

AAOIFI Financial Accounting Standard 34
Financial Reporting for Sukuk-holders

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AAOIFI Financial Accounting Standard 34 “Financial Reporting for Sukuk-holders” is set out in paragraphs 01-21. 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 FAS 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 The AAOIFI secretariat, with due approval of the respective technical boards, in April 2015 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). This project aimed to reflect latest market developments with regards to Sukuk, particularly that the existing standards were issued relatively long time back. On the accounting side, the idea was to include other stakeholders as well, particularly the issuer or originator of the Sukuk for which accounting was not defined earlier. At a later stage, a governance standard was also added to the comprehensive project.
- PR2 During discussions at various working group meetings as well as market interaction during a workshop for industry participants conducted for the project in October 2016, the need was eminent for accounting and financial reporting requirements for the benefit of the Sukuk-holders and other relevant stakeholders with regard to the assets and businesses underlying the Sukuk. This becomes more relevant for the instruments which are off-balance sheet for the principal issuer of Sukuk.
- PR3 This standard intends to introduce the financial reporting for the benefit of the Sukuk-holders and other stakeholders with regard to the assets and businesses underlying the Sukuk. It is expected that with the introduction of the same, the Sukuk market will have an improved level of transparency and financial discipline, as well as, enhance the level of compliance with Shari'ah.

Introduction

Overview

- IN1 This standard, AAOIFI Financial Accounting Standard (FAS) 34 “Financial Reporting for Sukuk-holders” intends to prescribe the accounting principles and reporting requirements for underlying assets of a Sukuk instrument. It requires the originator to prepare or cause to prepare financial reports as needed under this standard.
- IN2 This standard prescribes the necessity of financial reporting for the benefit of Sukuk instruments stakeholders’ and their underlying assets in a manner that a transparent and fair financial information sharing takes place. At the same time it does not intend to require comprehensive financial statements for the same and accordingly, allows a simplified version of financial reporting.
- IN3 This standard considers two primary types of Sukuk instruments for the purpose of financial reporting to the Sukuk-holders. Even within the two types of summarized financial information, it allows further simplified financial reporting for non-business Sukuk, as compared to the business Sukuk considering the fact that the information needs for the stakeholders of such Sukuk are further limited.

Rationale for issuing this standard

- IN4 AAOIFI, so far, has not issued any specific standard in this area and normally there are no established practices of financial reporting to the Sukuk-holders or for the accounting for the special purpose vehicles (SPV). Through market interactions and expert discussions during the comprehensive Sukuk project, the need for improved transparency and financial reporting practices was identified and noted by the board.
- IN5 Accordingly, the board concluded that a financial reporting standard introducing the financial reporting for this specific segment of stakeholders and fulfilling the information needs of the Sukuk-holders is necessary for the purpose of transparency additionally and for improved Shari’ah compliance on the other hand.

AAOIFI Financial Accounting Standard 34

Financial Reporting for Sukuk-holders

Objective of the standard

1. The objective of this standard is to establish the principles of accounting and financial reporting for assets and business underlying the Sukuk to ensure transparent and fair reporting to all relevant stakeholders particularly Sukuk-holders.

Scope

2. This standard shall apply to Sukuk in accordance with Shari'ah principles and rules issued by an IFI or other institution (called "originator"), directly or through the use of a Special Purpose Vehicle (SPV) or similar mechanism. In respect of Sukuk which are kept on-balance sheet by the originator in line with requirements of FAS 29 "Sukuk in the Books of the Issuer / Originator"¹, the originator may opt not to apply this standard.

Definitions

3. For the purpose of interpreting and applying this standard, the following short definitions are relevant:
 - a. 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;
 - b. Fair value – is 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;
 - c. Originator – for the purpose of this standard, is an IFI or other institution that issues a Sukuk in line with Shari'ah principles and rules, directly, or through the use of a Special Purpose Vehicle (SPV) or similar mechanism;
 - d. Special Purpose Vehicle (SPV) [also referred to as Special Purpose Entity (SPE)] – is a legal entity (corporate entity, trust or limited partnership, etc.) created to fulfill narrow, specific or temporary financial objectives. An SPV, in the context of Sukuk, is not a pass-through entity and rather is an entity in itself, meeting the definition of a business, usually managing the virtual Sukuk entity;

¹ FAS 29 "Sukuk in the Books of the Issuer / Originator" is in exposure draft stage at the time of issuance of this standard. [Explanation: Till the time of issue of FAS 29, the requirements of AAOIFI's Conceptual Framework shall be considered for determining whether a Sukuk shall be on- or off-balance sheet.]

- e. Sukuk – are certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs and services or (in the ownership of) the assets of particular projects or special investment activity. Such special investment activity is referred to as a business in this standard. Sukuk may be tradable or not tradable according to the nature of the governing contract, or arrangement, as well as, the nature of the underlying assets or business;
- f. Sukuk entity – is a real or virtual entity having the Sukuk-holders as owners and owning the underlying Sukuk assets; and
- g. Sukuk-holders – are the investors being owner of the underlying assets or business, for a Sukuk issuance by virtue of owning the Sukuk certificates.

Financial reporting responsibility

- 4. The originator of Sukuk shall prepare or cause to prepare the financial reports of the Sukuk entity, for each Sukuk issuance, in line with the requirements of this standard on a periodic basis, at least on an annual basis in order to make the same available to the relevant stakeholders, along with the financial information of the originator. Preferably such financial reports may be shared with the stakeholders along with the financial information of the originator, although the same can also be shared separately with the stakeholders. Interim financial reports may also be prepared.

Classification of Sukuk for the purpose of financial reporting to Sukuk-holders

- 5. For purpose of this standard, based on the nature of investment, Sukuk shall be classified as either:
 - a. business Sukuk; or
 - b. non-business Sukuk.

Business Sukuk

- 6. Business Sukuk represent a Sukuk instrument whereby there exists an underlying business i.e., either of, or a combination of, Islamic finance and investment, trade, services or similar activities.

Non-business Sukuk

- 7. Any Sukuk which is not a business Sukuk in line with paragraph 6 shall be considered a non-business Sukuk.

Accounting treatment and financial reporting for business Sukuk

Accounting treatment

- 8. All assets and liabilities underlying the Sukuk and related revenues and expenses shall be recognised and measured in the books of account of the Sukuk entity applying the accounting principles in

accordance with respective FAS and, in absence thereof, in line with generally accepted accounting principles applicable to such transactions and balances².

Financial reporting

9. Nature of any business for the purpose of financial reporting may be bifurcated into the following:
 - a. Islamic finance transactions; and / or
 - b. assets, goods and services other than Islamic finance transactions.
10. Financial reporting and characteristics of financial statements of an institution shall be distinguished by the nature of business carried out by the institution. While Islamic finance transactions shall be accounted for under the requirements of FAS 1 “General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions”, the transactions other than Islamic finance transactions shall be accounted for under the financial reporting requirements of generally accepted accounting principles³.
11. The set of financial reports for a business Sukuk shall comprise of a summarized form of the following:
 - a. a statement of financial position;
 - b. an income statement (duly disclosing earnings per Sukuk unit); and
 - c. notes to the financial statements (refer presentation and disclosure below) including any movements in reserves, if any.

Presentation and disclosures

12. In addition to the selected presentation and disclosure requirements stated in FAS 1: “General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions” following are the minimum disclosure requirements:
 - a. disclosure of the nature of business, its assets, its main activities and the structure for Sukuk or other instrument of investment, as applicable and any changes thereto;
 - b. disclosure in respect of value of the underlying asset(s) and information necessary to ascertain its tradability in line with Shari’ah principles, depending on the nature of instrument;
 - c. disclosure regarding the transfer of legal ownership from the originator to the SPV;
 - d. disclosure about the ownership and control of the SPV, particularly, if it is controlled by the originator;

² The application of generally accepted accounting principles in all situations shall not result in an accounting treatment which is repugnant to the requirements of AAOIFI’s Conceptual Framework or Shari’ah.

³ The application of generally accepted accounting principles in all situations shall not result in an accounting treatment which is repugnant to the requirements of AAOIFI’s Conceptual Framework or Shari’ah.

- e. disclosure of fair valuation of the business and the significant assets, (preferably both, but at least one of them) along with necessary disclosures of valuation techniques used to determine the fair value along the level of observable inputs used in line with generally accepted accounting principles [Note: fair value to be determined with suitable frequency ensuring that the decision making of the stakeholders might not be affected by the obsolescence of information];
- f. at the time of liquidation of Sukuk entity, the details of the transaction execution;
- g. disclosure of any charity and its movement, including any income taken to charity, if any, and its disposal; and
- h. disclosure of Zakat fund and its movement, including any income taken to Zakat, if any, and its disposal.

Accounting treatment and financial reporting for non-business Sukuk

Initial recognition

- 13. On initial recognition, underlying assets shall be recognised at cost which is the consideration paid or payable for the same.

Subsequent measurement

- 14. Subsequent to initial recognition, the underlying assets shall be measured at fair value at each reporting date, except for the Islamic finance transactions which are not allowed to be carried at fair value, which shall be accounted for in line with the respective FAS⁴.
- 15. In instances where fair value cannot reasonably be determined, or where objective evidence is available that the fair value does not differ materially from the carrying value, underlying assets at each reporting date shall be measured at carrying amount calculated at cost or amortized cost basis, as appropriate, adjusted for any impairment in the value of underlying assets.
- 16. Fair valuation of the assets, on an individual or collective basis, shall be determined with suitable frequency ensuring that the decision making of the stakeholders might not be affected by the obsolescence of information.

Revenue and expenses

- 17. Unless contrary to a specific requirement of this standard, the resulting revenues, expenses, gains and losses, arising from the underlying assets, shall be measured and accounted for, respectively, according to the nature of the contract(s) in line with the requirements of respective or similar FAS applicable to such transactions in line with the Framework or in absence thereof, in line with the generally accepted accounting principles⁵.

⁴ These may include the amounts reflecting a receivable like Murabaha receivable, on which respective FAS shall apply.

⁵ The application of generally accepted accounting principles in all situations shall not result in an accounting treatment which is repugnant to the requirements of AAOIFI's Conceptual Framework or Shari'ah.

Financial reporting

18. A set of financial reports shall comprise of:
- a. statement of net assets with a Net Asset Value (NAV) disclosure;
 - b. statements of changes in net assets; and
 - c. significant notes to the financial statements.

Presentation and disclosures

19. Following are the minimum disclosure requirements along with the summarized financial reports:
- a. disclosure of the type of asset, the main activity and underlying contracts, if any, and significant investment policies that govern the investment activities and investment objectives it seeks to achieve;
 - b. disclosure of the accounting policy to recognise revenues, fair value changes and expenses;
 - c. disclosure regarding the transfer of legal ownership from the issuer to SPV or the holders of the instrument;
 - d. disclosure in respect of value of the underlying asset and its tradability which, along with other factors, depends on the nature of such assets and the underlying contracts;
 - e. disclosure of NAV at each reporting date – to be made on the face of the statement of net assets;
 - f. disclosure of valuation techniques used to determine the fair value along the level of observable inputs used in line with the generally accepted accounting principles [Note: fair value to be determined with suitable frequency ensuring that the decision making of the stakeholders might not be affected by the obsolescence of information];
 - g. at the time of liquidation of Sukuk entity, the details of the transaction execution;
 - h. disclosure of any charity and its movement, including any income taken to charity, if any, and its disposal; and
 - i. disclosure of Zakat fund and its movement, including any income taken to Zakat, if any, and its disposal.

Effective date

20. This standard shall be effective on the financial statements of the institutions beginning on or after 01 January 2021⁶. Early adoption of the standard is encouraged.

⁶ The effective date was deferred from 1 January 2020 to 1 January 2021. See paragraph H7 of Appendix C: Brief history of the preparation of the standard.

Transitional provisions

21. An entity may opt not to apply this standard only on such transactions:
 - a. which were already executed before the adoption date of this standard for the entity; and
 - b. their original maturity falls no later than 12 months after the adoption date of this standard for the entity.

Appendices

Appendix A: Adoption of the standard

This standard was presented for the approval in the AAOIFI Accounting Board's 9th meeting held on 7-8 Rajab 1439H, corresponding to 24-25 March 2018 and was in principle approved 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.

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. Dr. Sh. Osaid Mohamad Kailani

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

Objective and name of the standard

- BC1 While initially the project was to develop accounting standard or guidelines for special purpose vehicles (SPVs), towards finalization of the same, the board reconsidered the name of the standard in the light of its eventual objective as well as the differences in legal and transaction structures. The board considered that in different jurisdictions and legal structures the SPVs may be owning the assets and hence the Sukuk-holder will become holders of equity or quasi-equity for such assets. However, in other structures (which in view of certain members would be more in number), the SPV would primarily be an incorporated entity to hold on behalf of the Sukuk-holders under a trustee relationship rather than owning it.
- BC2 Accordingly, the board decided that the objective of financial reporting is paramount. Therefore the financial reporting needs of the Sukuk-holders shall be met and accordingly, the name of the standard was changed to “Financial Reporting for Sukuk-holders”.

Responsibility for financial reporting

- BC3 The board considered as to whether the responsibility of preparing and issuing the financial reports required under this standard shall be with the SPV (or the Trustee) or shall rest with the originator (original issuer) of Sukuk. Considering different factors, most important of whom being, the practicality, common use of tax free, investment friendly jurisdictions for Sukuk issuance, and the normal information recourse of the Sukuk-holders, the board decided that the responsibility for the same shall rest with the originator who may choose to publish the same along with its own financial reports.

Classification of Sukuk for the purpose of financial reporting to Sukuk-holders

- BC4 The board considered different options of simplified financial reporting with regard to different types of entities and funds. Considering the normal information needs of the Sukuk-holders, the board decided that one model may not fit all situations.
- BC5 After due deliberations, the board considered that the information needs of the Sukuk-holder of a business Sukuk that represents an underlying business i.e., either of, or a combination of, Islamic finance and investment, trade, services or similar activities shall primarily be of the statement of affairs and the operational performance including e.g., earnings per Sukuk. On the other hand, the information needs of a Sukuk-holder whose instrument does not comprise of a business and represents only a single or a portfolio of assets, the main information consideration would be that of the net assets and net asset value – which shall primarily be based on fair value. Considering these factors, the board decided to define basic types for the purpose of financial reporting i.e., a business Sukuk and a non-business Sukuk.

Simplified financial reporting

- BC6 With due consideration to the classification for the purpose of financial reporting to the Sukuk-holders, the board decided that it would be more appropriate duly considering the information needs of the Sukuk-holders of the business Sukuk that represents an underlying business i.e., either of, or a combination of, Islamic finance and investment, trade, services or similar activities shall provide a summarized set of normal financial statements.

- BC7 On the contrary, the board agreed that in case of non-business Sukuk, the basic information need is the valuation (mainly fair value) and hence a further simplified approach of information about net assets and movement thereon would be sufficient and more appropriate.

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 1st working group meeting on Sukuk was held on 3 Dhul-Hijjah 1437H, corresponding to 5 September 2016. The members decided to include guidelines for accounting by the SPV and it was concluded that SPV is a critical topic and should be accounted for in AAOIFI standards.
- H3 The project was initiated as a part of the comprehensive Sukuk project and the initial discussion on the need for a separate standard on SPV accounting (or financial reporting for Sukuk-holders) took place in the Sukuk workshop held in Jeddah, Saudi Arabia on 25-26 Muharram 1438H, corresponding to 26-27 October 2016.
- H4 At the 6th AAB meeting held on 21-22 Shawwal 1438H, corresponding to the 15-16 July 2017, the key principles and approach towards developing such standard were discussed. AAB evaluated the need and approach and advised the secretariat to complete the project in line with the guidance provided.
- H5 At the 7th AAB meeting held on 2-4 Muharram 1439H, corresponding to 22-24 September 2017, the members discussed the first version of this standard’s exposure draft as presented by the secretariat. The board considered, inter-alia, the standard’s name and decided to rename the draft standard as “Financial Reporting for Sukuk-holders”. After due deliberations, AAB decided to approve the exposure draft in principle and advised the secretariat and the working group to incorporate changes as identified along with basis of conclusion. The board also decided to hold public hearings and obtain industry comments along with the views and comments of The Committee of the Shari’ah board for Review of Accounting and Governance Standards.
- H6 The public hearing sessions for the standard were held along with FAS 29 “Sukuk in the Books of the Issuer / Originator” in Turkey, Bahrain and Pakistan in the months of October and November of 2017. All comments received from public hearings along with the views and comments from different industry participants on the exposure draft was then presented for discussion at the AAB 9th meeting held on 7-8 Rajab 1439H, corresponding to 24-25 March 2018 in the Kingdom of Bahrain. The board incorporated changes required and the standard was approved. The standard was approved for publishing with instructions for making suggested 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.