Issues on *Takaful* Affecting the Choice of Accounting Policies: A Case Study of Two *Takaful* Companies in Malaysia

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Abstract

The paper adopts a descriptive case study method to examine the impact of juristic views on the operations of two Malaysian takaful companies. In order to achieve this objective, the annual financial reports of both companies were analysed. Interviews with each company's finance managers and with a member of the Malaysian Shariah Advisory Council were undertaken for a more in-depth coverage. Also a written correspondence with a senior official of the central bank was accomplished. Similarities and differences between the two companies were identified and it is concluded that the differences are serious enough to warrant interventions from the regulators in the form of mandatory disclosures in the annual reports.

Keywords: *Takaful,* Islamic insurance, Malaysia, Accounting policy, Mudharabah, Wakalah, Shariah, Madhahib

1. Introduction

The insurance industry is one of the pivotal financial intermediaries that mobilises economic resources of a country. In Malaysia, in line with the drive towards the Islamisation of the financial sector, Islamic insurance (*takaful*) services were made available to the public in 1983. (Note 1) To date, the potential growth of the industry, especially in the life business is tremendous, with majority of the Malaysian public, especially the Malaysian Muslims, uninsured. *Takaful* main attraction is that it falls within the principles prescribed by Islam, and this has encouraged the Muslims especially, to take up *takaful* coverage to fulfil their insurance needs without going against the *Shariah*. (Note 2) The industry, though, is still in its formative years and there are many areas which remains unresolved (Bhatty, 2001). Some of the unresolved areas that this paper will attempt to highlight include those within the domain of the business model, marketing, and accounting and financial reporting.

Islamic Financial Institutions (IFIs), such as the *takaful* companies, are bound to operate their businesses within the precept of the *Shariah*, the knowledge sourced from divine revelations. The revelations contain two category of knowledge which can be classified as the specific and the general. Many of the specifics and detailed rulings govern the area of interactions between man and God, whereas many of the general principles are that of between man and man, including business transactions. The general principles, being not specific, would have to undergo the process of *ijtihad* before they can be utilized according to current times and situations. (Note 3) The *ijtihadi* process can take more than one method of conducting jurisprudence in understanding the *Qur'an* and *Sunnah* and might consequently leads to disagreement among scholars, particularly in the details of practical application, resulting in the establishment of several legal systems or schools of Islamic jurisprudence called *madhahib* (Bakar, 2000). (Note 4) Currently there are four *madhahibs,* each named after its founder, and all four legal systems impact the business practices, policies and strategies of IFIs in Malaysia in one way or another. (Note 5) Accounting wise, as highlighted by Karim (1990), the interpretations of the different schools influence the differences and similarities of the accounting policies adopted by different Islamic banks of different countries.

This paper seeks to add to that knowledge by bringing to light a case study of Malaysia, whereby differences in juristic view (*khilaf*) has not only affected the accounting and financial reporting policy but other operational aspects of two *takaful* companies. The differences that have been identified include:

i). the marketing approach in selling the *takaful* schemes (plans), i.e. the use of sales agents against walk-in customers;

ii). the *takaful* modes adopted (or planned to be adopted), i.e. *mudharabah* against modified *mudharabah* model; (Note 6) iii). the benefits accorded by the plans, i.e. either protection or savings and

iv). accounting issues regarding methods of distribution and bases of income recognition.

An interesting aspect of this study is that, although both companies are based in the same country, the policies chosen vastly differ, which in turn would allow a within-country type of evaluation to be carried out. In contrast to this, the policies of Islamic banks in Malaysia are the same and differ only with those of other countries. This paper will present among the pertinent issues of the Malaysian *takaful* industry that the central bank of Malaysia, Bank Negara Malaysia (BNM), as the regulator, has to face in standardising the accounting and financial reporting policies of *takaful* companies. BNM has admitted that currently, the monitoring of the companies especially in terms of performances for instance is fraught with difficulties and unnecessary activities such as requiring and compiling additional reports from the companies to derive additional information, which could and should have been easily obtained from the annual reports. It is also hoped that this paper will stimulate further discussions and research on *takaful*, so that it will share the same significance and meaning as to the Islamic banking.

The paper is structured as follows. The next section provides a brief overview on the background of the two companies and the similarities that they share. The penultimate section discusses the different features, unique to each company, which in turn led to the differences in the aspect of accounting and financial reporting. The final section concludes.

2. Companies background and areas of similarities

At the time this study was conducted, there were two established *takaful* companies*,* namely*, Syarikat Takaful Malaysia Berhad (STMB)* and *Takaful Nasional Sdn Bhd* (TNSB). The former is a public listed company and a subsidiary of BIMB Holdings *Berhad* (BIMB Holdings) group of companies. BIMB Holdings also owns *Bank Islam Malaysia Berhad* (BIMB), the first Islamic Bank in Malaysia to be given the license to operate in accordance with the requirement of *Shariah*. The latter is unlisted and a subsidiary of Malaysia National Insurance (MNI) *Berhad*. It began its *takafu*l operations in 1993, with the birth of MNI *Takaful Sdn Bhd*., which changed its name to TNSB in 1998.

A major similarity between the two companies lies in the *takaful* model adopted by them. A *takaful* model depicts the relationship between the company and the participants. The model is based upon the concept of *mudharabah* where the company and the participants share any profits made from investments based upon a pre-agreed ratio. This model is used for the family as well as the general *takaful* business. (Note 7)

Apart from this, both companies focus on the retail side of the *takaful* business, by providing only the life and general *takaful* schemes or plans. (Note 8) To differentiate from conventional insurance, the *takaful* plans take up specific names. Generically, *takaful keluarga* (family *takaful*) is life insurance in its conventional sense while general *takaful* represents the Islamic alternative to general insurance. STMB's and TNSB's mission and objectives, although worded differently, are basically projected towards providing the Malaysian public with the alternative to conventional insurance. Both companies compete predominantly in the Malaysian market, as they have not aggressively ventured overseas. Hence, the Malaysian population, regardless of their religions, is the companies' target market; although currently, individual non- Muslims and Non-Muslims managed companies, in that order, make up a small percentage of all policy-holders (participants).

Both companies again mirror each other in terms of the internal organisational structure. The *Takaful* Act 1984 and the guidelines issued by BNM, shaped the organisational structure especially at the highest level of the organisation. The Act requires the establishment of the *Shariah* Advisory Council (SAC), an independent body comprises of experts in the *Shariah* and which oversees the *Shariah* aspect of *takaful* operations. The guidelines meanwhile, affect mostly the composition of the board of directors and senior management, as well as the establishment of committees such as the audit and remuneration committees.

On the investment front, by being IFIs, the liquid investment portfolios of both companies are limited to investment opportunities in green counters of KLSE, the Islamic bond markets and the government Islamic certificates. Hence, optimum returns on investment would largely depend on the expertise and skills of the investment managers, as there are lesser avenues to manoeuvre as compared to non-IFIs.

It can be concluded then that the internal and external factors facing both companies are the same. Majority of the Malaysian public would not be able to tell differences between them to the extent that many thought that one company is a subsidiary of the other and vice-versa.

However, there are still certain aspects that differentiate them, some of which are quite clear while some others are not that visible to the public. These aspects would also affect the accounting and financial reporting practices of the companies, which makes comparative analysis of the two companies much more difficult. These differences will be discussed in detail in the next section.

3. Difference in the treatment of management expenses

It was mentioned in the previous section that the companies apply the *mudharabah* model. Although the chosen model is the same, the rules and regulations which govern the *mudharabah* contract of each company is based upon the interpretation of different schools of Islamic jurisprudence. Furthermore, recent developments indicate that the future orientation of TNSB's model would no longer be based solely upon *mudharabah*. These two issues will be dealt with separately henceforth.

The four Islamic legal schools have their own sets of rules pertaining to business matters with varying degrees of agreement and disagreement among them and this include the operationalisation of the *mudharabah* concept. One of the rules that do not receive a full unanimous backing from all the schools pertains to the treatment of management expenses. The *Shafi'is* view is that covering such expenses from the *mudharabah* capital or its realised profits will lead to the element of *gharar* (uncertainty) and the presence of *gharar* makes the *mudharabah* contract to be null and void. The other schools of law have held the view that expenses can be deducted from the business account or realised profits depending on the nature of the expenses. The *Hanafis* and *Malikis* would confine the permissibility to the case of journey and its related expenses to cover both the lodging and food. *Hanbalis*, on the other hand, do not limit it to the case of journey whereby the manager i.e. the *mudharib* may deduct his management expenses from the account even during his stay in his hometown. These expenses are related to necessary expenses such as food, cloth, lodging, salaries of employees and the like, but must be at the standard norms of the society or industry. From analysis of annual reports, STMB adopts the *Shafi'is* interpretation. Hence, all management expenses are solely borne by the company. In contrast, TNSB follows the interpretation of other schools of thought and charges the portion of management expenses related and traceable to the *takaful* funds, as well as commissions of sales intermediaries, against the funds. That leaves only the portion of management expenses not related to the *takaful* funds to be borne by the company through shareholders' funds.

A recent development has occurred that would provide TNSB with a newer justification to charging the expenses against the *takaful* funds. A member of TNSB *Shariah* council reveals that the future orientation of TNSB's family *takaful* model might be amended as a consequence of this. In the future, the charge, instead of depending upon the interpretation of Islamic scholars, will be regarded as an agent's (*wakalah*) fees, taken as a compensation by the company for procuring and managing the funds. When the SAC passes a *fatwa* (religious ruling), TNSB's family *takaful* model will no longer be based purely on *mudharabah*, but will be known as a modified *mudharabah* through the combination of *wakalah* and *mudharabah*. In fact this new orientation of the family *takaful* is already unofficially taking its course within the company, garnered through few interviews, helped in part by the fact that changes had already taken place within the general *takaful* model.

With regards to general *takaful*, a *fatwa* has been passed which has changed the model from pure *mudharabah* to a pure *wakalah*. This is to ensure that the surpluses of general *takaful* (instead of returns from investments) which the company shares with, is not based upon *mudharabah*, but is taken as a form of an agent's fees. The *Shariah* prohibits surpluses (in contrast to returns from investments) from being shared under the *mudharabah* concept, although the *Takaful* Act 1983 does not disallow any sharing of surpluses. A written statement from the central bank showed that BNM does not have any reservation with the types of model adopted as long as the models do not run contrary to the *Shariah*.

3.1 Difference in marketing approach

A dissimilarity that is beginning to gain awareness among the public lies in the marketing approach of the companies in soliciting and procuring premiums (contributions), in other words in selling their plans. TNSB's main channel of business is the agency system (*al wakalah* in Arabic). It uses sales agents, individual and companies such as banks and brokers, to bring in the premiums, with individual agents, which currently numbered close to 7000, accounting for the bulk of the business. STMB, on the other hand does not use any intermediaries in their approach. Instead, in their place, it has full time marketing personnel to promote its plans, and at the same time persuading potential participants to walk-in into any of STMB branches located throughout the country in order to buy the plans. Previously, many had thought that STMB decision in not using sales agents might be attributed to a *Shariah* prohibition. It has been ascertained through the interviews that this is not the case. Agency is in-fact approved by the *Shariah*, as verses from the *Quran* testify. One of the verses that testify this approval is *Surah Al Kahf*, Verse 19, which tells of the episode when one of the companions of the cave was chosen to buy food from the city:

"…Now send ye then one of you with this money of yours to the town, let him find out which is the best food (to be had) and bring some to you, that (ye may) satisfy your hunger therewith…"

Shariah scholars have unanimously agreed that this relates to the permissibility of the agency system. As *al wakalah* is permissible in Islam, this is not the reason for the differences in the company's sales and marketing operation.

STMB's decision is due more to its own analysis on the productivity of sales agents. Through comparative analysis between agents' statistics released by BNM and STMB's report on performance of its marketing officers, it found out that the agents' productivity is lower than that of its marketing officers. In the case of TNSB, it believes in the combination of effective cost management (the Pareto principle) and the motivational aspect of the agency system, where the harder the agents work in bringing in the premium, the more commission that they will earn and consequently the more profitable the company will be. TNSB thinks that by having fixed salaried marketing officers would not make a good business sense as it feels that fixed costs of a company should be kept to the minimum.

The difference in the marketing approach is also related to the interpretation governing the concept of *mudharabah* explained in the previous section. Recall that TNSB can charge the commission against the *takaful* funds. Hence it would not affect the profitability of the company to the same extent of STMB, if STMB decides to use agents. However, since STMB does not use agents, it incurs other fixed costs apart from salary of the marketing officers. These include the fixed overhead expenses of operating its numerous branches, which would in the end still affect its profitability. Thus, the higher profitability of TNSB, is not only due to its ability to charge part of the expenses to the *takaful* funds, but also of its lower fixed costs helped by the higher portion of its variable costs, especially in terms of agents commissions.

3.2 Difference in the benefits of family takaful plans

A further aspect of the business that differentiates the two companies is in the benefits that the family *takaful* plans provide. The benefits a *takaful* plan provides are in terms of the amount received upon claims compared to the total savings upon maturity in the event that no claims have been made. An important distinction between *takaful* and conventional insurance is the allocation of the premiums into 2 separate accounts, namely the Special Participants and the Participants Accounts. Using a fix percentage, a portion of the premium is placed into the special participants accounts (SPA) and this represents the amount which will be paid for claims made. This amount cannot be reimbursed upon maturity as it represents a contribution of the participants. The balance of the premium is placed into the participants accounts (PA), which represents the amount for savings, and will be paid out to the participants upon maturity.(Note 9) Although the schemes or plans of both companies are similar to one another, the benefits are structured slightly differently. This difference in the benefits stems from the difference in the percentage of allocating the premiums into the PA and SPA. For STMB, from the first month onwards, a maximum of 15% of the premium goes into the SPA with the balance of 85% going into the PA. This is regarded by STMB as being more beneficial to the participants, as it emphasise in terms of more savings upon maturity. Even if the participants were to surrender the plans in the first year itself, they will get at least 85% of their money back in terms of the surrender value. Nonetheless, the main element of any insurance schemes, conventional or Islamic is the element of protection. Therefore in the case of STMB, due to the smaller allocation into the SPA, participants will have to buy additional plans (riders) to increase protection.

TNSB, on the other hand focus more on protection, as has been observed that in the first three years, more than 50% of the premiums goes into the SPA. Thereafter, at least 25% goes to SPA with the balance of 75% going to the PA. This means that upon maturity, participants will get lesser amount of savings as compared to taking from STMB, but will get more through claims, if calamities were to happen (other factors such as returns on investments remain constant). If participants surrender their policy in the first few years, they could only collect back less than 50% of their money. TNSB, thus mirrors the conventional way of running insurance business. (Note 10)

This difference in the benefits relates back to the juristic interpretation chosen by each company. Due to the charging of expenses to the *takaful* funds, TNSB allocates more into the SPA for the first three years at least, to pay for commissions of agents and management expenses relating to the *takaful* funds. From past experience, claims of old and new plans can be covered by the funds, resulting in underwriting surplus to pay for the commissions and management expenses relating to the *takaful* funds. Thus, if TNSB were to put more of the premiums into the PA instead of the contributed SPA, it may not be able to pay these expenses.

3.3 Differences accounting and financial reporting

The juristic interpretation chosen by both companies directly impact the distributional aspect of their accounting. By bearing all the management expenses solely, STMB is practicing the separate investment method, while the case of TNSB is best represented by the pooling method. (Note 11) Asked if by not being able to charge part of the expenses against the *takaful* funds would depress STMB's earnings, the STMB finance manager agrees that it does to a certain extent. Nonetheless, he continues that STMB will continue to use the *Shafi'is* interpretation, despite the profit concern and despite the fact that that it is perfectly alright to change to other schools' interpretation. STMB is not willing to change for two reasons. Firstly, it has the interest of the participants as its main concern as it prefers to make sacrifices in terms of its profitability, for the benefits of the participants. Secondly, and of a more business in sense, is that up till now, STMB is still very much profitable and maintaining a strong presence in the *takaful* industry, helped by virtue of being the first in the industry. (Note 12)

As for TNSB, the interpretation that it has chosen seems to take more from the participants through the charging of specific expenses to the funds and to share in the profits from investment at the same time. TNSB justification is that, firstly, it is permissible by the *Shariah*. Secondly, the charging of the expenses made up of sales agents' commissions (Note 13) and management expenses relating to the *takaful* funds are necessary inducements, because the company, as an agent (Note 14) to the participants, first and foremost is required to acquire the premiums on the participants' behalf. Thirdly, the sharing in profits made from investments is a fair reflection of the efforts that the company puts in, in managing the funds to its fullest potential. Then again the portion of TNSB's share is only 20% of the returns, with the balance going back into the funds. (Note 15) And the fact revealed earlier that this charge will be taken as an agency fee in the future cemented TNSB's stand.

The second accounting issue that was identified is the basis use in recognising the premiums, in other words the debates on the use of cash against accruals basis. The accounting recognition that is adopted flows directly from the type of *mudharabah* model in place. Both companies in their 2003 annual reports, recognises the premiums and investment incomes based upon the cash basis. Due to the *mudharabah* model, profits from investment can only be shared and distributed based on actual cash receipt. That is, recognising the premiums by using the cash basis, allows the meaningful implementation of the *mudharabah* principle (Yusoff, 1996). The expenses, in contrast, is recognised using the accrual basis, making the recognition principle to be more of a modified cash basis, and hence very conservative. The accrual basis in recognising the expenses is consistent with the Islamic principle that all debts should be put in writing.

However information derived from the interview, disclosed that the future reporting of TNSB would move away from the cash basis of recognition. Beginning with financial year end 2004, all items will be reported under the accrual convention, and this has been approved by the SAC and the board. This decision to convert to the accrual basis is based upon two important rationales. Firstly, the move will be consistent with the future outlook of BNM. In its statement, BNM said that it is moving towards this basis, which provides a matching of income against expenditure, in order to be in line with the Accounting and Auditing of Islamic Financial Institutions (AAOIFI) standards as well as other internationally accepted accounting standards. In the meantime it is still allowing the choice of either cash, modified cash or accrual bases.

4. Conclusions

As was shown, the similarities and differences between the two companies relay back to divine back to divine sources of revelation or the *Shariah*, specifically to the general rulings which went through various scholars' interpretation. This should be seen in a positive light of the dynamism of the process of *ijtihad* that shows how the *Shariah* is relevant for all times. Hence, the differences are inevitable and on the company level, the respective SAC can choose any one interpretation.

Of all the differences explained above, the serious one concerns the accounting and financial reporting aspects as these affect many number of stakeholders, internally and externally, as compared to other differences.

The fact that BNM is moving towards the accrual basis, showed its concern in regulating the industry. But the problem is that there cannot be uniformity unless there is also uniformity in the chosen interpretation. Now that TNSB is moving towards a new model (modified *mudharabah*) the problem will magnify. The point here is that if the *Shariah* allows different interpretations, BNM will find it tough to standardise. It has to take into perspective of international scale as well in order to be internationally standardised due to the presence of different models in other countries. On the national level, the standardisation can be done by passing a *fatwa* for each company to implement the same accounting policy. But this is easier said than done. The future intention of BNM is against what STMB is currently doing. Being the first to be established, STMB have the clout and ability to hold on to what it has been doing. This will be concerned with regulations if it affects STMB and it thinks that if the *Shariah* allows it, the number of models of interpretation should not be restricted.

As such the advice to BNM is that instead of implementing a straight changeover to form coherent standards, it should be maintain the current approaches with improvement on another aspect of reporting. This aspect which needs the improvement is regarding the level of transparency of the companies, particularly the level of disclosures apparent in the annual reports. Compromise will be easily achieved if BNM would argue in favour of higher disclosure. A higher level of disclosure will solve many things especially with improve transparency. Secondly, most if not all stakeholders' needs will be satisfied. For instance BNM shall require lesser amount of special reports, analysts and researchers will be able to make better comparisons between the two companies, the participants will be aware of their rights and the public at large will be more informed of the companies.

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Notes

Note 1. Takaful is an Islamic insurance concept by observing the rules and regulations of Islamic law. This concept has been practised in various forms for over 1400 years.

Note 2. Shariah refers to the sacred law of Islam. All Shariah is derived from two primary sources, the divine revelations set forth in the Qur'an, and the sayings and example set by the Prophet Muhammad in the Sunnah.

Note 3. Ijtihad is a technical term of Islamic law that describes the process of making a legal decision by independent interpretation of the legal sources, the Qur'an and the Sunnah

Note 4. Quran is is the central religious verbal text of Islam. Sunnah refers to the sayings and living habits of Muhammad, the last prophet of Islam. Madhahib refers to Islamic schools of law, or *fiqh* (religious jurisprudence).

Note 5. They are, in the order of time (beginning with the oldest), the Hanafi, the Maliki, the Shafi'i and the Hanbali.

Note 6. Mudharabah is a special kind of partnership where one partner gives money to another for investing it in a commercial enterprise. The investment comes from the first partner who is called "rabb-ul-mal", while the management and work is an exclusive responsibility of the other, who is called "mudharib".

Note 7. Apart from the this model, other models are also in operation, which significantly differ from the *mudharabah* model chosen by the two *takaful* companies. For example a model used by Sudan is based on 100% co-operative. *Takaful* participant must join the co-operative in order to purchase the *takaful* coverage. The co-operative will elect some of the participants to manage the co-operative. Due to lack of expertise and business acumen among the elected participants, the *takaful* business in Sudan does not grow as compared to Malaysia. This shows that the co-operative model, unlike the Malaysian model, does not work. In Kuwait, the *takaful* model is based on the concept of *wakalah*, where instead of sharing in the profits from investment, the *takaful* company would charge agency fees.

Note 8. The retail business provides a smaller risk and consequently results in a good underwriting guideline, lower retention of premiums and higher profits. The retention is lower if the associated risk is higher due to *retakaful* (reinsurance), as the company needs other insurance company to back it up resulting in the profits being transferred to the reinsurer.

Note 9. For the purpose of investments, the two accounts will be joined, with any income made from the investments credited to each account using the same fix percentage used to allocate the premiums.

Note 10. In conventional insurance, the SPA account does not exist. Hence, on average, if policyholders were to surrender their policy in the first few years, they will not get their money back, i.e. zero surrender value.

Note 11. Both finance managers though, are unaware of the specific accounting terms (i.e. separate investment vs pooling methods) which emerged as a results of the different treatment on part of the management expenses and the sales commissions.

Note 12. Annuar, et al (2003) showed that the position of STMB as the leading player in the *takaful* business is being challenged in terms of its small yearly growth in premiums and steady growth in expenses. On the contrary, TNSB recorded very strong growth in premiums and profitability.

Note 13. TNSB commissions are derived from guidelines on commission on insurance business issued by the BNM. To date, BNM has not issued any guidelines to regulate the commission payment of *takaful* companies. However, in the absence of any specific guidelines issued for the *takaful* industry, the *takaful* company should abide by the guidelines on insurance business which are also applicable on *takaful* business.

Note 14. The agents or *wakil* are to be remunerated by the payments of wages or *ujur* which can be in the form of a fee. All Muslim jurists agree that agents must be remunerated.

Note 15. Newer *takaful* companies such as Mayban *Takaful*, a subsidiary of Maybank and *Takaful Ikhlas*, a subsidiary of Malaysian National Reinsurance *Berhad*, cannot adopt the interpretation chosen by STMB. Being newcomers into the industry, they could not afford to bear all of the expenses. *Takaful Ikhlas* has forecasted that even then, it will only make profits by the fourth year.