AAOIFI Financial Accounting Standard 33

Investments in Sukuk, Shares and Similar Instruments

Updated as of 10 November 2022 in line with consequential amendment of FAS 1 “General Presentation and Disclosures in the Financial Statements” [Effective date: 1 January 2024]

Contents

AAOIFI Financial Accounting Standard 33 "Investment in Sukuk, Shares and Similar Instruments" is set out in paragraphs 01-42. All the paragraphs have equal authority. This standard should be read in the context of its objective and the Conceptual Framework for Financial Reporting as endorsed by AAOIFI.

All AAOIFI FASs shall be read in conjunction with the definitions, Shari'ah principles and rules and key considerations provided by AAOIFI Shari'ah Standards (SS) in respect of such products and matters.

Preface

PR1 In April 2015, the AAOIFI secretariat with due approval of the respective technical boards, initiated a comprehensive project on Sukuk which included plans to revise its existing Shari’ah Standard on Sukuk (Shari’ah Standard 17) (issued 2003) and its Financial Accounting Standard (FAS) 25 “Investment in Sukuk, Shares, and Similar Instruments (issued 2010), as well as, to develop standards on the accounting side for the areas not covered earlier, including accounting for the Sukuk issuance. The objective of review and revision included, in particular, the improvements from Shari'ah and transparency perspective.

PR2 This revised standard aims at setting out and improving the principles for the recognition, measurement, presentation and disclosure of investment in Sukuk, shares and other similar investments.

Introduction

Overview

IN1 This standard improves upon and supersedes the AAOIFI's Financial Accounting Standard (FAS) 25 "Investment in Sukuk, Shares and Similar Instruments" issued in 2010. This standard aims at setting out principles for the classification, recognition, measurement, presentation and disclosure of investment in Sukuk, shares and other similar instruments of investments made by Islamic financial institutions (IFIs / the institutions).

IN2 The standard defines the key types of instruments of Shari'ah compliant investments and defines the primary accounting treatments commensurate to the characteristics and business model of the institution under which the investments are made, managed and held.

Rationale for issuing this standard

IN3 A review of the FAS 25 "Investment in Sukuk, Shares and Similar Instruments" as a part of AAOIFI's comprehensive project on Sukuk (including the comments through public interaction, workshops and public hearings of the other draft standards within the project), identified needs for improvement in FAS 25 "Investment in Sukuk, Shares and Similar Instruments" from Shari'ah and transparency aspects, as well as, in terms of the accounting choices available in line with the global good practices of accounting. It was particularly observed that there were needs for improvement of the same in line with the changes in the industry and global best practices of accounting. Observations and comments of certain terminology and approaches used in the said standard were noted from the Shari'ah perspective as well.

IN4 A limited scope amendment to the standard was issued by the AAOIFI Accounting Board (AAB / the board) in its meeting held on 11-12 Rabi' II 1439H, corresponding to 29-30 December 2017, to overcome certain issues faced by the industry, but still there was a need for comprehensive revision to the said standard. Accordingly, AAB decided to issue a comprehensively revised standard on the subject.

Significant changes from previous standard

IN5 This standard (FAS 33 "Investments in Sukuk, Shares and Similar Instruments") brings significant changes from its predecessor standard (FAS 25 "Investment in Sukuk, Shares and Similar Instruments"), inter-alia, in the following aspects:

a. overall classification approach is now in line with the business model, rather than classification choices in line with global best practices;

b. certain classification choices which were not allowed by FAS 25 "Investment in Sukuk, Shares and Similar Instruments" have been allowed in line with the global best practices;

c. additional classifications commensurate to the Shari'ah requirements have been provided so that the accounting treatment may be brought in greater conformity with Shari'ah;

d. certain specific Shari'ah requirements, particularly, with regard to monetary debt-type instruments and amortised cost accounting have been specified;

e. definition of effective profit rate method / effective rate of return method has been improved and brought in greater conformity with Shari'ah and other recently issued FASs;

f. impairment requirements are now primarily referred to the specific standard on impairment i.e., FAS 30 “Impairment, credit losses and onerous commitments”;

g. detailed guidelines on the subsequent reclassification have been provided; and

h. accounting choice for equity-type instruments at cost due to impracticality is done away with, and only allowed if it is an approximation of fair value.

AAOIFI Financial Accounting Standard 33
Investment in Sukuk, Shares and Similar Instruments

Objective of the standard

1. The objective of this standard is to set out principles for the classification, recognition, measurement, presentation and disclosure of investment in Sukuk, shares and other similar instruments made by Islamic financial institutions (IFIs / the institutions).

Scope

2. This standard shall apply to an institution's investment, whether in the form of equity-type instruments, debt-type instruments or other investment instruments.

3. This standard shall not be applied for accounting of:

   a. investment in entity's own equity instruments;

   b. investment that requires special accounting treatment such as investments in subsidiaries and associates;

   c. investment in real estate;

   d. investment in contracts with insurance and discretionary participation features; and

   e. Islamic finance transactions (e.g. Murabaha, Ijarah, Musharaka, Mudaraba, Wakala, Salam, Istisna'a etc.) that are not executed through issuance of a transferable / tradable, Sukuk or similarly structured instrument, and instead, are directly executed between two or more parties. Such transactions shall be accounted for under the respective FAS.

Definitions

4. For the purpose of interpreting and applying this standard, the following short definitions are relevant:

   a. Amortised cost – of an instrument is the amount at which the instrument is measured at initial recognition minus payments / redemptions, plus or minus the cumulative amortisation using the effective profit rate method of any difference between that initial amount of investment and the maturity amount, and minus any reduction (directly or through the use of an allowance account) for impairment or uncollectibility;

   b. Business – is an integrated set of activities and assets that is capable of being conducted and managed for the purpose of providing a return in the form of dividends, lower cost or other economic benefits directly to investors or other owners, members or participants. A business, for example, may comprise a single or portfolio or leased assets, services, trading activity etc.;

   c. Control – for the purpose of this standard, an institution controls an asset or business, when it has substantially all risks and rewards incidental to ownership of such asset or business, duly meeting both of the following conditions:

i. it is directly exposed to, or has rights to, variable returns (negative or positive, respectively) from its involvement with such assets or business; and

ii. it has the ability to affect those returns through its power over the assets or business;

d. Debt-type instruments – are a type of investment instruments, whereby the transaction structure results in creation of a monetary or non-monetary liability;

e. Effective rate of return method / effective profit rate method – is a method of allocating income from an asset or venture uniformly, and equitably over the contractual (or expected) period of expected benefit from the asset or continuity of venture. This method allocates the cash flows from asset or venture through a uniform rate of return including all cash flows considering all contractual terms (or best expectations) excluding expected future losses. Any fee paid or received, the transaction costs, premiums or discounts are included in the cash flows insofar these are part of the base contract, or are ancillary costs;

f. Equity-type instruments – are the instruments that evidence a residual interest in the assets of an entity after deducting all its liabilities and quasi-equity balances, including ordinary equity instruments and such other structured investment instruments that classify as equity instrument in line with the requirements of FAS 29 “Sukuk in the books of the originator”1;

g. Fair value – the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date;

h. Investment held for trading purposes – is an investment that is acquired or originated principally for the purpose of generating a profit from short-term fluctuations in price or dealer’s margin or that form part of a portfolio where there is an actual pattern of short-term profit taking;

i. Liability – is a present economic obligation that is enforceable against the institution. Liabilities result from past transactions or other past events. A distinction should be made between present obligation and a future commitment;

j. Monetary debt-type instruments – are debt-type instruments whereby the transaction structure results in creation of a financial liability / debt, such as Murabaha payable;

k. Non-monetary debt-type instruments – are debt-type instruments whereby the transaction structure results in creation of a non-financial liability, such as goods (Salam or Istisna’a) or usufruct (Ijarah Mawsufah fi al-Dhimmah) or services (service Ijarah) to be delivered in future;

l. Other investment instruments – are such investment instruments which do not meet the definition of either debt-type or equity-type instruments;

[1] FAS 29 “Sukuk in the books of the originator”, at the time of issuance of this standard, is in exposure draft stage.

m. Owner's equity (or ordinary equity) – is the residual interest in the assets of the institution after deducting all its liabilities and quasi-equity balances;

n. Participatory structure – is the type of contractual arrangement under which the parties to the contract share the profits, losses and residual interest in the net assets of the underlying assets or business;

o. Sukuk – are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity, however, this is true after receipt of the value of Sukuk, closing of subscription and employment of funds received for the purpose for which the Sukuk were issued.

Classification and initial recognition

Categorization and classification

5. For the purposes of this standard, each investment is to be categorized as investment in:

   a. equity-type instruments;

   b. debt-type instruments, including:

      i. monetary debt-type instruments; and

      ii. non-monetary debt-type instruments; and

   c. other investment instruments.

6. Unless the irrevocable initial recognition choices provided in paragraph 10 are exercised, an institution shall classify investments subject to this standard as subsequently measured at either of (i) amortised cost, (ii) fair value through other comprehensive income or (iii) fair value through income statement, on the basis of both:

   a. the institution's business model for managing the investments; and

   b. the expected cash flow characteristics of the investment in line with the nature of the underlying Islamic finance contracts.

Amortised cost

7. An investment shall be measured at amortised cost if both of the following conditions are met:

   a. the investment is held within a business model whose objective is to hold such investment in order to collect expected cash flows till maturity of the instrument; and

   b. the investment represents either a debt-type instrument or other investment instrument having reasonably determinable effective yield.

Fair value through other comprehensive income

8. An investment shall be measured at fair value through other comprehensive income if both of the following conditions are met:

a. the investment is held within a business model whose objective is achieved by both collecting expected cash flows and selling the investment; and

b. the investment represents a non-monetary debt-type instrument or other investment instrument having reasonably determinable effective yield.

Fair value through income statement

9. An investment shall be measured at fair value through income statement unless it is measured at amortised cost in accordance with paragraph 7 or at fair value through other comprehensive income in accordance with paragraph 8 or if irrevocable classification choices at initial recognition are applied in line with paragraph 10.

Irrevocable classification at initial recognition

10. An institution may make an irrevocable election to designate a particular investment, at initial recognition, being:

a. an equity-type instrument that would otherwise be measured at fair value through income statement – to present subsequent changes in fair value through other comprehensive income; and

b. a non-monetary debt-type instrument or other investment instrument – as measured at fair value through income statement if doing so eliminates or significantly reduces a measurement or recognition inconsistency that would otherwise arise from measuring assets or correlated liabilities or quasi-equity or recognizing the gains and losses on them on different bases. This shall, however, be subject to the Shari'ah requirements with regard to the attribution of, and distribution of such gains to the respective stakeholders.

Common classification choices at initial recognition

11. Investments in a non-monetary debt-type instrument or other investment instrument, may be classified under any of the following categories:

a. investment at amortised cost – as per paragraph 7; or

b. investments at fair value through other comprehensive income – as per paragraph 8; or

c. investments at fair value through income statement – as per paragraph 9 or if the irrevocable classification choice at initial recognition is exercised as per paragraph 10(b).

12. Investment in a monetary debt-type instrument, as it reflects a debt at the back-end, shall be classified and measured at cost, till the time the transaction at the back-end is executed; and at amortised cost thereafter. Similarly, non-negotiable Sukuk shall not be eligible to be categorized as investment at fair value through other comprehensive income, or as investment at fair value through income statement.

13. Investment in equity-type instruments may be classified under the following categories:

a. investments at fair value through income statement – as per paragraph 9; or

b. investments at fair value through other comprehensive income – if the irrevocable classification choice at initial recognition is exercised as per paragraph 10(a).

14. An investment held for trading purposes shall always fall in fair value through income statement classification.

15. In limited circumstances, cost may be an appropriate estimate of fair value for an equity-type instrument. That may be the case if more recent information is not sufficient to measure fair value, or if there is a wide range of possible fair value measurements and cost represents the best estimate of fair value within that range (see paragraph 24).

Initial recognition

16. All investments shall be initially recognised at their fair value plus transaction costs except for investments at fair value through income statement. Transaction costs relating to investments at fair value through income statement are charged to the income statement when incurred.

17. A regular way purchase of investments shall be recognised upon the transfer of control to the investor.

Subsequent measurement

Amortised cost

18. At the end of each reporting period, investments carried at amortised cost shall be re-measured as such using the effective profit rate method. All gains or losses arising from the amortisation process and those arising from derecognition or impairment of the investment, are recognised in the income statement. While applying the effective profit rate method, the commencement (or consummation in case of trade-based transaction) date of the respective transaction in line with Shari'ah shall be considered as the date of initial cash outflow, if the investment is made at the subscription stage of the instrument or at any time before the commencement (consummation) of such transaction.

19. Investments carried at amortised cost shall be tested for impairment at each reporting period in accordance with FAS 30 "Impairment, credit losses and onerous commitments".

Fair value through income statement

20. Investment carried at fair value through income statement shall be re-measured at fair value at the end of each reporting period. The resultant re-measurement gain or loss, if any, being the difference between the carrying amount and the fair value shall be recognised in the income statement. All other income and expenses arising from these investments shall be recognised in the income statement.

21. For investment at fair value through income statement, items accounted for in income statement shall be recognised taking into consideration the split between the portion related to owners' equity and the portion related to the quasi-equity, including investment accountholders.

Fair value through other comprehensive income

22. Investment carried at fair value through other comprehensive income shall be re-measured at fair value at the end of each reporting period. The resultant re-measurement gain or loss, if any, being

the difference between the carrying amount and the fair value shall be taken through other comprehensive income to “investments fair value reserve”, taking into consideration the split between the portion related to owners’ equity and the portion related to the quasi-equity, including investment accountholders.

23. Investments carried at fair value through other comprehensive income (and those accounted for in line with paragraph 15 and 24) shall be tested for impairment at each reporting period in accordance with FAS 30 “Impairment, credit losses and onerous commitments”.

Investment carried at cost (in limited circumstances)

24. In those limited circumstances (see paragraph 15), where the institution is unable to determine a reliable measure of fair value of equity-type instruments, the cost of the investments may be deemed as best approximation of fair value. If on a subsequent date, a reliable measure of fair value is determinable, the investment shall be accounted in accordance with paragraph 20 or 22, respectively.

Realised gains / losses and dividends

25. The realised gains or losses resulting from the sale or maturity of any investment shall be measured as the difference between the carrying amount and the net proceeds from the sale or at maturity (in case of instruments having a maturity) of each investment. The resulting gains or loss together with the balance of the “investments fair value reserve” account for investments designated at fair value through other comprehensive income shall be recognised in the income statement for the current reporting period, taking into consideration the split between the portion related to owners’ equity and the portion related to quasi-equity, including investment accountholders.

26. Dividends and other return (cash or in-kind) on equity-type instruments shall be recognised in the income statement, with due attribution to the profit and loss taking stakeholders, including investment accountholders, as appropriate. These shall be recognised, only when:

    a. the institution’s right to receive payment of the dividend or other return is established; and

    b. it is probable that the economic benefits associated with the dividend or other return will flow to the institution; and

    c. the amount of the dividend or other return can be measured reliably.

Reclassification

27. When, and only when, an institution changes its business model for managing investments, it shall reclassify all affected financial assets in accordance with the following table, prospectively from the reclassification date. In case of reclassification, an institution shall not restate any previously recognised gains, losses (including impairment gains or losses) or returns / profits (see details in table below). Any adjustments from / to equity or from / to the income statement shall be appropriately split between the amounts attributable to the owners and those attributable to the profit and loss taking stakeholders, including investment accountholders.

28. Any changes to business model are expected to be very infrequent and are determined by ‘those charged with governance’ of the institution, as a result of external or internal changes and must be

significant to the institution's operations and demonstrable to external parties. This will occur only when an institution either begins or ceases to perform an activity that is significant to its operations.

	Reclassification from	*Reclassification to*	*Measurement*	*Treatment of gains and losses*
a)	Amortised cost	Fair value through income statement	The investment's fair value is measured at the reclassification date.	Any gain or loss arising from a difference between the previous amortised cost of the investment and fair value is recognised in income statement.
b)	Fair value through income statement	Amortised cost	The investment's fair value at the reclassification date becomes its new gross carrying amount for the purpose of applying the amortised cost accounting.	Not applicable.
c)	Amortised cost	Fair value through other comprehensive income	The investment's fair value is measured at the reclassification date.	Any gain or loss arising from a difference between the previous amortised cost of the investment and fair value is recognised through other comprehensive income.

	Reclassification from	*Reclassification to*	*Measurement*	*Treatment of gains and losses*
d)	Fair value through other comprehensive income	Amortised cost	The investment is reclassified at its fair value at the reclassification date, considering as if it was always measured at amortised cost.	The cumulative gain or loss previously recognised in equity as a reserve is removed from equity and adjusted against the fair value of the investment at the reclassification date.
e)	Fair value through income statement	Fair value through other comprehensive income	The investment continues to be measured at fair value.	Not applicable. However, future gains and losses are carried to equity, rather than income statement.
f)	Fair value through other comprehensive income	Fair value through income statement	The investment continues to be measured at fair value.	The cumulative gain or loss previously recognised in equity as a reserve is reclassified from equity to income statement as a reclassification adjustment.

29. Considering the specific nature of the institution's operations, transfer of ownership of investments between shareholders and different classes of profit and loss taking stakeholders (on- or off-balance sheet) and amongst different classes of profit and loss taking stakeholders, should not be considered by itself as a change of business model. If the investments are transferred to a portfolio being managed under a different business model, such transfer may be considered as a change in business model. The transfers shall be adequately disclosed in line with the requirements of FAS 21 "Disclosure on transfer of assets".

30. The reclassification effects, where relevant, shall be adequately attributed to the owners' equity and equity of different classes of quasi-equity including investment accountholders.

Presentation and disclosure requirements

Presentation

31. Investments shall be presented separately as a line item on the assets side of the statement of financial position. Disclosure shall be made of the significant components of each type of investments either on the face of the statement of financial position or in the notes to the financial statements.

32. Income and gains / losses from all types of investments shall be presented in the income statement under “income or gains / losses from investments” taking into consideration the split between the portion related to owners’ equity and the portion related to profit and loss taking stakeholders, including investment accountholders. The income and gains / losses from the main components of each type of investment shall be presented separately, in the notes to the financial statements.

Disclosures

33. In addition to the disclosure requirements stated in FAS 1 “General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions”, the ensuing paragraphs provide the minimum disclosure requirements.

34. General disclosures shall include:

    a. accounting policies adopted for classification, recognition and measurement (including impairment) of investments;

    b. any restrictions and incumbrances on investments, their profits or sale;

    c. any investments whereby the legal title is not held by the institution;

    d. the classification of investment portfolio in the following categories:

        i. investments carried at amortised cost;

        ii. investments carried at fair value through income statement; and

        iii. investment at fair value through other comprehensive income;

    e. for each category of investment, the details of the nature of investments in its portfolio (i.e., in the form of the type and classification of Sukuk or similar instruments, ordinary equity investments, other equity-type investments including Sukuk eligible to be classified as such, investment in funds, units etc.). An institution shall also provide the summary and amounts of investments that are rated, along with the respective ratings; and

    f. the cumulative “investments fair value reserve” indicating the balance at the beginning of financial period, changes during the period and the balance at the end of financial period, with due attribution to the owners’ equity and the equity of quasi-equity, including investment accountholders.

35. In respect of for any reclassifications during the period as a result of change in business model (see paragraphs 27-30), disclosure shall be made of the carrying amount of investment before and after

being re-measured, effects of changes recognised during the period, as appropriate, and the necessary information on the basis and justification of change in business model.

36. For investments measured at fair value, disclosure shall be made by category of investments of the basis of determination of fair value in the following levels that reflects the significance of the inputs used in measuring fair values:

a. level 1: fair values measured using quoted prices in active markets for identical instruments;

b. level 2: fair values measured using directly or indirectly observable inputs; and

c. level 3: fair values measured using inputs that are not based on observable market data.

37. For investments measured at fair value, classified as per paragraphs 8 and 9, disclosure shall be made of:

a. the amount of unrealised gains / losses included in the income statement and changes in equity during the period for each level of valuation;

b. the transfers between levels of basis of determination of fair value during the period, if any;

c. changes in valuation techniques from one period to another, including the reasons thereof, for each category of investments; and

d. in respect of investments valued using inputs that are not based on observable market data, significant estimates and judgments used in determination of fair value including effect on the valuation due to possible changes in key variables used for valuation.

38. For investments carried at amortised cost, an institution shall also disclose the fair values of the investments in a way that permits it to be compared to the carrying amounts, unless determination of fair value requires undue cost or efforts.

39. Disclosures shall be made regarding the transaction structure and underlying assets or business in respect of investment instruments, to enable the users of financial statements to understand the underlying risk factors.

Effective date

40. This standard shall be effective on the financial statements of the institutions beginning on or after 01 January 2021[2]. Early adoption of the standard is encouraged.

Transitional provisions

41. The standard shall be applicable on a retrospective basis. However, the cumulative effect, if any, attributable to profit and loss taking stakeholders, including investment accountholders related to previous periods, shall be adjusted with the investments fair value reserve pertaining to such class of stakeholders.

[2] The effective date was deferred from 1 January 2020 to 1 January 2021. See paragraph H10 of Appendix C: Brief history of the preparation of the standard.

Amendments to other standards

42. This standard supersedes FAS 25 “Investment in Sukuk, shares and similar instruments”.

Appendices

Appendix A: Adoption of the standard

This standard was presented for the approval in the AAOIFI Accounting Board 12th meeting held on 21-22 Rabi' I 1440H, corresponding to 29-30 November 2018 and was duly approved in principle with specific instructions. After due process of incorporation of instructions of AAB, the standard was issued on 24 Rabi' II 1440H, corresponding to 31 December 2018.

Members of the board

1. Mr. Hamad A. Al Oqab – chairman
2. Mr. Mohamed Bouya Ould Mohamed Fall – deputy chairman
3. Mr. Abdelhalim Elsayed Elamin
4. Dr. Abdulrahman M. Alrazeen
5. Dr. Bello Lawal Danbatta
6. Mr. Firas Hamdan
7. Mr. Hondamir Nusratkhujaev
8. Mr. Irshad Mahmood
9. Mr. Mohamed Ibrahim Hammad
10. Mr. Muhammad Jusuf Wibisana
11. Mr. Nader Yousif Rahimi
12. Dr. Saeed Al-Muharrami
13. Mr. Sulaiman AlBassam
14. Mr. Syed Najmul Hussain
15. Mr. Tarik Bolukbas

Reservation

The standard was approved unanimously.

Working group members

1. Mr. Hamad A. Al Oqab - chairman
2. Mr. Hondamir Nusratkhujaev
3. Mr. Imtiaz Ibrahim
4. Mr. Irshad Mahmood
5. Mr. Mahesh Balasubramanian

Executive team

1. Mr. Omar Mustafa Ansari (AAOIFI)
2. Mr. Mohammad Majd Bakir (AAOIFI)
3. Ms. Zahra Jassim AlSairafi (AAOIFI)
4. Ms. Farida Cassim (AAOIFI)
5. Mr. Atif Rashid (Executive Assistant)

Appendix B: Basis for conclusions

Need for revision of FAS 25

BC1 The need for an amendment (or limited improvement) to FAS 25 "Investment in Sukuk, Shares and Similar Instruments" was evaluated and decided by the AAOIFI Accounting Board (AAB / the board) at the initiation of the comprehensive Sukuk project. This comprehensive project resulted in the development of FAS 29 "Sukuk in the books of the originator" and FAS 34 "Financial reporting for Sukuk-holders" along with Shari'ah and governance standards on the subject.

BC2 The initial version of the preliminary study was, accordingly, developed with an intention of limited improvement to FAS 25 "Investment in Sukuk, Shares and Similar Instruments". However, after further observation and discussion it was concluded by the board that a mere amendment would not suffice, and instead a revision of the entire standard was required. While the board issued a limited amendment to the FAS 25 "Investment in Sukuk, Shares and Similar Instruments" in December 2017, yet, it concluded that FAS 25 "Investment in Sukuk, Shares and Similar Instruments" needed a revision in line with the global changes toward principle based approach regarding categorization and classification of type of investments i.e., to be primarily based on the institution's business model for managing investment and cash flow characteristics of the underlying Islamic finance contract. It was also felt that certain concepts need to be brought in greater conformity to Shari'ah and certain confusing and misrepresenting terms need to be revised, particularly, the term 'debt-type instrument'.

BC3 The board further decided that the revised standard would need to include all instruments that entail characteristics of not only debt and equity but also quasi-equity. In addition, FAS 25 "Investment in Sukuk, Shares and Similar Instruments" also needed to incorporate changes in certain definitions and treatments, in line with the changes brought in by FAS 29 "Sukuk in the books of the originator" and FAS 34 "Financial reporting for Sukuk-holders" and to follow the new format and style structure followed by newer AAOIFI FAS.

Business model based classification approach

BC4 In line with the global good practices of accounting, the board decided that the accounting model for classification and accounting for investments instruments shall be based on the business model. While the term business model, or investment strategy as an alternate (although with certain differences), was not alien under the previous FAS 25 "Investment in Sukuk, Shares and Similar Instruments", yet the overall structure of the standard was not based on the same. The board preferred to follow the overall business model based approach for classification and accounting for such investments, as the accounting is a mere reflection of the business facts and hence the accounting shall be driven by the business facts.

BC5 As a result, the board decided that the classification choices shall be provided similar to that of generally accepted accounting principles. The board decided to add a one-time irrevocable classification choice at the time of initial recognition to reduce accounting mismatch or inconsistencies. However, the accounting mismatch concept is when there is an inability to match the returns attributable to Dain. The board was of the opinion that in Islamic finance it is not an accounting mismatch but a cash flow mismatch.

BC6 The board further concluded that the business model shall have the same meaning and understanding as generally accepted accounting practices, and therefore does not require an additional explanation or definition in the standard.

Reclassification

BC7 Earlier FAS 25 "Investment in Sukuk, Shares and Similar Instruments" did not permit reclassification of investments after initial designation. Particularly, no subsequent reclassification into or out of the fair value and amortised cost category was permitted. However, the revised standard allows reclassification in limited circumstances, where the business model is changed which mandates a change in the accounting classifications and also provides guidance with regard to the treatments of such reclassifications. In this respect, the board was of the view that in common scenarios, reclassification shall not be allowed. However, since the new accounting requirements are revolving around the business model of the institution, hence it would be more justified to allow reclassifications in line with the global good practices if, and only if, the business model in respect of such investments is changed.

BC8 Considering the relevant Shari'ah requirements, the board concluded that the reclassification effects, where relevant, shall be adequately attributed to the shareholders and different classes of profit and loss taking stakeholders including investment accountholders, including the relevant disclosures.

Other investment type / quasi-equity type instruments

BC9 The earlier FAS 25 "Investment in Sukuk, Shares and Similar Instruments" only allowed classification of debt-type and equity-type, where equity-type was defined as the residual interest in the assets of an entity after deducting all its liabilities. This created confusion with regard to certain types of Sukuk as well, which as per Shari'ah entail equity or quasi-equity characteristics, but were falling within the definition of debt-type instruments under the earlier standard. The board also took into consideration instruments that are quasi-equity type. The definition of quasi-equity would refer to the same as in the other Sukuk standards i.e., FAS 29 "Sukuk in the books of the originator" and FAS 34 "Financial reporting for Sukuk-holders". The board discussed to include three categories - 'equity', 'debt' and 'other', being the default category. After due consideration, it was decided to include a 'other investment instruments' category which would include quasi-equity and others that due to Shari'ah could not be classified as debt or equity. This was intended to ensure that all the definitions shall not be exclusive and while 'equity' and 'debt' can be under exclusive definitions, the 'others' category shall be available to include whatever is left, including the 'quasi-equity' type instruments.

BC10 The board additionally considered the implications including the Shari'ah compliance and reputation related risks in using the term debt-type for a large number of Sukuk and similar instruments, which were communicated to the board by different quarters. Accordingly, the board concluded that the classification and definition for debt-type instruments needs improvement and better reflection of the nature and Shari'ah requirements.

BC11 Considering the above factors and Shari'ah considerations, the board concluded that it would be appropriate to classify instruments into three broad types: 'debt-type', 'equity-type' and 'other investment instruments'. This third category i.e., 'other investment instruments' would include quasi-equity instruments and other instruments which do not fall within the strict definition of the previous two types, and hence most common Sukuk will fall in this category. 'Debt-type' will be sub-categorized into monetary (e.g. Murabaha payable) and non-monetary (e.g. Salam or Istisna'a). This category will be allowed to be carried at fair value or at amortised cost if it is intended to hold till maturity. The treatment will be same as IFRS 9, under the exception of the condition – where the initial outflow date will be considered when the transaction is executed.

Amortised cost and effective profit rate / rate of return method

BC12 The board considered the definition of "amortised cost" and the relevant treatment to be in line with the generally accepted accounting principles, with due Shari'ah consideration particularly considering the fact that it is dependent on the effective rate of return or effective profit rate method. The definition required to include the recognition amount and the reasons the amortised cost is calculated and how the effective rate is calculated. There were certain observations on the earlier definition from Shari'ah perspective and the same was slightly different from the definition used in more recently issued AAOIFI FASs. The board decided that it is relevant to allow amortised cost based on the revised and improved definition.

BC13 The board further considered the Shari'ah aspects of instruments that are tradable (negotiable) and transferable (non-negotiable). The board decided that if the instrument is non-negotiable then it is subject to amortised cost accounting only. For example, Murabaha-Sukuk is non-negotiable from Shari'ah perspective.

BC14 The value that such instruments actually going to fetch may be (either the fair value, as in certain situations acceptable by Shari'ah or the face value) different from the amortised cost. However, at initial recognition the amortised cost method is suited due to the intention and the business model, which is to hold till maturity because of being non-negotiable. However, instead of actual date of investment (cash outflow), the date of transaction consummation shall be considered as the date of initial cash outflow to apply the amortised cost method.

Disclosures for underlying assets and treatment for monetary debt-type instruments

BC15 The board discussed the concept of accounting for the instruments based on the value of the underlying asset and disregarded the idea because the investment instruments themselves are generally tradable / transferable and have a value different from the value of the underlying assets, as they have different characteristics and are subject to different market conditions. However, it was considered that the fair value of the underlying assets (at the backend) of Sukuk shall be determined and disclosed, if material.

BC16 However, the board concluded that the accounting for any instrument based on debt (having a debt at the backend, e.g. Murabaha) shall be driven by Shari'ah principles and specific provisions are needed for their accounting including no revenue recognition before the transaction consummation and accounting based on amortised cost only.

Change in cash flow / yield predictability model

BC17 The board considered and concluded that the context of 'reasonably determinable effective yield' as being more acceptable and relevant for Islamic finance instruments (other than equity-type and debt-type instruments) in contrast to the generally accepted accounting term of 'contractual cash flow' which might be applicable on pure monetary debt-type instruments. The board concluded that such term, or even the 'expected yield / cash flows' is also not suitable for numerous other instruments including e.g. Mudaraba, Salam, Istisna'a etc. This is in contrast to the generally accepted accounting principles whereby it denotes only principal and interest (or their equivalent) which is not accepted by Shari'ah.

Impairment

BC18 Earlier FAS 25 "Investment in Sukuk, Shares and Similar Instruments" included the impairment requirements related to relevant instruments within the standard as the earlier FAS 11 "Provisions and Reserves" did not cater to these types of instruments specifically. However, considering issuance of FAS 30 "Impairment, credit losses and onerous commitments" which deals with accounting for, inter-alia, these instruments as well, the board decided to refer to the said standard for any impairment requirements in order to ensure consistency of the impairment requirements.

Cost model

BC19 Earlier FAS 25 "Investment in Sukuk, Shares and Similar Instruments" allowed accounting for certain investments at cost. Considering the practical constraints, the board considered the matter at length and decided to narrow down the caveat by allowing the cost model for equity investments, only when the cost reflects a good estimate of fair value, considering the relevant constraints. This is also in line with the global best practices of accounting.

Appendix C: Brief history of the preparation of the standard

H1 AAOIFI initiated the Sukuk comprehensive project for revision and development of the Shari'ah and Accounting standard on Sukuk, in 2015. Following this, the overall approach and plan for the Sukuk standard was discussed at the 1st meeting of the newly formed AAOIFI Accounting Board (AAB), held on 6-7 Jumada II 1437H, corresponding to the 15-16 March 2016 in the Kingdom of Bahrain.

H2 The Sukuk workshop was held in cooperation with King Fahd University of Petroleum and Minerals on 25-26 Muharram 1438H corresponding to 26-27 of October 2016. Accounting experts from regulatory and supervisory bodies, Islamic financial institutions, national accounting bodies and academics were present. It was concluded that issuers and investors should fully comply with Shari'ah principles and rules related to Sukuk structuring. Furthermore, it was recommended that AAOIFI's technical boards consider in the development process of the standard the fact that most Sukuk meet the definition of instruments quasi-equity. Finally, the participants stressed the need to set up a governance mechanism for Sukuk and other instruments.

H3 The secretariat team held several meetings with the executive assistant and the preliminary study and consultation notes were developed, after which the initial draft of the standard was forwarded to the working group.

H4 The exposure draft was presented with the comments and recommendations from the working group members at the 9th AAB meeting held on 6-7 Rajab 1439H, corresponding to 24-25 March 2018. After due deliberations, the exposure draft was approved for issuance.

H5 The public hearings for the standard were conducted in Bahrain, Sudan, Oman and Lebanon during the months of June to September 2018. All comments received for the exposure draft through the public hearing events and comments and views received in writing from industry participants were presented to the working group on 4 Rabi' I 1440H, corresponding to 12 November 2018 for discussion and conclusions. After due deliberation, the working group forwarded the standard with its recommendations to the AAB for approval.

H6 The standard was, in principles, approved at 12th AAB meeting held on 21-22 Rabi' I 1440H, corresponding to 29-30 November 2018, with specific instructions for making changes and taking into consideration Shari'ah committee comments. After due process, the standard was issued on 24 Rabi' II 1440H, corresponding to 31 December 2018.

H7 The AAB, in its 18th meeting held on 23-24 Dhul-Qa'dah, 1443H corresponding to 22-23 June 2020, deliberated on the feedback received from the institutions operating in various markets, about the potential constraints in adopting and implementing the recently issued AAOIFI FASs, in the wake of the COVID-19 pandemic. The AAB decided to defer the effective date of the recently issued AAOIFI FASs, namely, FAS 30 "Impairment, Credit Losses and Onerous Commitments", FAS 31 "Investment Agency (Al-Wakala Bi Al-Istithmar)", FAS 33 "Investments in Sukuk, Shares and Similar Instruments", and FAS 34 "Financial Reporting for Sukuk-holders"; from 1 January 2020 to 1 January 2021. The AAB emphasized that institutions are still encouraged to early adopt these standards.