# THE IMPACT OF INTERNATIONAL FINANCIAL REPORTING STANDARD ( IFRS ) ON THE TAX PAYABLE: THE CASE OF TAKAFUL OPERATORS

BY

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A research paper submitted in fulfillment of the requirement for the degree of Master of Science in Islamic Banking and Finance

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MAY 2014

# ABSTRACT

International Financial Reporting Standard ( IFRS ) has been announced to be adopted fully in Malaysia starting from 1st January 2012. All business entities including Islamic banks and financial institutions in Malaysia have to follow this new accounting guideline. As for conventional insurers, they have to adhere to the requirement of IFRS 4. Islamic insurer which is known as takaful operators also have to apply IFRS 4 in their financial reporting. The purpose of this research is to study the impact of IFRS 4 and also other IFRS on the tax payable of the takaful operators. The study is significant in order to ensure that adoption of the IFRS will not jeorpadize the takaful business and at the same time can be at level playing field with the conventional insurer. Primary data collection is done by interviewing the tax agents and officers of Inland Revenue Board of Malaysia ( IRB ). The result of the interview revealed that there is no impact on the tax payable of takaful operators even though IFRS has been adopted. All of the interviewees agreed that the way financial transactions are recorded may be different. However, tax for takaful operators still can be computed based on the current provision of income tax law. As for now tax for the takaful operators is governed by Section 60 AA of the Income Tax Act 1967. Since IFRS has no impact on the tax computation for the takaful operators, there is no need to change, repeal or amend the existing provision.

# ملخص البحث

لقد تم إعلان تبني المعيار العالمي للتقرير المالي ( International Financial Reporting Standard) بماليزيا في اليوم الأول من يناير عام 2012م. وكان من الواجب على جميع الكيانات التجارية بما فيها البنوك الإسلامية والمؤسسات المالية في ماليزيا أن تتَّبع هذا الدليل التوجيهي الجديد للمحاسبة. أما أصحاب التأمين المعتاد، فقد كان من المتوقع أن يلتزموا بمتطلبات هذا المعيار الموسومة بـ(IFRS 4)، وكذلك التأمين الإسلامي المعروف بالمؤسسات التكافلية فإنها أيضًا تُمسِّك بمتطلبات (IFRS 4) في تقاريرها المالية. إن الهدف الأساسي في هذا البحث هو دراسة أثر نظام (IFRS 4)، وغيره من أنظمة (IFRS) في الضرائب التي تدفعها المؤسسات التكافلية. وتبرز أهمية هذه الدراسة في إثبات الضمان بأن تبني هذا المعيار العالمي (IFRS) لم يعرِّض التكافلَ التجاري لأي شيء من الأخطار، وأن هذا التكافل في الوقت ذاته يصلح أن يتساوى في مستوى الميدان المالي مع التأمين المعتاد. وقد تم جمع البيانات الأساسية عبر المقابلة المجراة مع وكلاء الضرائب وموظفي مجلس الدخل البلدي في ماليزيا (Inland Revenue Board of Malaysia -IRB). تبدي نتيجة المقابلة عدم التأثير في الضرائب التي تدفعها المؤسسات التكافلية، حتى لو كان نظام (IFRS) هو المتبَنَّى. ويتفق جميع المقابَلين على أنه من الممكن أن يختلف طريق تدوين المعاملات المالية، بيد أن الضرائب التي تُحصِّلها المؤسسات التكافلية لا تزال مقدَّرة وفق القانون الجاري للضرائب الداخلية. حتى الآن، فإن ضرائب المؤسسات التكافلية لا تبرح محكومة بمادة (60 AA) الواردة في قرار الضرائب الداخلية لعام 1967م. وإذ لم يوجد لتبني نظام (IFRS) أيُّ تأثيرٍ في إحصاء ضرائب المؤسسات التكافلية، فلا داعي لتغيير القرار الموجود، أو إلغائه، أو تعديله.

# APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science in Islamic Banking and Finance.

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This research paper was submitted to the Institute of Islamic Banking and Finance and is accepted as a partial fulfillment of the requirements for the degree of Master of Science in Islamic Banking and Finance.

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# DECLARATION PAGE

I hereby declare that this dissertation is the result of my own investigations, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Nur Hazlina Al Shaari

Signature....................................... Date:.....................................

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# ACKNOWLEDGEMENTS

In the name of Allah, the Most Gracious and the Most Merciful. Alhamdulillah, all praises to Allah for giving me His blessing in doing this research. First and foremost, my appreciation goes to my supervisor, Dr Sheila Nu Nu Htay for her patience in giving me guidance and support. Her comments and suggestions have greatly helped me a lot in completing this research. I would like also to extend my appreciation to my lecturers, classmates, colleagues in Inland Revenue Board ( Lembaga Hasil Dalam Negeri Malaysia) and others who had directly and indirectly giving help and support for me while doing this research. Last but not least, my deepest gratitude goes to my beloved family;my husband Uzir Osman, my children Muhammad Aqil Nur Uwais and Aqilah Nur Umairah, my parents, in- laws and siblings. Thank you so much for always standing behind me, giving an endless support and continuously motivate me. Their prayers, love and care had made me finally complete the research.

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# CHAPTER ONE

# INTRODUCTION

## 1.1 BACKGROUND OF STUDY

Takaful is derived from Arabic word kafalah which means a pact that guarantees individuals in a group against loss or damage sustained by anyone of them. By referring to this concept, Muslim jurists had decided that insurance in Islam must be based on mutuality and cooperation principles. Therefore takaful can be described as a system of an Islamic insurance based on the principle of *ta'awun* ( mutual assistance ) and *tabarru'* ( donation ) where the risk is shared collectively by a group of people on voluntary basis.

The legality of takaful or islamic insurance can be found in the Quranic verses and also several hadiths of the Prophet S.A.W

> *Help ( ta'awun ) ye one another in righteousness ( birr ) and piety, but help ye not one another in sin and rancour, fear Allah, for Allah is strict in punishment.(Al- Maidah: 2)*

> *Prophet Muhammad ( S.A.W ) asked a Bedouin who had left his camel untied, " Why do you not tie your camel?" The Bedouin answered, " I put my trust in God". The Prophet then said, " Tie up your camel first then put your trust in God"*[1]

[1] Narrated by Al- Tirmidhi and Ibn Majah, Book 60 No 2517 )

By looking at the hadith above, it is clear that Islam is not opposing on managing risk. However there are certain conditions in conventional insurance that make it *haram* or not allowed by Shariah. According to a definition given in the International Financial Reporting Standard[2] ( IFRS ) 4, insurance is defined as 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.

By looking at the definition of both takaful and conventional insurance, there are substantial differences between the two. According to SheilA, Arif, Younes, Hanna, Ibrahim ( 2013 ) the differences are tabulated in the Table 1 shown below:-

Table 1.1

Difference Between Takaful and Conventional Insurance

| **Takaful** | **Conventional Insurance** |
|---|---|
| Based on mutual cooperation where risks are shared among takaful participants | Based solely on commercial factors where it involves risk transfer mechanism |
| Governed by the Shariah principles where all prohibited elements such as *riba* ( interest ), *maysir* ( gambling ) | Include elements of interest, gambling and uncertainty. |

[2] accounting standard developed by International Accounting Standards Board (I ASB )

| | |
|---|---|
| and *gharar* ( uncertainty ) are not included in the transactions | |
| All or part of the contribution paid by the participant is considered as donation to the takaful fund. It is used other participants by providing protection against potential risk | The premium which is paid to the conventional insurance companies is belong to the companies and is considered as an exchange for bearing all expected risks. |
| Takaful companies are subjected to the governing law as well as a Shariah supervisory board, which regulates takaful to ensure that all operations are conducted in line with the Shariah principles and fulfill the Islamic objectives of social welfare. | Conventional insurance companies are subject to the governing laws. |
| There is full segregation between the participants' takaful fund account and the shareholders' accounts | Premium paid by the policy holders are considered to belong to the companies and are owned by the shareholders. |
| Any surplus in the takaful fund is shared among the participants only, and the investment profits are distributed among the participants and shareholders based on the takaful contract. | Any surpluses and profits belong to the shareholders only |

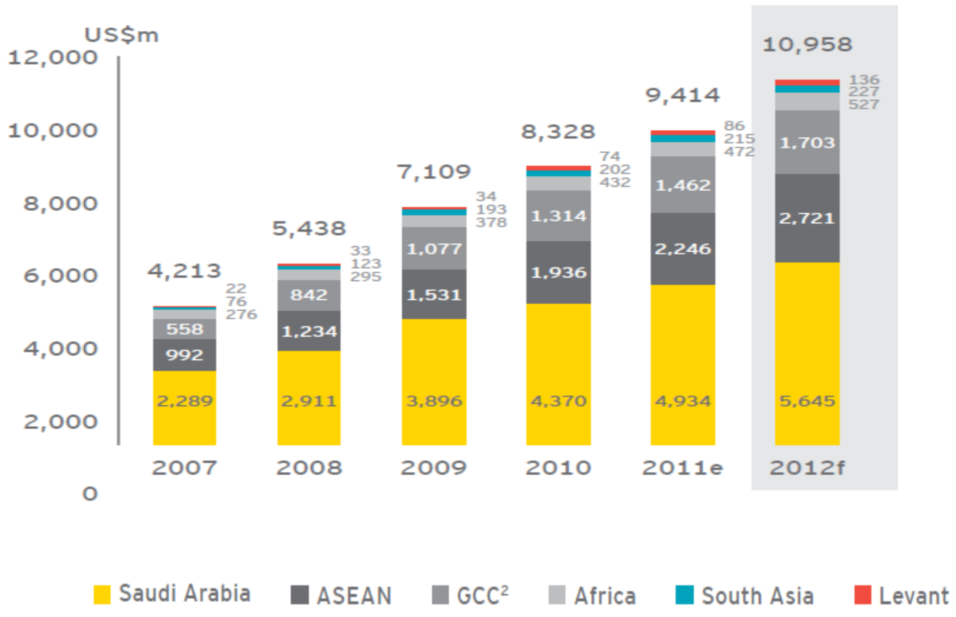
| | |
|---|---|
| In case of the deficit of a participant's takaful fund, the takaful operator provides a free interest loan ( *qard hasan* ) to the participants. | In case of deficit, the conventional insurance company covers the risks. |
| The plan owners' and shareholders' capital is invested in investment funds that are Shariah- compliant | The capital of the premium is invested in funds and investment channels that are not necessarily Shariah-compliant. |
| Takaful companies have re- insurance with retakaful companies or with conventional re- insurance companies that comply with certain Shariah conditions | Conventional insurance companies do not necessarily have re- insurance with re- insurance companies that adhere to shariah conditions. |

The concept of takaful had existed before the era of the Prophet S.A.W. It is based on the concept of '*Aqilah*' which means mutual co-operation. After that, the insurance transactions were growing successfully from one era to another era. In 1979, Sudan was the first country that established an Islamic insurance company. It was known as Islamic Insurance Co. Ltd. The success of the company was proved when it was able to distribute profits to its shareholders. The rate of profit distributed was 5% in 1979, 8% in 1980 and 10% in 1981. Due to the success of this company, other Islamic insurance companies started to emerge in the market throughout the countries. In 1985, the Grand Council of Islamic Scholars of the Organisation of the Islamic

Conference ( OIC ) formally approved the use of takaful as the Islamic alternative to conventional insurance.

According to Ernst & Young ( 2013 ), recent development of takaful industry showed that global takaful contributions reached US$11b in 2012. Even though the growth showed slow movement from the year 2007 till 2011, that is from 22% to 16% but the rate is sustainable. In term of global takaful players, Saudi Arabia remained the largest market in GCC[3]. The global takaful contribution growth can be seen from the Graph 1 below.

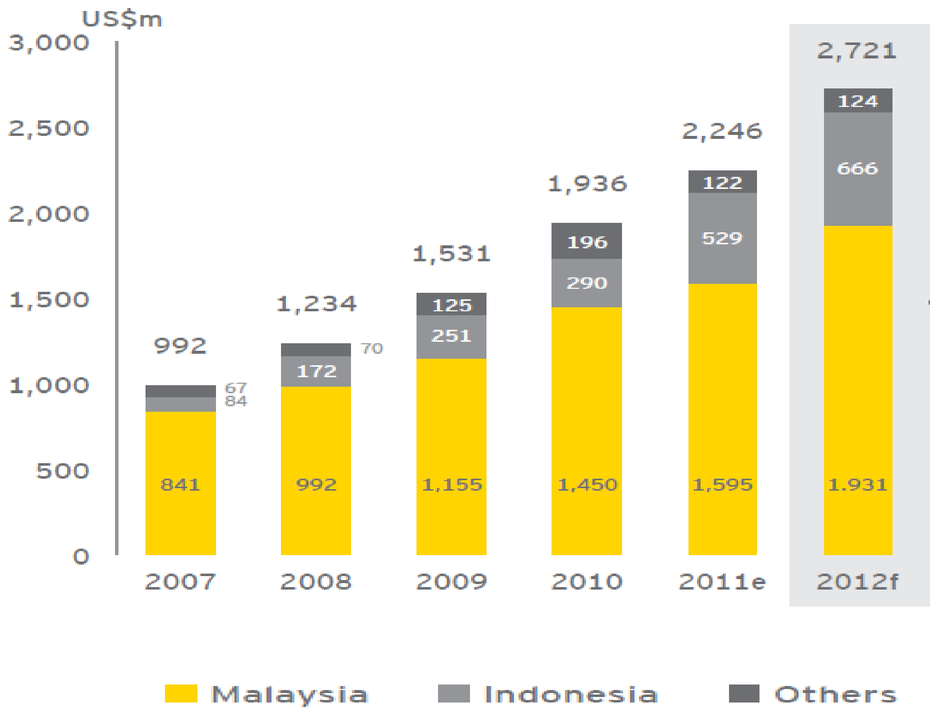
Chart 1: Global Gross Takaful Contributions B Region 2007 - 2012f




[3] Gulf Cooperation Council consists of countries namely Qatar, Kuwait, Bahrain, UAE, Saudi Arabia & Oman

As for the South East Asia including Malaysia, takaful performance has shown a great success. The Contribution Annual Growth Rate ( CAGR ) has increased by 22 % from 2007 - 2012. In this ASEAN region, Malaysia holds the major market share with 71% of the CAGR comes from the Malaysia takaful market. The Graph 2 below shows the takaful contribution of ASEAN countries.

Graph 2: Selected ASEAN countries' gross takaful contributions, 2007 - 2012f




Even though takaful contributions seem to be fast growing, there are still many untapped markets for takaful. According to Ernst & Young ( 2013 ), market share for insurance market in the majority countries in the world is still below 2%. For example, in Turkey insurance market share is about 1.4% as compared to its 74 million of population. As for Indonesia, its insurance market only caters for 1.77% of market share but its population is reaching 247 million of people. According to PricewaterhouseCoopers ( 2008 ), there are various reasons for the low market share of takaful business. One of the reasons is the lack of customers awareness on the importance of having takaful. Many Muslims are still considering insurance is not contrary to the *shariah* principles. Therefore they have to be made aware that takaful is actually an approved concept of insurance in Islam. At the same time, non-Muslims also need to be informed of why takaful is ethical.

Second reason for the low market penetration for insurance particularly takaful is due to the lack of human resources who understand both technical insurance principles and have a good knowledge in Shariah finance. Another reason is due to the lack of regulatory framework that governs the takaful business. This is true especially for countries where takaful industry is still at the early stage. Therefore, there is a need to set the regulations that can ensure the growth of the takaful industry. This is important to ensure that the takaful business will not be treated less favorably as compared to conventional insurance.

For the purpose of adopting suitable accounting standards, the Accounting and Auditing Organization For Islamic Financial Institutions ( AAOIFI ) has established accounting standards for takaful business. However, since most of the countries are now moving towards convergence with International Financial Reporting Standards ( IFRS ), countries which have long established takaful industry are also affected. In order to be comparable, transparent and also competitive with the conventional counterparts, financial reporting of Islamic financial institutions including the takaful companies should adopt IFRS for the purpose of preparing financial reports ( Nazatul, 2013 ).

As many countries are moving to convergence with IFRS, Malaysia is no exception. On the 1st August 2008, the FRF[4] and MASB[5] had announced their plan to bring Malaysia to full convergence with International Financial Reporting Standards ( IFRS ) by 1st January 2012. IFRSs are being used by more than 100 countries around the world, and other economies such as Korea, India and Canada have also announced IFRS convergence by 2011 whilst the United States have issued a proposed roadmap for the potential use of IFRS by US issuers. IFRS is issued by the IASB whose mission is to develop, in the public interest, a single set of high quality, understandable, enforceable and globally accepted financial reporting standards for general purpose financial statements. The changeover from Financial Reporting Standards (FRS) to Malaysian Financial Reporting Standards (MFRS), which is equivalent to IFRS will help to place Malaysian businesses on a level playing field with its international counterparts.

## 1.2 PROBLEM STATEMENT

As stated in the previous section, MASB has announced that starting on the 1st January 2012, it will fully adopt the IFRS. This definitely has led to many accounting issues that need to be resolved. One of issues is the application of IFRS towards accounting for takaful business. Before the year of 2012, generally MASB standards are formulated based on other countries' accounting standards such as New Zealand, Australia, United Kingdom and United States. Besides, MASB also adopts standards of IASB. The purpose of adopting various accounting standards is to ensure

[4] Financial Reporting Foundation
[5] Malaysian Accounting Standard Board

Malaysia's accounting standards are harmonized with the international financial reporting standards.

As for Islamic financial institutions, apart from following the conventional accounting standards which are in line with Shariah principles, MASB has issued several Technical Releases such as Accounting for Zakat on Business ( *TRi* -1 ) and also Statement of Principles such as Financial Reporting from an Islamic Perspective ( SOP*i* -1 ). In other words, for Islamic financial institutions, there are additional standards established in order to ensure financial reporting of these institutions are not contravene with Shariah principles. Therefore, for the financial reporting standards of takaful operators, Bank Negara Malaysia ( BNM ) has issued the Guidelines on Financial Reporting for Takaful Operators. The guidelines are basically based on the standards issued by MASB and the Accounting and Auditing Of Islamic Financial Institutions ( AAOIFI ).

However when MASB has decided to fully convert to IFRS, a conflict arise whether those standards are applicable for the Islamic financial transactions. Fully IFRS convergence means MASB will adopt exactly the IFRS standards. Instead of adopting harmonized accounting standards worldwide MASB now has moved to follow only one accounting standards namely IFRS. A research done by the Asian-Oceanian Standard-setters Group ( AAOSG ) in 2010 had detected Shariah issues in applying IFRS to Islamic financial transactions.

One of the issues that has been highlighted is the application of IFRS 4 and relevant others IFRS towards financial reporting of takaful operators. IFRS 4 is the standard that governs financial reporting of conventional insurance. Therefore the question arises on whether adopting IFRS will bring impact on financial reporting of the takaful operators. In Malaysia, MASB ( 2011 ) has come out a discussion paper on application of IFRS towards takaful transactions. Basically the paper discusses on the issues of applying the IFRS and possible solutions to overcome those issues. The paper is released in order to get the feedback from experts in various fields such as takaful players, academicians, regulators and so on. The feedback is then taken into account in formulating the best solution for the issues.

As accounting standards changed, there may be impact on the tax law. It is a fact that tax law is one of the tools in developing economy of a country. Therefore any movements in the economy including changes in accounting standards may give implication on the tax law. This paper will specifically study whether the application of IFRS on takaful financial reporting may have impact on the tax computation for the takaful operators. One of the factors that lead to the success of Islamic banking and finance implementation in Malaysia is its robust regulatory framework. Tax law is part of the regulatory framework. In order to boost up Islamic finance sector, tax neutrality and tax incentives are provided so that the Islamic finance sector will compete at parallel level with the conventional finance. Therefore there is a need to review whether any changes in Islamic financial institutions that caused by the adoption of IFRS standards will lead to the need to amend the existing tax law. Currently, the provision of tax law for takaful operators and conventional insurance are stated under Section 60AA and Section 60 of Income Tax Act 1967 respectively. With the adoption of IFRS standards, a study will be conducted in order to know whether the existing provision of tax law need to be amended, changed, repealed or maintained. This is to ensure that there will be no leaking in tax collection and at the same time provide fair and just tax charge to the takaful operators so that it will not affect the takaful business.

## 1.3 RESEARCH QUESTIONS

As mentioned above, the adoption of IFRS in financial reporting for takaful operators may give impact on their tax computation. Therefore, this research will try to answer the following questions.

1. Will there be any difference between tax computation for takaful operators and conventional insurance before and after the adoption of IFRS?

2. Should the provision of Section 60AA of Income Tax Act 1967 be amended, repealed, changed or maintained?

3. Apart from Section 60AA of Income Tax Act 1967, are there any other existing provisions of Income Tax Act 1967 which related to tax computation for takaful operators that need to be amended, repealed, changed or maintained?

## 1.4 RESEARCH OBJECTIVES

After completing this study, it is expected that the following objectives will be achieved.

1. To identify which items in financial reporting of takaful operators that will affect their computation.

2. To determine whether there is a need to amend, repeal, change or maintain Section 60 AA of Income Tax Act 1967.

3. To identify other existing provision of tax law that need to be amended, repealed, changed or maintained?

4. To forecast whether the same or different tax treatment should be imposed on takaful operators and conventional insurance companies.

## 1.5 SCOPE OF RESEARCH

The scope of the research will focus on how the tax for takaful operators should be computed after IFRS is implemented. In order to do so, a study on existing provision of tax law on takaful operators will be conducted. The main provision to be studied is Section 60AA of Income Tax Act 1967. The study also will look on other provisions of tax law which may affect the tax computation of takaful operators.

Then a study and analysis will be done on the requirement of IFRS 4 and other relevant IFRS in preparing financial reporting of takaful operators. This study will look whether existing items in financial report of takaful operators are presented according to the requirements of IFRS or otherwise. These items include the format of presenting financial statements, the measurement of qard, recognition and presentation of revenue and investment of part of takaful fund.

Once both studies have been completed, a conclusion will be sought whether tax computation for takaful operators should be remained or changed according to the requirement of IFRS.

## 1.6 SIGNIFICANCE OF STUDY

This study might bring significant value to regulators, accounting and auditing firms, takaful operators and researchers

1. Regulators

Basically this study is relevant for the two regulators namely Bank Negara Malaysia ( BNM ) and Inland Revenue Board of Malaysia ( IRB ). In Malaysia, takaful business is regulated through Takaful Act 1984. Section 54 ( 1 ) of Takaful Act 1984 states that the power to enforce and administer the provisions in the Act is conferred to BNM. Therefore BNM need to alert any changes in the environment of takaful business. Since BNM is given the power to administer the takaful business, it has further established several rules and guidelines in order to ensure the smooth growing of takaful business. Therefore, when IFRS is adopted BNM need to know the possible changes in takaful financial reporting. These changes may affect current provisions in the Takaful Act 1984 and also BNM's rules and guidelines. Through this study, BNM will know the changes in the tax regulation towards the takaful operators. By having this knowledge, BNM can review the existing provisions of Takaful Act 1984 and also the rules and guidelines so that any possible amendments can be made for the benefit of sustaining the takaful business.

On the other hand, IRB is one of the statutory bodies that is responsible in collecting revenue for the government of Malaysia. The revenue is in the form of various taxes. These taxes are administered through various Acts such as Income Tax Act 1967, Petroleum ( Income Tax ) Act 1976, Stamp Act 1949 and many more. Tax on takaful operators is administered through Income Tax Act 1967. Therefore this study is so significant to IRB because any changes in takaful financial reporting probably will affect the provisions stated in the Act. IRB may have to make recommendations to change, amend or repeal the existing provisions. This is important so that the provisions of tax law is relevant to the current state of the country's economy.

2. Accounting and auditing firms

Most of the business entities especially the listed companies, they will engage external accountant to prepare their financial statements and also tax computation. In order to perform their duties, these accountant need to have full knowledge on the latest accounting standards and also the tax laws. Therefore, this research is expecting to give them views on possible changes, if any, in tax computation of takaful operators once IFRS is fully adopted. This is important because they need to advise on that matter to their clients, that is the takaful operators.

3. Takaful Operators

For the takaful operators, even though they are not computing their tax themselves, they still need to be aware of any possible changes in tax laws. Tax is an expense to the companies. Therefore, they need to know the latest provision of tax laws because it might affect the companies' income.