addition, developing the discount rate application principle such as the US GAAP's SFAC 7(Statement of Financial Accounting Concept No.7) and including this in the conceptual framework are needed.

#### **Question 4 – Risk adjustment versus composite margin**

Do you support using a risk adjustment and a residual margin (as the IASB proposes), or do you prefer a single composite margin (as the FASB favours)? Please explain the reasons for your view.

AOSSG members support using a risk adjustment and a residual margin approach as it reflects the change in the risk underlying the contract over the coverage period because the IASB's proposals:

- (a) would provide more useful information to users about the insurer's perceptions of the effects of uncertainty on the amount and timing of future claims liability fulfillment cash flows; and
- (b) could reduce the amount of residual margin, which need to be released by rather subjective methods, so that it will provide users of financial statements with more reliable information.

However, some AOSSG members support the composite margin method for the reasons explained below.

#### **Easier management and comparability**

For the composite margin approach, the operational burden will be relatively small since risk adjustment is not measured separately, even though the future cash flow occurring in insurance contract is forecasted and this cash flow is discounted. Also, it is expected that the comparability between companies is not to be deteriorated since avoiding the subjectivity when measuring risk adjustment is possible.

Moreover, for the composite margin approach, since the risk adjustment does not influence remeasurement of the insurance contract liability, it is expected that the insurers can easily disclose remeasurement of insurance contract liability or its related information. Moreover, the users of financial information can easily understand the related information and external auditors' audit will be relatively easy.

### **Possibility of a loss at the point of the first time adoption of the standard**

It is likely to have little difference in actuarial estimates between the point of insurance products pricing and the point of measuring a liability after selling the insurance. However, there may be a large fluctuation of the change of economical assumptions. According to the two margin approach which distinguishes between risk adjustment and residual margin, the change in assumptions influence the insurance contract liability relatively big, thus, when economic assumptions greatly change, the possibility of a loss at the point of the first adoption of the standard is greater than the situations of applying the composite margin approach. In addition, since the required risk adjustments for smaller insurers may be big, the possibility of a loss at the point of the first time adoption may be high. This may cause the problem that the accounting value may differ depending on the size of an insurer or ability to assess.

#### **Question 5 - Risk adjustments**

- (a) Do you agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment cash flows exceed those expected? Why or why not? If not, what alternatives do you suggest and why?
- (b) Paragraph B73 limits the choice of techniques for estimating risk adjustments to the confidence level, conditional tail expectation (CTE) and cost of capital techniques. Do you agree that these three techniques should be allowed, and no others? Why or why not? If not, what do you suggest and why?
- (c) Do you agree that if either the CTE or the cost of capital method is used, the insurer should disclose the confidence level to which the risk adjustment corresponds (see paragraph 90b(i))? Why or why not?
- (d) Do you agree that an insurer should measure the risk adjustment at a portfolio level of aggregation (i.e. a group of contracts that are subject to similar risks and managed together as a pool)? Why or why not? If not, what alternative do you recommend and why?
- (e) Is the application guidance in Appendix B on risk adjustments at the right level of detail? Do you have any comments on the guidance?

Q5-a) AOSSG members generally agree that the risk adjustment should depict the maximum amount the insurer would rationally pay to be relieved of the risk that the ultimate fulfilment

cash flows exceed those expected.

However, Some AOSSG members also note that the proposed definition of risk adjustment does seem to contain ‘fair value measurement’ elements. The measurement objective (fulfilment value) of insurance contract liability in the ED does not presume the transfer of insurance liability to the third party. Nonetheless, the definition of risk adjustment seems to assume the transfer of insurance contract liability, thus, it does not align with the measurement objective.

Q5-b) AOSSG members basically agree with the three types of techniques allowed on estimating risk adjustments in the ED. Including too many techniques in the accounting standards may deteriorate the understanding of the users and the comparability of financial statements. Moreover, the three types of techniques proposed are currently used in real operations so that there will not be difficulty in operational application.

However, considering the possibility of developing more elaborate measuring method in future, it is proper for the IASB to provide comprehensive principles which cover the three types of techniques and include three types of techniques as examples.

Q5-c) AOSSG members agree to the proposal of disclosing the confidence level used in the CTE approach and the cost of capital approach. Confidence level plays an important role in estimating the risk adjustment to the all three techniques proposed in the exposure draft.

Therefore, disclosing the different method of confidence level applied by insurers with similar risks will increase the comparability between companies, and will increase the understandability of the users of financial statements.

Q5-d) AOSSG members assent to the proposal of measuring the risk adjustment at a portfolio level. According to the definition of portfolio, if the objects of risk adjustments to be measured have similar risks, and managed together, measurements at an individual level as well as a portfolio level may share similarities. Also, portfolio’s diversification effect may be applied which is projected to reduce the operational burden and maintain accuracy.

However, some insurance companies in certain AOSSG member countries measure the risk adjustment at an individual level, with the effect basically similar to at a portfolio level. So we suggest providing an option for insurance companies to measure the risk adjustment at an individual level.

Q5-e) Considering the principle based accounting standards preferred by the IASB, the level of guidance seems appropriate.

However, additional information of determination method of individual components (e.g. various risk premiums) required to estimate the capital ratio for the cost of capital technique needs to be provided.

Additionally, when determining the risk adjustment, (The maximum amount that the insurers can pay reasonably in order to be free from the risk of the real fulfilment cash flow exceeding the expected fulfilment cash flow) there is possibility of inputting the insurers’ arbitrary opinion and this may deteriorate the comparability of the financial statements. Hence, a more



explicit guidance needs to be provided.

**Question 6 – Residual/Composite Margin**

- (a) Do you agree that an insurer should not recognise any gain at initial recognition of an insurance contract (such a gain arises when the expected present value of the future cash outflows plus the risk adjustment is less than the expected present value of the future cash inflows)? Why or why not?
- (b) Do you agree that the residual margin should not be less than zero, so that a loss at initial recognition of an insurance contract would be recognised immediately in profit or loss (such a loss arises when the expected present value of the future cash outflows plus the risk adjustment is more than the expected present value of future cash inflows)? Why or why not?
- (c) Do you agree that an insurer should estimate the residual or composite margin at a level that aggregates insurance contracts into a portfolio of insurance contracts and, within a portfolio, by similar date of inception of the contract and by similar coverage period? Why or why not? If not, what do you recommend and why?
- (d) Do you agree with the proposed method(s) of releasing the residual margin? Why or why not? If not, what do you suggest and why?
- (e) Do you agree with the proposed method(s) of releasing the composite margin, if the Board were to adopt the approach that includes such a margin? Why or why not?
- (f) Do you agree that interest should be accreted on the residual margin? Why or why not? Would you reach the same conclusion for the composite margin? Why or why not?

(Q6-a) AOSSG members agree that an insurer should not recognise any gain at initial recognition of an insurance contract. Expected profits for an insurance contract arise as the insurer fulfils the insurance contract, which means that profits should be recognised based on this process.

(Q6-b) AOSSG members agree that a loss at initial recognition of an insurance contract should be immediately recognised in profit or loss. Reasons are followed below:

- (a) Consistent with the ED of ‘Revenue from Contracts with Customers’ which proposes to recognise the loss of onerous contracts
- (b) Able to provide the useful information to the users of financial statement on timely manner
- As a reason for the residual margin is negative, (1) When measuring the insurance contract liability, differences between the expected cash flows and expected cash flows at the point of developing the insurance contract (2) When developing the new insurance product, the aggressive manner (manner that bears loss and not based on the practical assumption) may be the cause.
  - In case of the first reason, if the changes in assumptions are caused by an observation of the current market or from an entity’s past experience, the entity will need to account for an additional fulfilment obligation due to the increase of cash outflows as a liability at the point of recognition. Also, the insurer will need to recognise the loss at initial measurement in order to inform the financial

- In case of the second reason, the entity needs to reflect the loss determined at the point of developing the insurance contract in its financial statements for an accurate financial information disclosure.

(Q6-c) AOSSG members generally agree with the proposal. In order to maintain consistency of the proposed definition, method of recognition and release of residual margin or composite margin, it is proper to measure the residual margin or composite margin on portfolio level.

However, some insurance companies in certain AOSSG member countries measure the residual margin at an individual level, with the effect basically similar to at a portfolio level. So, AOSSG members suggest providing an option for insurance companies to measure the residual margin at an individual level.

(Q6-d) AOSSG members agree with the proposed principles of recognition method in this ED. However, when considering the insurance contracts' wide range of coverage period, date of inception of an insurance contract, as well as an age of a policyholder, it is projected that the number of portfolios for measuring residual margin will not greatly differ with the number of insurance contracts.

In order to estimate large number of portfolios, there will be additional time or system required which will result increase in operational burden. In order to improve these kinds of problems, adding simplified operational method which requires recognizing the residual margin from insurance contracts with similar coverage period within the portfolio level or small portfolio level is necessary.

(Q6-e) AOSSG members agree with the proposal. Composite margin is not included in the future cash flow (building block 1) related to the insurance contract. But, it includes many components of many insurance prices that were considered when calculating the price (e.g. non-incremental acquisition cost and overhead).

According to the ED's proposal, these components are all included in the composite margin, which in turn will be released over the remaining coverage period. AOSSG members believe this method is reasonable.

(Q6-f) AOSSG members believe that at insurance contracts' initial recognition, the residual or composite margin are calculated by deducting the present value of future fulfilment cash outflows from the present value of future fulfilment cash inflows.

Therefore, the time value of money is applied. Considering this fact, in the event of subsequent measurement, it is proper to recognise the interest expense with applying discount rate to the residual and composite margin that was used at the initial measurement.

However, some AOSSG members argue that accreting interest on margin is cumbersome to apply in practice and fixed interest rate at inception may result in the estimates being artificially stated and being not representative of the observable market interest rates over the duration of the insurance contracts.

Also, some AOSSG members mention that residual margin is only a credit, a difference by calculating certain items, which has in itself not much economical substance. Therefore, accrediting interest on the margin does provide reliable and useful information to users of financial statements.

**Question 7 - Acquisition costs**

(a) Do you agree that incremental acquisition costs for contracts issued should be included in the initial measurement of the insurance contract as contract cash outflows and that all other acquisition costs should be recognised as expenses when incurred? Why or why not? If not, what do you recommend and why?

AOSSG members agree with the ED's proposal that only applying the incremental cost to the current value of fulfilled cash flows at initial measurement of insurance contract.

However, we suggest changing the assessment of the incremental cost on portfolio level, not the individual contract level. On the ED's paragraph B61, it states projection of all cash flows of insurance contracts are to be assessed from portfolio level.

As cash flow projection items, it states the direct cost and systematically allocated indirect cost. However, according to the paragraph (f), it suggests that the acquisition costs should contain the incremental costs only at the level of an individual insurance contract rather than at the level of a portfolio of insurance contracts.

In addition, the interpretation of what falls under incremental and non-incremental acquisition costs may differ from one insurer to another dependent on the type of distribution channels applied. To facilitate consistency in treatment of acquisition costs by insurers, the Board should consider further elaboration in the proposed standard.

**Question 8 – Premium allocation approach**

(a) Should the Board (i) require, (ii) permit but not require, or (iii) not introduce a modified measurement approach for the pre-claims liabilities of some short-duration insurance contracts? Why or why not?  
(b) Do you agree with the proposed criteria for requiring that approach and with how to apply that approach? Why or why not? If not, what do you suggest and why?

(Q8-a) AOSSG members believe it is appropriate to permit but not require the modified measurement approach. Our reasons are followed below:

- AOSSG members believe that it is not reasonable to regulate applying different models for contracts covering the same risks just because its duration is less than one year from logical consistency perspective.
- Therefore, in principle, AOSSG members think that it is appropriate to apply the measurement method using the building block. Therefore, from cost-benefit perspective, it is proper to allow the use of unearned premium approach when the insurers decide the pre-claims liability do not have material differences with the measurement method using building block.

(Q8-b) AOSSG members agree with the proposal because the proposed judgment criteria and application approaches are easy to understand, convenient to implement and will not damage the accounting information relevance and decision usefulness.

However, some AOSSG members also note that the IASB should introduce the concept of life insurance contracts and non-life insurance contracts as the criteria of adopting the modified measurement approach, rather than introduce the time criteria.

Generally, non-life insurance contracts that use an unearned premium approach have the coverage period of one year or less in general, but there are other insurance contracts that have a coverage period of more than one year such as builders risk insurance and worker's compensation insurance. When the insurers are measuring pre-claims liability using unearned premium approach, due to the fact that requisite of applying unearned premium approach requires the insurance coverage to be less than one year, it is inappropriate to apply different measurement methods on contracts with same risks and this will confuse the information users.

Therefore, it is appropriate that the unearned premium approach to be applied depending on the characteristics of a contract rather than on the coverage period.

**Question 9 – Contract boundary principle**

Do you agree with the proposed boundary principle and do you think insurers would be able to apply it consistently in practice? Why or why not? If not, what would you recommend and why?

AOSSG members agree with the IFRS 4 ED's proposal. When measuring an insurance contract liability, all the cash flows expected to arise as the insurer fulfils the obligation have to be reflected. This means that unless an insurer can avoid the cash flows for the contract, cash flows within the range of an insurance contract which can be viewed as one contract, should be considered.

In this point of view, AOSSG members believe the proposal in this exposure draft, suggesting the boundary of an insurance contract would be the point at which an insurer is either no longer required to provide coverage or has the right or the practical ability to reassess the risk of the policyholder and, as a result, can set a price that fully reflects that risk, is reasonable.

**Question 10 – Participating features**

- (a) Do you agree that the measurement of insurance contracts should include participating benefits on an expected present value basis? Why or why not? If not, what do you recommend and why?
- (b) Should financial instruments with discretionary participation features be within the scope of the IFRS on insurance contracts, or within the scope of the IASB's financial instruments standards? Why?
- (c) Do you agree with the proposed definition of a discretionary participation feature, including the proposed new condition that the investment contracts must participate with insurance contracts in the same pool of assets, company, fund or other entity? Why or why not? If not, what do you recommend and why?

(d) Paragraphs 64 and 65 modify some measurement proposals to make them suitable for financial instruments with discretionary participation features. Do you agree with those modifications? Why or why not? If not, what would you propose and why? Are any other modifications needed for these contracts?

(Q10-a) AOSSG members agree that payments arising from the participating features should be included in the measurement of insurance contracts, because it corresponds with the principle that all the cash flows expected to arise as the insurer fulfils the obligation should be included.

Reflecting distributions on the measurement of the liability arising from participating contracts would bring consistency in measurement of an insurance contract liability. In some countries, future distributions from unrealised gains and losses of an underlying asset are accounted as a separate liability by the shadow accounting.

However, if the future distributions are included in the cash flows, the possible liability arising from the participating contracts will automatically be included in an insurance contract liability and the shadow accounting will not be necessary.

According to this ED's paragraph 32, it suggests that if the amount, timing or uncertainty of the cash flows arising from an insurance contract depends wholly or partly on the performance of specific assets, the discount rate's calculation of the insurance contract shall reflect that dependence.

Especially for participating insurance contracts, applying the cash flow caused by future distributions decided by the performances of operating assets in forecasting cash flow can maintain consistency with the rules of paragraph 32.

Thus, future distributions to a policyholder should be included in the cash flows to measure an insurance contract liability.

(Q10-b) AOSSG members believe that in order to be identified as insurance contract, financial instruments with discretionary participation features should be tested for whether the insurance risk transferred is significant. If the insurance risk is significant, financial instruments with discretionary participation should be within insurance contract standards. Otherwise, financial instruments with discretionary participation features should be within financial instrument standards.

In principle, as participating investment contracts that have discretionary participating features do not transfer significant insurance risk, it will be more appropriate to be excluded from the scope of the IFRS on insurance contracts but included within the scope of the IASB's financial instruments standards. There is a possibility of deterioration in comparability of financial statements if different standards are applied on the participating investment contracts issued by an insurance company and by other financial institutions.

However, there were some views that using the same accounting standards for both types of contract will produce more relevant information for users and simplify the accounting for those contracts. That's because participating investment contracts and participating insurance contracts are sometimes linked to the same underlying pool of assets and sometimes

participating investment contracts even share in the performance of insurance contracts.

(Q10-c) AOSSG members disagree due to the review opinion of (b).

If financial instruments with discretionary participation features want to be regarded as insurance contract, the insurance risk transferred must be significant. If the insurance risk transferred is not significant, financial instruments with discretionary participation should not be regarded as insurance contract.

That is, whether financial instruments with discretionary participation should be regarded as insurance contract should be determined according to the definition of insurance contract.

(Q10-d) AOSSG members agree with the proposal.

Despite of review opinions of (B), if the participating investment contracts that have discretionary participating features are necessary for scope of the insurance related IFRS, we believe this ED's proposal that applies characteristics of participating investment contracts is appropriate.

**Question 11 – Definition and scope**

- (a) Do you agree with the definition of an insurance contract and related guidance, including the two changes summarised in paragraph BC191? If not, why not?
- (b) Do you agree with the scope exclusions in paragraph 4? Why or why not? If not, what do you propose and why?
- (c) Do you agree that the contracts currently defined in IFRSs as financial guarantee contracts should be brought within the scope of the IFRS on insurance contracts? Why or why not?

(Q11-a) AOSSG members agree with the proposal. In this ED, when deciding whether to transfer the significant insurance risk, following two are considered additionally.

Therefore, it could prevent classifying the contracts that do not transfer the significant insurance risk as insurance contracts and appropriately apply economic substance of insurance contract.

- A contract does not transfer insurance risk if there is no scenario that has commercial substance in which the present value of the net cash outflows paid by the insurer can exceed the present value of the premiums. (B25)
- In determining whether it will pay significant additional benefits in a particular scenario, the insurer takes into account the effect of the time value of money. (B26)

(Q11-b) AOSSG members agree with the scope exclusions in paragraph 4 in the proposed standard which are similar to the exclusions in the existing IFRS 4.

(Q11-c) AOSSG members agree with the proposal because if financial guarantee contract meets the definition of insurance contract, it should be within the insurance contract standard.

In estimating or recognising financial guarantee contracts, it is reasonable to apply the IFRS on insurance contracts as this will satisfy the accounting principle of applying the same

accounting standard on the same transaction.

Especially, applying different standards just because financial guarantee contracts are issued by a non-insurance company other than an insurance company, will deteriorate the comparability and may not be able to provide useful information to the users.

One member country argue from the practical perspective that since applying accounting for insurance contracts to financial guarantee contracts which entities other than insurance companies issue is burdensome for those entities and would create confusion, those contracts should be scoped out of the IFRS 4.

Likewise, another member support that non-insurers should be given the option to account for financial guarantees as financial instruments or as insurance contracts. The ED Amortized cost and impairment of financial instruments issued in November 2009 proposed that financial liabilities accounted for at amortized cost should continuously be measured and estimated based on the expected cash outflows at each measurement date.

If the proposal is accepted eventually, the measurement of financial guarantee liabilities should theoretically be similar under both the financial instruments standard and the new insurance contracts standard. In addition, allowing financial guarantee contracts to be accounted for as financial instruments may be more reflective of their economic substance since they transfer credit risk. Further, the proposed presentation and disclosure requirements, which are more suitably applied to insurers, may be too burdensome for these contracts which are mostly issued by non-insurers.

#### **Question 12 – Unbundling**

Do you think it is appropriate to unbundle some components of an insurance contract? Do you agree with the proposed criteria for when this is required? Why or why not? If not, what alternative do you recommend and why?

If components of an insurance contract can be explicitly separated, AOSSG members believe that it is appropriate to unbundle in order to enhance the comparability with other financial instruments or other financial institutions. However, more detailed guidelines need to be provided for this ED's 'insurance components that are closely related'.

- For example, in order to unbundle a savings component from an insurance contract, it is required to be measured separately. But, in some countries, insurance premium is calculated per contract and business expenses are shared, which means that in order to separately measure a component, arbitrary allocation is necessary.

In the IAS 39, it contains detailed examples on how to separate an embedded derivative from its host contract when they are closely related to its host contract as well as when they are not closely related to its host contract. Therefore, AOSSG members suggest detailed examples to be provided to clarify the definition of a close relationship in unbundling like the IAS 39.

#### **Question 13 - Presentation**

- (a) Will the proposed summarised margin presentation be useful to users of financial statements? Why or why not? If not, what would you recommend and why?
- (b) Do agree that an insurer should present all income and expense arising from insurance contracts in profit or loss? Why or why not? If not, what do you recommend and why?

(Q13-a) AOSSG members suggest retaining the existing presentation of financial statements to present all income and expenses arising from insurance contracts in profit or loss but include the proposed summarised margin presentation as a note to the financial statements.

Summarised margin approach directly presents release of residual or composite margin, change in risk adjustment, experience adjustment, change in estimates of cash flows and discount rates, and interest on insurance contract liabilities in the statement of comprehensive income. Thus, this approach has consistency with the ED's proposed measurement model and clearly presents the changes in building blocks. Considering above facts, AOSSG members conceptually agree in principle that this approach provides useful information to the users of an insurer's financial statements.

However due to following reasons, AOSSG members support the written premium approach for financial statements presentation:

- Importance of the premium income, claims and benefits
- Enhancement of understanding through the reconciliation
- Meaningful application of unbundling

### **Importance of the premium income, claims and benefits**

As stated in basis for conclusion in proposed ED, premium income as well as claims and benefits are very important information to the users of the financial statements since they help in analyzing the information on insurers' origin of revenue.

However, the summarised margin approach that does not present the premium income, claims and benefits is unfamiliar presentation method even to the companies who participate in insurance industry. As a result, other companies who does not participate in insurance industry will have great difficult in understanding and interpreting.

### **Enhancement of understanding through the reconciliation**

Disclosing changes in building blocks such as the release of composite or residual margin, the changes in risk adjustment, experience adjustment, changes in estimates of cash flows and discount rates and interest on insurance contract liabilities on financial statements, could sufficiently provide useful information to users.

### **Meaningful application of unbundling**

In summarised margin approach, only residual margin and the change in risk adjustment are recognised in profit and loss, and premium received is accounted for as a deposit. Thus, whether to apply the unbundling does not have any impact on an accounting treatment. Therefore, under the summarised margin approach, since there is no actual differences in accounting treatment whether to apply the unbundling, there is no need of rules related to



unbundling.

On the other hand, there is another view that the written premium approach is a cash basis presentation and would result in an overstatement of revenue for a contract that includes a lot of deposit element that would not be unbundled. So, they are of the view that further consideration should be given to the expanded margin model.

(Q13-b) In concept, AOSSG members agree with the proposal because presenting all income and expense arising from insurance contracts in profit or loss can provide users of financial statement with relevant and useful accounting information.

However, due to following practical reasons, some AOSSG members express concern on the proposal that all the income and expenses arising from an insurance contract liability should be presented in profit or loss in a statement of comprehensive income. They suggest review of an alternative of recognizing the change in insurance liability due to the assumption change in discount rate in OCI.

Unlike in Europe, emerging markets do not have advanced long-term financial markets and so that a long-term financial asset that meets the duration of an insurance contract cannot be managed.

Therefore, there will be a difference between gains and losses arising from the subsequent measurement of assets and liabilities even when they are measured at fair value due to the difference in duration. As a result, insurers from the emerging market will face a huge fluctuation in gains and losses from the subsequent measurement.

Thus, some AOSSG members suggest that a part of gains and losses affected by a market variable (e.g. discount rates) to be recognised in other comprehensive income and the rest to be recognised in current profit and loss.

According to the ground of this ED's decision, the IASB expresses the profits or losses occurred in insurance contracts are the core of insurers' operational outcome.

However, the change in insurance liability due to change in discount rate of market is not related to the insurers' operational outcome. Thus, some AOSSG members think that, among the insurance liability's profits or losses, recognizing the portion due to change in market (discount rate) in OCI will provide useful information in presenting company's current outcome.

**Question 14 – Disclosures**

- (a) Do you agree with the proposed disclosure principle? Why or why not? If not, what would you recommend, and why?
- (b) Do you think the proposed disclosure requirements will meet the proposed objective? Why or why not?
- (c) Are there any disclosures that have not been proposed that would be useful (or some proposed that are not)? If so, please describe those disclosures and explain why they would or would not be useful.

(Q14-a,b,c) AOSSG members generally agree with the proposals relating to the disclosure, primarily because they are principles-based.

However, AOSSG members suggest providing additional guidelines on sensitivity analysis and uncertainty analysis from perspective of improving comparability.

Additional proposals that can be included in a guideline for sensitivity analysis:

- Basic input and assumption included in disclosure
- Application examples
- Examples for changes in possible risk variables

Additional proposals that can be included in a guideline for uncertainty analysis:

- Examples on how to judge the materiality
- How to estimate when several assumptions change concurrently
- How to determine the correlation between assumptions

**Question15- Unit-linked contracts**

Do you agree with the proposals on unit-linked contracts? Why or why not? If not what do you recommend and why?

AOSSG members agree with the proposal, because the proposals on unit-linked contracts can faithfully reflect the nature of these contracts and provide to the users of financial statement with relevant information which are decision usefulness.

And also AOSSG members note that insurers should present single line items on financial statements for assets and liabilities relating to the unit-linked contracts. Unit-linked contracts are different from general insurance contracts in a way that the actual investment return would be accumulated. They are also different from investment trust in the sense that additional insurance benefit is provided.

Assets/liabilities relating to unit-linked have different characteristics from the assets/liabilities of a general account, therefore they need to be separately managed and recognised. Also, AOSSG members believe that it is more appropriate to reflect on financial statements of an insurer as they are assets/liabilities of the insurer unlike the investment trust, even though they are independently managed from the assets/liabilities of a general account.

AOSSG members also agree that insurers should present single line items on financial statements for both income and expense for the same reasons explained above.

However, when considering the possibility of unbundling, it is not specified clearly in the exposure draft up to what extent of income/expense should be presented.

Therefore, AOSSG members believe that examples or additional explanation on presentation of unit-linked contracts should be provided in case of unbundling.

**Question 16 – Reinsurance**

- (a) Do you support an expected loss model for reinsurance assets? Why or why not? If not, what do you recommend and why?
- (b) Do you have any other comments on the reinsurance proposals?

(Q16-a) Reinsurance assets are a cedant's net contractual rights under a reinsurance contract. Like general accounting receivables, a cedant faces the risk that the reinsurer may default.

AOSSG members believe that the impairment test of a reinsurance asset should follow the same principle applied on the impairment test of a financial asset.

Therefore, the principle that is applied on the impairment of the reinsurance asset should be aligned with the principle to be set in the future financial instrument standards.

(Q16-b) At initial recognition and in subsequent measurement, a reinsurance contract is measured. In case of a reinsurance ceded, a cedant can measure the reinsurance asset on the same basis as its underlying direct insurance liability.

However, the reinsurer may have difficulties in measuring the reinsurance contract on the same basis as its underlying direct insurance due to the lack of information on the underlying direct insurance.

Generally, cedants do not provide enough information about the underlying direct insurance to a reinsurer, because the corresponding information such as premium rate is considered to be confidential, especially for the business insurance.

Therefore, estimating with the information the reinsurer has, without relying on the information from the cedant would require judgement, and will be practically very difficult.

For the reasons stated above, reinsurers in some countries recognise the same amount informed by the cedant as provisions. Reinsurance liabilities of a reinsurer, especially, if the cedant is a foreign insurer, are difficult to estimate as information on the occurrence of the insured event does not exist.

The rationale for recognising the same amount informed by a cedant as provisions is that the need to re-estimate the reinsurance liability is low as the amount is already estimated by the cedant.

Therefore, AOSSG members believe that additional guidance on estimating reinsurance liability of a reinsurer is necessary in order to supplement its practical limitation.

For example, assuming that a cedant has made a reasonable estimation on the reinsurance liability, the reinsurer will be able to use the estimation from the cedant if there is guidance which allows this. However, the reinsurer should not recognise the impairment of reinsurance assets estimated by the cedant in any case.

In addition, some short-duration insurance contracts are currently covered by 'umbrella' reinsurance contracts that run for more than one year. Under the proposals, the direct insurance contracts would be measured using an unearned premium approach whereas the

reinsurance contract would be measured using the comprehensive measurement approach, which is arguably inconsistent with the IASB's intentions.

**Question 17- Transition and effective date**

- (a) Do you agree with the proposed transition requirements? Why or why not? If not, what would you recommend and why?
- (b) If the Board were to adopt the composite margin approach favoured by the FASB, would you agree with the FASB's tentative decision on transition (see the appendix to the Basis for Conclusions)?
- (c) Is it necessary for the effective date of the IFRS on insurance contracts to be aligned with that of IFRS 9? Why or why not?
- (d) Please provide an estimate of how long insurers would require to adopt the proposed requirements.

(Q17-a) Some AOSSG members supported full retrospective restatement method rather than modified retrospective approach, because insurance companies in their country have adopted retrospective restatement method already, so they consider transition requirements to be unduly onerous. Thus they are suggesting that if entities can reliably restate their financial statement to comply with the proposals, they should be permitted to do so.

On the other hand, most AOSSG members argue that the full retrospective application may not be practicable particularly where insurers have made distributions to policyholders and shareholders prior to the implementation of this proposed standard. It is also legally not possible to 'claw-back' previously distributed surpluses to policyholders and shareholders.

Furthermore, it is impracticable to determine composite margins, residual margins and risk adjustments for legacy insurance contracts. It is also doubtful whether this requirement would address cost-benefits to insurers and users of financial statements.

Thus, most AOSSG members agree with the use of the prospective application of the proposed standard for new insurance contracts.

AOSSG members also suggest the following matter to be considered by IASB for inclusion in the final standard.

If a new measurement model is applied on an existing insurance contract at the date of transition and its residual margin is regarded as zero, the contract's residual margin's applicable amount will all be reflected in the retained earnings at the date of transition. In other words, when considering characteristics of insurance contracts that its outcome is occurred over long term basis, the revenue is supposed to be distributed over the insurance contract period. However, the revenue is applied as retained earnings immediately, thus this creates distortion on profit and loss. Moreover, there is possibility that this will deteriorate the comparability with revenue of new insurance contracts originated after the transition date

In order to solve the problem mentioned above, AOSSG members suggest following alternative methodology that allows the subsequent release of residual margin of the existing insurance contracts at the transition date over the remaining insurance coverage period.

Residual margin: Max [0, (A-B)]

(A) Insurance liability recognised under existing provision on the date of transition (But, only if it satisfies the adequacy test for liability required by IFRS 4 (Phase I). If it does not satisfy the test, reflect immediately in retained earnings.).

(B) Present value of future fulfilment cash flows measured using the ED's measurement model on the date of transition.

Although the proposed ED states in the basis for conclusion that estimated value of a residual margin using the method stated above is not comparable with the residual margin of the new subsequent contracts, AOSSG members believe this problem can be complemented by separately presenting the residual margin of the existing and new subsequent contracts.

(Q17-b) Using the risk adjustment measured according to the IASB's selected approach (in order to measure the composite margin of currently existing contracts) as proxy value of composite margin is not consistent with FASB's approach who opposes classification between risk adjustment and residual margin.

In addition, applying the composite margin (except for the amount related to risk adjustment) of currently existing contracts on the date of transition to retained earnings rather than releasing will cause same problems as residual margin.

Therefore, there is need for an alternative method to measure the composite margin other than the risk adjustment. Refer to our review comments on (a) regarding this alternative.

(Q17-c) AOSSG members consider that the effective date of the IFRS on insurance contracts should be aligned with that of the IFRS 9, because doing it can reduce or eliminate accounting mismatch and increase accounting information understandability and decision usefulness.

According to this proposed ED, the financial assets can be re-designated as measured in financial assets that are recognised in profit or loss at the beginning of the earliest period presented. Hence, AOSSG members believe that there would not be a significant problem even if the guidance on recognition and measurement in IFRS 9 is first adopted in 2013. As long as the effective date of IFRS 4 is not earlier than that in IFRS 9, there will be no operational problems with IFRS 9 in applying IFRS 4.

However, if there is a timing difference between the effective dates of IFRS 9 and IFRS 4, it will be burdensome for an entity since it must go through the IFRS conversion process twice and the existing business model may have to be modified to comply with IFRS 4. Therefore, we believe that the setting up same effective date for both IFRS 9 and IFRS 4 will be effective and efficient from companies' perspectives.

(Q17-d) According to the survey done in Korea, the preparers of financial statements expressed that in order to adopt the IFRS (Phase 1); it will take at least 5 years as a preparation period. The table below is the summary of expected period in order to adopt ED's Phase II in real operations that is calculated on the basis of actual period taken to adopt IFRS 4 Phase I in real operations.

<The actual time taken to adopt IFRS 4 Phase I>

Stages	Large-sized insurer	Small to medium-sized insurer
Analysing the effect of IFRS 4 on regulatory accounting and insurance industry	1 year	1 year
Selecting a consulting firm	2 months	1 month
Observing the process of a large-sized insurer	6 months	3 months
Analysing the difference of IFRS 4 Phase I	N/A	1 ~ 1.5 years
System designing, building and testing	1 year	6 months
Stabilisation of the system and preparation of financial statements	6 months	3 months
<b>Total estimated period</b>	<b>3 years and 2 months</b>	<b>3.1 ~ 3.5 years</b>

<Estimated time taken to adopt IFRS 4 Phase II>

Stages	Large-sized insurer	Small to medium-sized insurer
1) Translation into a local language	1 month	1 month
2) Analysing the effect of IFRS 4 on insurance industry	3~6 months	3~6 months
3) Establishing the management plan for regulatory accounting	6 months~1 year	6 months~1 year
4) Selecting a consulting firm	2~3 months	1~2 months
5) Analysing the difference of IFRS 4 Phase II	6 months~1 year	3 months
6) Data accumulation and observing the process of a large-sized insurer	6 months~1 year	3~4 years
7) System designing, building and testing	1.5~2 years	6 months~1 year
8) Stabilisation of the system and preparation of financial statements	6 months~1 year	3~6 months
<b>Total estimated period</b>	<b>4~7 years</b>	<b>5~7.5 years</b>

**Translation into a local language**

Even if the final draft is published in June 2011, it will take time to translate it into a local language and accordingly, this should be taken into consideration when deciding the effective date.

**Analysing the effect of IFRS 4 on insurance industry and establishing the management plan for regulatory accounting**

Like in the Phase I project, it is essential to analyse the macroeconomic effect of the standard throughout the industry before launching the Phase II project. It also plays a

very crucial role in establishing the management plan for regulatory accounting. Therefore, a preparation period is required to understand and establish basic management plan through the macroeconomic analysis before starting the project, even if a detailed management plan for regulatory accounting will be established later.

### **Selecting a consulting firm**

Like all the other IFRS conversion projects, it is practically impossible for a company to conduct the IFRS 4 project alone. Therefore, the project should be conducted in coalition with an accounting firm and consulting firms like an IT system building company. It is likely to be a very large project leading to a very dramatic change in systems that costs a large amount of time and money. It may take a long time to select a consulting firm as it needs to be discreet.

### **Analysing the difference, system designing, building and testing / system stabilisation and preparation of financial statements**

A dramatic system change is required as a new measurement model needs to be applied in IFRS 4 Phase II. Considering the fact that Phase I, which did not require a dramatic system change took around 3 years, we believe that 5 years of preparation time would still be short as Phase II requires a dramatic change of system, building and testing.

### **Data accumulation and observing the process of a large-sized insurer**

For small to medium-sized insurers, it is difficult to launch the implementation at the same time as the large-sized insurers due to its costs. Therefore, they should start implementing after the large-sized insurers establish the system to an extent so that they can share the knowledge and experience from the large-sized insurers. This means that it will take a good amount of time for the overall industry to adopt IFRS 4.

Data accumulation for the new measurement model is a different matter even if the small to medium-sized insurers can share the knowledge and experience. Considering that the majority of the small to medium-sized insurers depend on the data produced by Korea Insurance Development Institute (KIDI), a preparation period to gather the own historic data of the company for the new measurement model will be required. For example, as non-market external data such as a mortality rate has lower credibility than the internal data, internal data is absolutely required. However, as these data are not accumulated, a long preparation time will be required.

### **Others**

IFRS 4 and 9 are likely to have an important impact on establishing a business plan such as asset management plan or risk management plan. Therefore, time to establish or modifying such plans will also be required.

#### **Question 18 – Other comments**

Do you have any other comments on the proposals in the exposure draft?

AOSSG members question whether, in practice, insurers could always clearly and consistently distinguish between portfolio transfers and business combinations.

Unless the replacement Standard for IFRS 4 includes more robust criteria for distinguishing between such transactions, we would recommend the replacement standard require portfolio transfers and business combinations to be accounted for on the same basis.

**Question 19 – Benefits and cost**

Do you agree with the Board's assessment of the benefit and cost of the proposed accounting for insurance contracts? Why or why not? If feasible, please estimate the benefit and cost associated with the proposal.

AOSSG members agree with the Board's assessment that the benefit will be greater than the cost.

AOSSG members also note that presenting the source of revenue on financial statements, measuring liabilities at the end of every reporting period, and detailed disclosure of change in insurance liability as a footnote will provide more useful information to the users than the previous IFRS 4 Phase I.

However, AOSSG members believe that parts of the exposure draft need to be improved to increase the benefit of the financial information, and parts need to be improved to lower the cost of the financial information.



30 November 2010

Sir David Tweedie  
Chairman  
International Accounting Standards Board  
30 Cannon Street  
London EC4M 6XH  
UNITED KINGDOM

Dear Sir David,

**AOSSG Islamic Finance Working Group comments on  
IASB Exposure Draft ED/2010/8 *Insurance Contracts***

The Asian-Oceanian Standard-Setters Group (“AOSSG”) is pleased to provide comments from its Islamic Finance Working Group to IASB ED/2010/8 *Insurance Contracts*.

***Introduction***

The AOSSG’s Islamic Finance Working Group (“AOSSG IF WG”) was set up to provide input and feedback on the adequacy and appropriateness of proposed and existing IFRS relating to Islamic financial transactions and events. The AOSSG IF WG comprises staff from the standard-setters of Australia, Dubai, Indonesia, Korea, Malaysia, Pakistan, and Saudi Arabia.

The working group has mainly discussed ED/2010/8 in the context of Takaful undertakings. During discussions, it transpired that the accounting issues identified relate to not only the recognition and measurement of insurance assets and liabilities, but may fall under the purview of IASB’s other projects, namely consolidation, financial instruments, and fair value measurement. Thus, the working group’s comments are not limited to the contents of ED/2010/8, and include issues relating to other aspects of Takaful accounting. Due to the significant issues relating to consolidation, a copy of this letter is also extended to the IASB staff responsible for the consolidation project.

The comments are additional to the AOSSG Insurance Working Group’s comments on IASB ED/2010/8 dated 30 November 2010. The AOSSG Islamic Finance Working Group had sought comment and feedback from AOSSG members prior to finalising this letter, and their views have been duly incorporated.

The working group’s comments are accompanied by a brief overview of Takaful to assist in providing an appreciation of the related accounting issues.

## What is Takaful?

### *Why is there a need for Takaful?*

- 1 Many Shariah scholars believe that conventional insurance may not be entirely free of elements prohibited by Shariah such as *gharar*, *maisir*, and *riba*. Simplistically, *gharar* implies an unacceptable level of uncertainty or ambiguity; *maisir* denotes gambling, gaming or speculation; and *riba* which is often translated as ‘usury’, but taken by a majority of scholars to include any interest above a principal loan amount.
- 2 Firstly, the ‘sale’ of insurance is deemed to contain *gharar* because the subject of sale - ‘protection’ or ‘safety’ - is unclear. It is uncertain whether the insurer’s liability will materialise, and if it does, it is uncertain how much the insurer would be liable for. Thus, insurance would fail to meet Shariah requirements for a valid sale contract, and a permissible contract other than ‘sale’ must characterise the relationship between an insurer and insured. Secondly, the way a conventional insurer invests funds may expose the policyholder to other Shariah prohibited elements. For example, investments in interest-bearing assets would result in *riba*, and there may be other impermissible elements, for example investments in alcohol businesses. Thirdly, a relatively smaller number of scholars also argue that a commercial insurance contract involves trading in risk and hence is contaminated by *maisir*.
- 3 To address these concerns, an alternative form of protection called ‘Takaful’ was developed. It is based in part on the risk-sharing practices of medieval Muslim merchant ships and caravans. Instead of a ‘sale’ of insurance from a company to an individual, Takaful is characterised by *ta’awun*, which denotes mutual assistance among participants contributing to a pool of funds; and by *tabarru’*, or ‘donations’ from that pool which would be used to compensate a participant upon a specified event befalling the participant. Another party - a ‘Takaful operator’ - may be appointed to safeguard and manage the participants’ funds. In Shariah, the uncertainty (*gharar*) that inevitably arises in providing protection would be tolerated in a structure based on *tabarru’* because a donation is not a contract of exchange, and no return would be expected. Moreover, the funds will also be invested in ways which are Shariah compliant.

### *How does Takaful work?*

- 4 Takaful is often described as a group of participants pooling their risks and funds to mutually indemnify each other should a specified event occur. These participants’ funds are often likened to mutual insurance, in that a mutual insurance entity is owned entirely by policyholders and there are no shareholders.
- 5 However, in practice, it is rare to find a Takaful fund that behaves like a true mutual insurance entity. The reasons for this are two-fold. Firstly, unlike in medieval times, Takaful today is not driven by members of any trade or profession mutually indemnifying each other against the similar risks that they share. Instead, the modern Takaful industry was developed primarily to offer Shariah-compliant alternatives to commercial insurance products. Secondly, the initial capital needed to meet operating expenses as well as to meet adverse risk outcomes in the early years

is prohibitive and generally beyond the capabilities of individual participants. In most jurisdictions there would be regulatory minimum capital requirements, for the same reasons of consumer protection and systemic stability as in the case of conventional insurance.

- 6 Thus, in most contemporary arrangements, Takaful funds are usually initiated by a Takaful operator who would solicit participants to a fund. A Takaful operator is often an entity funded by shareholders, and would undertake many of the activities that a commercial insurer would, e.g. underwriting, risk management, claims processing. Nevertheless, a Takaful operator is deemed to be a ‘manager’ of participants’ funds, and (to use Islamic classical terms) its relationship with participants can take the form of:
- (i) *Wakalah*, or ‘agency’, where the Takaful operator would be entitled to a fee for managing a participants’ fund; or
  - (ii) *Mudarabah*, or ‘profit-sharing’, where a Takaful operator would be entitled to a share of surpluses made by a participants’ fund; or
  - (iii) a ‘hybrid’ model where a Takaful operator gets a management fee for managing the underwriting activity of the fund, as well as a share in any profits made by investing the assets of the fund.

The ‘hybrid’ model is the most commonly-used amongst Takaful operations being established today. Other models have been discussed (for example, one based on a trust structure) but these have not achieved widespread acceptance.

- 7 Takaful may be a pure protection product, as is commonly the case for general Takaful such as motor or household. However, some products – often referred to as ‘family Takaful’ - may also have an investment element. In family Takaful, it is common to divide the participants’ contributions between a risk pool, used to cover mortality risk, and an investment pool. The economic structure thus becomes very like that of a conventional life insurance product, particularly a unit-linked product, in the sense that the sum payable at the end of the policy is directly linked to the performance of the investment pool.
- 8 Thus the structure of a typical modern Takaful undertaking<sup>1</sup> comprises a normal shareholder-owned company, embedded within which are funds which are considered to be the property of the participants, but which generally do not have separate legal personalities.

### ***How is Takaful different from insurance?***

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<sup>1</sup> In this letter, “Takaful funds” refer to participants’ funds. Where we refer to the “Takaful operator”, we mean the commercial operation which manages the Takaful funds, and the assets and liabilities attributable to that operation (and thus to the shareholders of the company). Where we refer to the “Takaful undertaking”, we mean the entire legal entity within which these different pools are contained. Where we need to consider the investment pool within a Family Takaful undertaking, we refer to this as the “participants’ investment fund”.

### *Structure*

- 9 The most important difference is the structural one explained above. Fundamentally this means that within the same legal entity there are pools of funds with different ownership. A parallel may be drawn with life insurers in Australia and in some parts of the EU where there are separate pools of funds to prevent cross-subsidisation and enhance policyholder protection.
- 10 A corollary of fund segregation is that, at least in Shariah terms, not all the assets of the undertaking are available to meet all the liabilities. For example, the Takaful fund cannot be used to pay the Takaful operator's rent. How far the principle of fund segregation would be respected in the event of insolvency may vary from country to country, and has not been tested in practical cases. Nevertheless, for financial reporting purposes, many Takaful undertakings would present separate financial statements for a Takaful operator and the funds it manages. This contrasts with the situation in Australia and the EU, where an insurance entity would generally consolidate these different pools of funds because all the funds are used to leverage a return for the insurer.

### *Contractual relationship*

- 11 In a conventional insurance contract, there is a sale of insurance by an insurer to a policyholder for a premium, and there is often a direct risk transfer from a policyholder to an insurer. With Takaful, while there is risk-sharing among participants, the role of a Takaful operator to a participants' fund is primarily that of a manager. There is some debate as to whether there is a transfer of insurance risk from a participant (or the group of participants) to the Takaful operator. The answer to this may depend on practices relating to *Qard*, described below.

### *Nature of revenue*

- 12 Due to the different relationships, the nature of revenue may also differ. An insurance entity may recognise premiums as income, while a Takaful operator may recognise revenue in the form of fees or profit-share. The premiums will, however, be income to the Takaful fund.

### *Treatment of policyholders' / participants' deficiencies*

- 13 For most conventional general insurers, and in many life insurers, there is in principle no separation between policyholders' and shareholders' funds. Thus if underwriting or investment outcomes are poor, the effect is that shareholders' equity is eroded. If it is sufficiently eroded, below solvency or more probably below regulatory requirements, then the insurer may be forced to be closed to new business. However, with Takaful, the most common way to overcome a deficiency in the Takaful fund is through *Qard*, that is an interest-free loan, from the Takaful operator to the fund, given that the initial capital for the Takaful undertaking comes from the Takaful operator's shareholders. *Qard* has no fixed terms of repayment, but would generally be paid back once a sufficient surplus is generated.

### *Treatment of policyholders' / participants' surpluses*

- 14 Because the Takaful fund is held to belong to the participants, if it achieves a surplus, that surplus may be distributed in whole or in part to the participants, and effectively becomes a rebate on premiums paid. The basis on which this will be done may be specified in the policy document. Part of any surplus may, for example, be retained to build up capital in the fund to cope with future adverse risk outcomes. The prospect that surplus may be distributed is seen as a significant selling point by some Takaful operators selling pure protection products.

### *Shariah compliance*

- 15 A Takaful undertaking would usually seek the counsel of a Shariah advisor or panel of advisors to ensure that various aspects of its operations are in compliance with Shariah. For example, Shariah advice would be sought as part of product development, and in making investment decisions.

### *Policy terms*

- 16 Shariah requirements will also have an impact on policy terms. In conventional life insurance, the sum assured is distributed among the named beneficiaries. However, in family Takaful, payments for Muslim participants must be distributed in accordance with Islamic inheritance laws. Again, “new for old” policies are normally not written, because the prospect that a participant might effectively make a gain raises the issue of *maisir* even among scholars who have no objection to protection on a pure indemnity basis.

### ***How is Takaful similar to insurance?***

#### *Activities*

- 17 Although their contractual relationships with policyholders / participants differ, a Takaful operator and a conventional insurer carry out many of the same activities. For example, a Takaful operator usually carries out underwriting activities to determine whether to accept a participant and how much contribution he should pay; it would also carry out other activities like claims processing, loss adjustment, etc. just like a conventional insurer would.

#### *Consumer perception*

- 18 In a number of countries, Takaful operators and conventional insurers compete for the same pool of consumers. Other than Shariah compliance, the differences between many Takaful and conventional insurance products are indistinct to the consumer in terms of the protection offered. For example, religious beliefs aside, a consumer could choose to purchase either general insurance or general Takaful. Similarly, he could choose either a life insurance product or a family Takaful plan. Product pricing, too, is often comparable within the same market segments.

#### *Regulatory requirements*

- 19 Indeed, in part due to the economic similarities, regulators in many jurisdictions subject Takaful undertakings to similar requirements as insurance companies, indicating that regulators perceive similar risks to consumers and to the financial system. For example, a Takaful operator may need to meet similar capital requirements, and to submit similar reports and returns as conventional insurers.

*Parity of consumers' risk*

- 20 Some regulators may institute measures to ensure that Takaful participants' risks are more or less on par with conventional insurance policyholders. For example, if a Takaful operator was acting purely as a manager, then theoretically any deficiency in a participants' fund ought to be made up by further contributions from participants. However, pursuing such a puritanical model may (a) be detrimental to existing Takaful participants, and (b) deter future participants from entering the fund.
- 21 Thus, for consumer protection, regulators in some jurisdictions would require a Takaful operator to provide financial assistance, usually *Qard*, to a fund that is facing a deficiency. This would also prevent the moral hazard of a Takaful operator continuing to enjoy management fees regardless of the health of its participants' funds, whilst an insurance company in a similar situation would bear its' policyholders' deficiencies. In fact, this is why the capital requirements set by many regulators for Takaful operators are similar to those for insurance entities. The amount of capital required for a Takaful operator is generally far higher than would be expected for a management business.

**Accounting issues relating to Takaful**

***Consolidation: Should the Takaful operator and the Takaful funds it manages be presented as a single entity?***

*View 1: The Takaful operator and the Takaful funds should have separate financial statements.*

- 22 A Takaful operator is seen as an entity that is distinct from the participants' funds it manages. The ownership of the pools of money is held to be different, and not all the assets are available to meet all the liabilities. Thus, in some jurisdictions, there may be presentation and disclosure requirements to emphasise this separation, such as a requirement to prepare separate statements for the participants' funds. Some financial services regulators will apply capital requirements at the level of the participants' funds, again requiring a basis to evaluate the assets and liabilities of those funds.

*View 2: The Takaful operator and the Takaful funds should have 'combined' financial statements.*

- 23 Some jurisdictions do recognise that separate presentations may not adequately reflect the economic relationship between a Takaful operator and the funds it manages, and that there is some merit to a single entity presentation. In these jurisdictions,

regulation may require the presentation of a single set of ‘combined’ financial statements which would aggregate or ‘combine’ the Takaful operator and the participants’ funds at the level of the legal entity, which is the Takaful undertaking. Some regulators may require presentations of both separate and combined financial statements.

- 24 ‘Combined’ accounts are not synonymous with ‘consolidated’ accounts. One notable difference is that inter-fund transactions are not eliminated. In particular we note that an unusual presentation results from combining the separate statements of the Takaful operator and the participants’ funds when *Qard* is treated as a receivable (financial asset). In the Takaful operator’s financial statement, *Qard* disbursed by the Takaful operator to participants is recorded as:

DR Qard (receivable)  
CR Cash

In the participants’ financial statement, because the purpose of the *Qard* is to correct a deficiency in the participants’ fund, it is usually recognised as a capital injection and not as a payable (financial liability), i.e.:

DR Cash  
CR Participants’ fund

Upon combining the Takaful operator’s and participants’ financial statements, the net effect would be:

DR Qard (receivable)  
CR Participants’ fund

It may seem anomalous for the combined entity to have a receivable due from itself, and an item of ‘revenue’ generated by itself. However, in jurisdictions where *Qard* is treated as a receivable, this is the customary presentation. [The classification of *Qard* is discussed in more detail in paragraphs 41-46.]

*View 3: The Takaful operator and Takaful funds should have consolidated financial statements.*

- 25 Outside of IFRS jurisdictions, such as the EU, it is less common to encounter financial statements that consolidate a Takaful operator and the funds it manages. From an accounting perspective, opponents of consolidation argue that since not all the assets of the legal entity are available to meet all the liabilities (e.g. the participants’ funds are not available to pay the salaries of the Takaful operator’s staff) it would be misleading simply to consolidate the various asset pools. In addition, there also seems to be a perception that the financial statement presentation must reflect the Shariah requirement for fund segregation, and that consolidation would be in conflict with this principle. Note also that in the case of family Takaful the arguments for consolidating (or not consolidating) the participants’ investment fund are somewhat different from those relating to the participants’ risk funds.

- 26 However, under IAS 27, the necessary criterion for consolidation – control – may be deemed to be present. A parallel may be drawn with the structure of life insurers in

Australia, where funds contributed by policyholders are isolated in Statutory Funds in accordance with prudential regulation. Despite the statutory segregation between policyholders' interests and shareholders' funds, Australian accounting standards require a life insurer to recognise in its financial statements the assets, liabilities, income, expenses and equity of the entity, whether they are designated as relating to policyholders or to shareholders. Paragraph 4.1.1 of AASB Standard 1038 *Life Insurance Contracts* explains:

*“Life insurers may have both policyholders and shareholders with a financial interest in the entity. It is sometimes argued that the interests of policyholders and the interests of shareholders form the bases of separate entities that should prepare separate primary financial statements. However, the view adopted in this Standard is that the interests of policyholders and shareholders are intertwined and form the basis of a single entity. The boundaries of this entity are defined by control. The directors of the life insurer, in pursuing its objectives, govern the decision-making in relation to the financial and operating policies of the life insurer, which includes the assets of the entity, whether they are designated as relating to policyholders or to shareholders.”*

Thus, in developing an accounting policy for the presentation of Takaful financial statement, giving due consideration to AASB's standards may be in line with IAS 8, paragraph 12 which states that:

*“...management may also consider the most recent pronouncements of other standard-setting bodies that use a similar conceptual framework to develop accounting standards ...”*

- 27 Others argue that although control may be present, beneficial ownership is not, and that the position of the Takaful operator is more analogous to that of a trustee. It would be misleading to consolidate the accounts of a trustee with those of the trusts it controls.
- 28 In the remainder of these comments, we assume that some jurisdictions will wish, at minimum, to be able to present separate financial statements for the Takaful funds and the Takaful operator, even if they also require financial statements at the level of the Takaful undertaking.

***Scope: Does Takaful fall within IFRS 4 Insurance Contracts? If not, should it?***

- 29 As described in the preceding paragraphs, there are various similarities and differences between insurance and Takaful. Thus there is some debate as to whether IFRS 4 would apply to Takaful. The crux of the disagreement lies in the definition of insurance contracts given in Appendix A, which is:

*“A contract under which one party (the insurer) accepts significant insurance risk from another party (the policyholder) by agreeing to compensate the policyholder if a specified uncertain future event (the insured event) adversely affects the policyholder”*

- 30 Additionally, there are other features of Takaful which some working group members



construe as indicating the presence of insurance risk, while others do not. In particular, these are:

(a) *Qard*

See paragraphs 41-46 for further explanation.

(b) Claims handling costs

A Takaful operator may bear claims handling costs. Staff of the Australian Accounting Standards Board (“AASB”) believe that, in accordance with paragraph B27 of ED/2010/8, such costs may indicate significant insurance risk for a Takaful operator if there is a significant risk of the handling costs exceeding the fees charged.

However, other working members may see such costs as administrative in nature. For example, staff of the Dubai Financial Services Authority (“DFSA”) cite the case of specialist claims administrators. These firms may not be remunerated through direct reimbursement of costs, and are exposed to financial risk if the cost of claims administration varies. They are not usually treated as insurers for regulatory or accounting purposes.

- 31 There are varying views among working group members as to how IFRS 4 would apply to Takaful. Some believe that IFRS 4 would not apply to Takaful. Others believe it may; for example, staff of AASB have indicated that whether or not IFRS 4 would apply a particular Takaful contract would depend on the circumstances specific to that contract. The staff of the DFSA support applying IFRS 4 to either the Takaful fund or the Takaful operator if the Takaful arrangement falls within the insurance contract definition. The IASB may wish to note that the Malaysian Accounting Standards Board (“MASB”) have not exempted Takaful entities from the scope of IFRS 4. We explain the three main views raised by working group members in the following paragraphs. Two of these views may not be mutually incompatible.

*View 1: Takaful is not insurance. Hence IFRS 4 does not apply to Takaful.*

- 32 Some working group members believe that the definition provided by Appendix A does not describe Takaful because Takaful is thought of as risk-sharing among participants, and not a risk-transfer from a participant to a Takaful operator. A Takaful operator acts only as a manager of the fund; it is not an insurer because it has not agreed to compensate the participant if a specified uncertain future event adversely affects the participant. Even where financial assistance such as *Qard* is lent by a Takaful operator to a participants’ fund, some believe that it may only expose the Takaful operator to financial risk, and not insurance risk. Thus, because the definition is not met, Takaful should fall outside the scope of IFRS 4.
- 33 However, the staff of the Korean Accounting Standards Board (“KASB”) have indicated that although Takaful may not always meet the definition of an insurance contract in IFRS 4, it may not necessarily mean that Takaful should be out of the scope of IFRS 4. They cite the example of a financial instrument with discretionary participation features which would be included in the scope of IFRS 4, although it may not necessarily meet the definition of an insurance contract. Thus, KASB staff believe that by analogy, the same would also apply to some Takaful contracts.

*View 2: A Takaful participants' fund accepts an individual participant's insurance risk. Hence IFRS 4 applies to the Takaful participants' fund.*

- 34 In practice, there is a contract entered into between a participant and a Takaful operator - acting on behalf of the participants' fund - for a group of participants to accept an individual participant's risk, and to compensate the participant should a specified adverse event befall the participant. Thus, at the very least the participants' funds would be subject to IFRS 4, and a parallel is drawn with a mutual insurer described in paragraph B17 of the Application Guidance:

*"...In the case of a mutual insurer, the mutual accepts risk from each policyholder and pools that risk. Although policyholders bear that pooled risk collectively in their capacity as owners, the mutual has still accepted the risk that is the essence of an insurance contract."*

*View 3: The economic substance of a Takaful operator's role is similar to that of an insurer's. Hence IFRS 4 applies to a Takaful operator.*

- 35 In jurisdictions where regulations or expectations compel a Takaful operator to provide *Qard* when there is a deficiency in a participants' fund, the Takaful operator's role may not be restricted to only that of investment manager. Since the amount (and recoverability) of the *Qard* depends on the performance of the participants' fund, the Takaful operator's exposure to the *Qard* could be seen as an acceptance of insurance risk (albeit, an indirect acceptance) and it could be argued that the Takaful operator is in essence an insurer, and would be subject to IFRS 4.

- 36 Interestingly, there are those who opine that whether or not a Takaful operator would be subject to IFRS 4 would depend on the accounting treatment for *Qard*. Currently, there are differing views on how *Qard* should be treated. [See paragraphs 41-46 for further explanation.] It has been opined that if a Takaful operator classifies *Qard* as a receivable from a participants' fund, then the definition of 'insurance contract' is not met. Paragraph B19 (b) of the Application Guidance is cited as the basis:

*"The following are examples of items that are not insurance contracts: ...*

*(b) contracts that have the legal form of insurance, but pass all significant insurance risk back to the policyholder through non-cancellable and enforceable mechanisms that adjust future payments by the policyholder as a direct result of insured losses ..."*

Paragraph B20 further adds:

*"If the contracts described in paragraph B19 create financial assets or financial liabilities, they are within the scope of IFRS 9 or IAS 39. Among other things, this means that the parties to the contract use what is sometimes called deposit accounting, which involves the following:*

- (a) one party recognises the consideration received as a financial liability, rather than as revenue.*
- (b) the other party recognises the consideration paid as a financial asset, rather than as an expense."*

The working group is uncertain whether this is an appropriate interpretation of the Application Guidance. It is further feared that such an interpretation may lead to accounting arbitrage, as well as a loss of comparability since Takaful transactions which are essentially similar may be treated differently depending on an entity's classification of *Qard*. Members also note that while there may be "mechanisms that adjust future payments" by participants generally, these may not operate at the level of individual participants (for example because they may choose to no longer participate in that Takaful undertaking and instead move their cover to another undertaking). Members are of the view that paragraphs B19 and B20 could be improved by more directly addressing 'deposit insurance', which involves a depositor entering an arrangement under which it expects to effectively receive interest. This would avoid the impression that *Qard* should be treated in accordance with those paragraphs, and that in doing so Takaful would not meet the definition of an insurance contract.

- 37 Because Views 2 and 3 are operating at different levels (one on the participants' fund and the other on the Takaful operator) they are not mutually exclusive. The treatment of the contract between a participant and the fund may be different from the treatment of that same contract at the level of the Takaful operator considered as a manager of the fund, and different again at the level of the Takaful undertaking as a whole.

*IFRS 4 by analogy*

- 38 Notwithstanding the preceding paragraphs, the application of IFRS 4 to Takaful would be in line with paragraphs 10 and 11 of IAS 8, where in the absence of a Standard that specifically applies to a transaction, management is required to use its judgement by considering the applicability of the requirements in Standards dealing with similar and related issues. In the whole corpus of IFRSs, IFRS 4 is the Standard that most closely relates to Takaful transactions. Moreover, in many jurisdictions, Takaful and insurance are perceived by consumers to be similar, and indeed similar regulatory standards often apply to both industries such that both should be subject to the same IFRS.

### ***Unbundling: Possible non-accounting implications***

- 39 In family Takaful, a participant's contribution would be apportioned into at least two funds. Some part of the contribution would be deemed *tabarru'*, or a 'donation' to the participants' risk fund. The remainder of the contribution would be placed in a participants' investment fund. Under the ED, the former would be treated as insurance, and the latter as an investment contract. Acquisition costs would be apportioned between the two. Thus the participant would see an immediate, and very substantial, reduction in his investment which, under a normal Takaful contract, would be paid to his beneficiary on death. We have not analysed in detail how this would impact on the economics of Takaful, though we note that there may be similar impacts on conventional unit-linked policies. There would, however, be more serious contractual problems in Takaful, since payments into the participants' investment fund are normally managed under a Mudarabah contract, which does not permit the deduction of an initial fee corresponding to the acquisition costs. Unbundling may therefore impact on business and contractual models as well as accounting.

### ***Valuation of contracts***

- 40 In a typical Takaful undertaking, certain expenses (e.g. claims) are met from the participants' fund and others (e.g. claims handling costs) by the Takaful operator. The application of the rules for contract valuation therefore needs to take account of this. At the level of the fund this is relatively straightforward to do by analysing the cash flows, since certain payments (for example a management fee) are made to the operator as recompense for conducting those activities. It does, however, mean that valuation of a contract at the level of the fund may not be identical with the valuation that would follow if it were considered at the level of the Takaful undertaking as a whole. This may pose issues for consolidation.

### ***Classification of Qard: Is it an item of expense, asset, or "equity"?***

- 41 As mentioned, Takaful operates as pools of participants' funds managed by a Takaful operator. The participants' funds may represent those of general Takaful, such as motor vehicle, shipping, and construction; as well as family Takaful, such as education, health and annuity plans. (Whether a Takaful operator chooses to segregate participants' funds by line of business varies from case to case.) In some product lines, it may be many years before a fund begins to generate a surplus. To 'top-up' a fund which is in deficiency, a Takaful operator may extend to the fund an interest-free loan, *Qard*. In classical texts, *Qard* would normally be provided out of benevolence and the provider would generally not expect repayment. However, because many modern Takaful operations are run as businesses, it is expected that a fund would repay *Qard* to the Takaful operator when there is a sufficient surplus even though the tenure may be unspecified, and *Qard* is deemed to be 'payable when able'.
- 42 There is some discussion as to how *Qard* from a Takaful operator to a participants' fund ought to be treated. The question needs to be answered both for the operator and for the fund, on the basis that accounts may be required at both levels. Currently, there are three main views on the matter:

- (a) *It is an expense of the Takaful operator and income for the fund.*

In a Takaful undertaking, it is common for participants' funds to, at some point, incur a deficiency. Thus, *Qard* extended to a fund may be viewed as an operational cost of engaging in Takaful, and should be an item of expense. Any subsequent recovery may be deemed other income. This view is also in line with classical views on *Qard* in that although repayment would be welcomed by the lender, it is not expected.

- (b) *It is the 'equity' of the Takaful operator in the fund.*

Some have likened *Qard* to 'an investment in a subsidiary' because the Takaful operator has control over the fund, and consequently, *Qard* could be measured at cost under paragraph 38 of IAS 27. On this basis, repayment of the *Qard* would need to be treated as redemption of equity. It has, however, the unfortunate effect that consolidation treatment would potentially depend on the level of the *Qard* outstanding at any time.

- (c) *It is a financial asset of the Takaful operator.*

A Takaful operator, which is often a business entity, would generally expect that a *Qard* it has extended would be repaid from a fund's eventual surplus irrespective of the tenure of the *Qard*. Moreover, purists insist that participants should ultimately bear the risks of Takaful, and therefore participants have a liability to repay the *Qard*. Thus, it ought to be recognised as a financial instrument.

- 43 If *Qard* is viewed as a financial instrument, paragraph 43 of IAS 39 requires that it be measured at fair value on initial recognition:

*"When a financial asset or financial liability is recognised initially, an entity shall measure it at its fair value plus, in the case of a financial asset or financial liability not at fair value through profit or loss, transaction costs that are directly attributable to the acquisition or issue of the financial asset or financial liability."*

With regards to interest-free loans, paragraph AG64 of the Application Guidance to IAS 39 further provides that:

*"...the fair value of a long-term loan or receivable that carries no interest can be estimated as the present value of all future cash receipts discounted using the prevailing market rate(s) of interest for a similar instrument (similar as to currency, term, type of interest and other factors) with a similar credit rating...."*

- 44 There are two views about how to discount the future cash receipts of *Qard*:

- (a) *The discount rate should be nil.*

The majority of Shariah jurists rule that a return cannot be imposed on *Qard* because it must not be commercial in nature. Thus, no Takaful operator charges interest on *Qard*. Therefore, some argue that the discount rate for the future cash receipts from *Qard* should be nil because this is "the prevailing market rate(s) of interest for a similar instrument"; or

- (b) *The discount rate should be either an internal rate, or a commercial rate, or at the very least, the risk-free rate.*

Although the ‘market rate’ for *Qard* may be nil, providing *Qard* over an indeterminate period carries an opportunity cost for the Takaful operator, since those funds might otherwise be invested. Thus, it would be more useful to apply a discount rate that reflected the entity’s cost of funds, or a commercial loan similar as to currency, term, type and other factors. The use of these other rates would provide information on the opportunity costs forgone.

- 45 If *Qard* is treated as a financial instrument, there is a question whether it can ever be treated as impaired. For example, the position of the participants’ fund may be such that no repayment can be expected for a long time. In this case, should the loan be shown as impaired in the accounts of the Takaful operator, and if so how should consolidation be handled?
- 46 There may be a stand ready obligation to provide *Qard*, in that some financial services regulators will insist as part of their regulatory regimes that the operator be willing to do so under certain specified circumstances, or to maintain a specified level of solvency in the participants’ risk fund. Such a stand ready obligation would probably be accounted for as a contingent liability under the existing IAS 37, but as a liability under the IASB’s 2005 proposed revisions to IAS 37.

### ***Disclosures***

- 47 Certain additional disclosures may enhance the usefulness of Takaful financial statements. For example, paragraph 39 of AAOIFI FAS 12 *General Presentation and Disclosure in the Financial Statements of Islamic Insurance Companies* requires that:

*“Disclosure should be made on the face of the statement of financial position of the following assets, with separate disclosures in the notes to the financial statements, of assets jointly financed by the owners’ equity and policyholders’ equity, and those exclusively financed by each of them wherever possible ...”*

Paragraph 40 requires similar disclosures for the various items of liabilities, and paragraph 2 of AAOIFI FAS 12 considers separate statements for participants’ revenues and expenses to be part of “the complete set of financial statements that should be prepared by the company”. Such disclosure and presentation are not required by current IFRS; and indeed are absent in the financial statements of many conventional insurance companies. However, some believe that without them, the formal structure of a Takaful set-up would be obscured, and the presentation of the accounts would mislead since not all assets are available to meet all liabilities.

**Need for clarification**

- 48 It is apparent to the working group that ED/2010/8 had not been drafted with alternative types of protection, namely Takaful, in mind. Given the accounting issues relating to Takaful that have been described in this comment letter, members of the working group would like the IASB to consider the matters herein, and especially to give consideration to the following questions:
- (a) Under what circumstances (if any) would the financial assistance given by a Takaful operator to meet a fund's deficiency constitute, in substance, an acceptance of insurance risk?
  - (b) What would be the most appropriate classification for the financial assistance, which is usually in the form of an interest-free loan, given by a Takaful operator to a participants' fund?
  - (c) Should a Takaful operator and the funds it manages be presented as a single consolidated entity, or would some other presentation be more appropriate?
- 49 The Working Group will be deliberating on the answers to these questions in its forthcoming discussions, and it is probable that these would continue well after IASB's intended completion date for IFRS 4 in 2011. Accordingly, working group members would like to see a longer transition period for IFRS 4 (for example, 1 January 2014) so that the working group might assist the IASB in addressing the issues during that transition period.

We thank you for this opportunity to express our concerns, and hope that you would give due consideration to our comments. If you have any queries regarding this submission, please feel free to contact us.

Yours sincerely,



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