

[Exposure Draft (ver. 1.6) of] Financial Accounting Standard No. 29

Sukuk Issuance

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AAOIFI Financial Accounting Standard No. 29 "*Sukuk Issuance*" is set out in paragraph ____ - _____. 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 rulings and principles and key considerations provided by AAOIFI Shari'ah standards in respect of such products and matters.

Preface

- PR1 This standard aims at setting out accounting and classification guidelines for Sukuk issued by Islamic financial institutions¹. Other institutions issuing Sukuk may also apply this standard to their Sukuk issuances.
- PR2 This standard is a part of a comprehensive project on Sukuk by AAOIFI commenced with an objective to improve the existing Shari'ah and financial accounting standards of AAOIFI and to fill in the gaps identified by the experts and industry, particularly for the avenues not covered by the existing standards.
- PR3 One of the most crucial observations was absence of an existing standard providing guidance to the Sukuk issuers. This standard aims to address this need in particular, although the expected outcomes of the project will further include the guidelines for accounting by the special purpose vehicles and limited improvements to the accounting and reporting by the investors in Sukuk.

¹ Referred to as the institution or IFI.

Introduction

Overview

- IN1 AAOIFI Financial Accounting Standard No. 29 Sukuk Issuance is effective for accounting periods beginning on or after 01 January 2019.
- IN2 This Standard prescribes accounting issues in classification of Sukuk issuance, in the books of the institution, its presentation requirements and related disclosure of information in the financial statements of the institution. It also provides guidance on off balance sheet Sukuk issued by the institution.

Reasons for issuing this standard

- IN3 This standard constitutes a part of a comprehensive project on Sukuk including Shari'ah and accounting standards. Absence of a standard for the accounting and financial reporting triggered the need for this standard on a priority basis.

Main features

- IN4 While accounting of Sukuk issuance shall be significantly dependent on the accounting for the respective product, and AAOIFI has already issued FAS for most of the common products; however, its presentation and classification on the liability side shall be based on the structure and characteristics of Sukuk. This standard aims to provide such guidance in particular.
- IN5 The standard aims to provide guidance for accounting classification and presentation for Sukuk issuances primarily based on the Sukuk structure, which may include on balance sheet, as well as, off balance sheet accounting. These classifications depend on the control of such assets comprising of power to control and nature of control i.e. for risks and rewards as well as varying benefits to the institution or the fiduciary responsibility on behalf of the Sukuk-holders.
- IN6 The standard further provides guidance on the on balance sheet structures, whereby these may include instruments to be reported as equity, quasi-equity, financial liability or a non-financial liability.

AAOIFI Financial Accounting Standard No. 29 (Exposure Draft)

Sukuk Issuance

Objective of this standard

1. The objective of this standard is to prescribe the accounting and financial reporting guidance for the accounting treatment and classification with regard to the Sukuk issuance, in the books of the Islamic financial institutions or other institutions issuing Sukuk (the institution). This Standard also deals with the presentation and disclosure of Sukuk issuance in the books of the issuer with regard to its structure.

Scope

2. This standard shall be applied for accounting and financial reporting for Sukuk issuance in the books of the issuer.
3. This standard determines the requirements for the primary accounting treatment and classification, as well as, presentation and disclosure of Sukuk issuance in the financial statements of the issuer.
4. This standard does not provide individual accounting treatment of each Sukuk type and structure based on either structure, or, the underlying product. Nevertheless, it provides principle based accounting treatments for broadly two types of Sukuk issuance i.e. off balance sheet and on balance sheet as well as any sub categories, as applicable.
5. Detailed accounting and disclosure requirements for the respective Sukuk structure, as well as, the underlying product shall apply in accordance with the requirements of the respective Financial Accounting Standards (FAS) for the time being in force.

Definitions

6. For the purpose of interpreting and applying this standard, the following short definitions are relevant:
 - a. 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.
 - b. Control – see paragraph ___ below.

- c. Liability – is a present economic obligation that is enforceable against the IFI. Liabilities result from past transactions of other past events. A distinction should be made between present obligation and a future commitment.
- d. Owner’s equity – is the residual interest in the assets of the institution after deducting all its liabilities and amounts shown in the balance sheet as equity of investment account holders [or other similar balances].
- e. 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.
- f. Quasi equity [also referred to as redeemable capital] – represents capital received by an institution on a profit sharing or participation basis. It has:
 - i. primary characteristics of equity, i.e. in case of loss (unless negligence/ misconduct/ breach to contractual terms is proved) institution is not required to return the funds to the fund providers and the fund providers share the residual interest in the underlying assets or business; and
 - ii. certain characteristics of a liability i.e. it has a maturity or a put option of redemption; and
 - iii. certain specific features i.e. the rights of the fund providers are limited to the underlying assets or business only and not on the whole of the institution as well as they do not have certain rights associated with owner’s equity only.
- g. Special purpose vehicle (SPV) [also referred to as Special Purpose Entity (SPE)] – is a legal entity (maybe a corporate entity, trust or limited partnership) created to fulfill narrow, specific or temporary financial objectives. An SPV conventionally is used by an entity to isolate it from certain financial risk or to securitize certain assets. Unlike conventional practices, 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.
- h. 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;

- i. Sukuk-holders – are the investors being owner of, or owner of the benefits of, the underlying assets or business, for a Sukuk issuance by virtue of owning the Sukuk certificates.
- j. Tier 1 equity – represents the most subordinated claims on an institution’s asset (residual interest) and are perpetual in nature i.e. are not callable by the issuer (except for discretionary buy backs allowed by relevant laws).
- k. Tier 2 equity – also represents a subordinated claim on institution’s asset after depositors [including investment account holders] and general creditors. These may be callable by the issuer for at least five years and only if they are replaced by tier 2 equity of same characteristics.

Initial classification of Sukuk issuance

Broad classifications

- 7. An institution issuing Sukuk shall determine the extent of control of the institution over the assets or business underlying the Sukuk instrument, depending on the structure, entailing contract / product governing the relationship of the Sukuk-holders, the SPV and the institution.
- 8. If the institution concludes that:
 - a. it controls the underlying assets or business – it shall account for the Sukuk issuance on an on balance sheet basis as detailed in paragraphs ____ to ____ below; or
 - b. it does not control the underlying assets or business – it shall account for the Sukuk issuance on an off balance sheet basis, as detailed in paragraphs ____ to ____ below.

Control

- 9. 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:
 - a. it is directly exposed to, or has rights to, variable returns (negative or positive, respectively) from its involvement with such assets or business; and
 - b. it has the ability to affect those returns through its power over the assets or business.
- 10. For the purpose of this standard:

- a. control includes the situations whereby the institution controls an asset or business, primarily, for the benefit of stakeholders other than its normal equity holders; and
- b. control does not include situations whereby the institution has the power but such power is exercisable in a fiduciary capacity, and not for the variable returns to the institution itself and hence the risks and rewards with regard to such asset is not with the institution. It is clarified that performance incentives receivable by an agent are in fiduciary capacity, and hence not considered to be variable returns for this purpose.

Independent contractual or promissory arrangements associated with Sukuk issuance

11. The structure of Islamic finance transactions including Sukuk having different underlying transactions may include certain independent additional contractual or promissory arrangements e.g. a guarantee or a purchase / sale undertaking etc. There is a rebuttable presumption that the nature of Islamic finance transactions from Shari'ah perspective, in most cases, would not accept these additional contractual or promissory arrangements as a part of the core contract.
12. Accordingly, these arrangements are considered to be independent contracts or contractual arrangements (including promises, which by virtue of institution's goodwill or customary practices may be deemed as constructive contracts).
13. Unless being part of the core contract, any guarantee or purchase / sale undertaking or similar contract or contractual arrangement shall not be combined with the core contract for the purpose of determination of initial classification and instead all such arrangements shall be treated and disclosed as commitments.
14. An institution, on a periodic basis, shall evaluate its obligations with regard to the commitments specified in paragraph ___ above. If it is established at any point of time that such arrangement is onerous in nature i.e. the same will result in a loss to the institution when executed (either currently, or later at maturity, or any other stage), any such loss shall be recognized by the institution currently.

On balance sheet Sukuk

15. On balance sheet Sukuk are those where the institution has the authority over decisions with regard to the use of and deployment of funds etc. with regard to the underlying assets or business. However, there are situations where the institution may not have complete authority over decisions with regard to the use of and deployment of fund but other evidence suggests that it has risk characteristics of on balance sheet Sukuk. Such Sukuk shall be recorded in the

books of the institution and classified and accounted for in line with the requirements of paragraphs ___ to ___ below.

Classification and presentation of Sukuk eligible for on balance sheet accounting

16. Sukuk eligible for on balance sheet accounting shall be classified and presented according to the structure, entailing contract / product governing the relationship of the Sukuk-holders, the SPV and the institution, as well as, the nature of underlying assets / business, as either:
 - a. equity; or
 - b. quasi-equity; or
 - c. liability.

Sukuk classified as equity

17. Sukuk issuance shall be classified, and accounted for, as equity in the books of the institution if, and only if, the following conditions are met:
 - a. instrument is participatory and nature i.e. risks and rewards of the underlying assets or business are shared by the Sukuk-holders; and
 - b. instrument is either perpetual or convertible in nature or a combination of both; and
 - c. instrument is subordinate to all liabilities, and / or, quasi-equity instruments of the institution.
18. These shall be classified as tier 1 or tier 2 equity, depending on the nature of the structure.
19. There is a rebuttable presumption that Sukuk structures based on Mudaraba and / or Musharaka shall be classified as equity in the books of the institution, if all above the above conditions are met. Moreover, certain Wakala Sukuk that do not meet the criteria of off balance sheet Sukuk may be classified as equity, if they meet the above criteria.
20. Accounting for the respective product shall be in line with the respective FAS and the framework and, in absence thereof, in line with the generally accepted accounting principles insofar these are not repugnant to Shari'ah.

Sukuk classified as quasi-equity

21. Sukuk issuance shall be classified and accounted for as quasi-equity if these meet the definition of quasi-equity under this standard, have the characteristics similar to the equity of investment account holders and do not meet the criteria for classification as equity.

22. These are the instruments whereby:
- a. the funds (or capital) arising from the issuance are made available to institution, in cash or in kind (in form of assets or business) on participatory (profit and / or loss sharing) basis;
 - b. the institution exercises control over underlying assets or business including management decisions, even if for the benefit of the stakeholders other than common owners;
 - c. the investment is not guaranteed i.e. unless loss is incurred due to negligence, the institution is not obliged to return the funds it has received;
 - d. the fund providers on the other hand also do not have the rights associated with owner's equity; and
 - e. the criteria for classification as equity as defined in paragraphs ___ is not met.
23. There is a rebuttable presumption that Sukuk structured on Musharakah and Mudarabah basis shall be classified as quasi-equity if they are redeemable by Sukuk-holders and / or there is a separate purchase undertaking by the issuer, and / or if they do not meet the criteria for classification as equity. Moreover, certain Wakala Sukuk that do not meet the criteria of off balance sheet accounting, may be classified as on balance sheet quasi equity Sukuk, if they meet the above criteria.
24. Similar to the equity of investment account holders, these shall be reported in the statement of financial position separately from the equity and the liabilities of the institution. Accounting, reporting and disclosures in respect of such Sukuk shall be in line with the requirements of respective or similar AAOIFI FAS².

Sukuk classified as liability

25. Sukuk issuance shall be classified as a financial liability is structured in a manner whereby it results in the creation of a present monetary obligation (Dain) on the issuer. On the contrary Sukuk issuance shall be classified as a non-financial liability if these results in an obligation to deliver goods or services.
26. Sukuk structures based on Murabaha and other deferred payments sales and services, whereby the goods or services are acquired by the institution, resulting in a financial liability (Dain)

² FAS 27 "Investment Accounts"

payable to the Sukuk-holders, on a one time basis, or in a series of transactions over the period of Sukuk would generally fall in this category.

27. Sukuk structure based on Salam, Istisnaa, or service Ijarah shall be classified as a non-financial liability because it creates a present obligation on the institution to deliver goods / services³. However, during different stages of the transaction, depending on the nature of the contract and overall arrangement, the amount received as advance may be presented as a financial liability.
28. These instruments shall be accounted for, presented and disclosed, in line with the accounting prescribed by respective or similar AAOIFI FAS.

Initial recognition of assets and liabilities on account of Sukuk issuance

Initial recognition

29. Unless contrary to a specific requirement of this standard, the resulting assets and liabilities arising from the execution of the contract (or contracts) for the Sukuk issuance, shall be initially recognized according to the nature of the contract(s) in line with the requirements of respective AAOIFI FAS applicable to such transactions.

Carrying value adjustments

30. If an institution issues Sukuk instrument eligible for on balance sheet accounting, resulting in transfer of risk and reward of its existing assets to the Sukuk-holders at a value different from the carrying value as of the date of transaction, the carrying value of such asset shall be adjusted in the books of the institution and any resulting gain or loss shall be accounted for in the following manner:
 - a. a gain or loss arising on the items of current nature, shall be recognized as an income / charge for the current period;
 - b. a loss arising on the assets of long-term nature shall be recognized as a charge for the current period; and / or
 - c. a gain arising on assets of long-term nature shall be recognized directly in equity⁴ as a revaluation surplus and shall be amortized (taken to retained earnings) according to the incremental depreciation or other recognition of expenses (like amortization or disposal).

³ Accounting for Salam FAS 7 and for Istisna FAS 10

⁴ Or as other comprehensive income, as applicable

Subsequent measurement of assets and liabilities and recognition of revenues, expenses, profits and losses on account of Sukuk issuance

31. Unless contrary to a specific requirement of this standard, the resulting assets and liabilities arising from the execution of the contract (or contracts) for the Sukuk issuance, movements therein, and the resulting revenues, expenses, profits and losses shall be measured and accounted for, respectively, according to the nature of the contract(s) in line with the requirements of respective AAOIFI FAS applicable to such transactions.
32. The revenue and expenses shall be recorded according to the nature of contract i.e. each head of revenue and expense shall be recorded separately in the financial statements of the institution .

Presentation and disclosure

33. In respect of on balance sheet Sukuk, an institution shall consider the following as minimum disclosure requirements:
 - a. Principal terms and conditions of each significant Sukuk issuance and in case of insignificant multiple issuance, on a combined basis;
 - b. Any receivable and payable between the institution and SPV shall be included in assets and liabilities according to their nature;
 - c. Any reserves (including PER, IRR, revaluation reserve etc.), undistributed surplus, undistributed performance incentives (receivable or payable) and other contractual balances shall be adequately accounted for and disclosed according to the contractual terms;
 - d. One time, or time to time, transfer of own asset(s) to Sukuk-holders or replacement of asset in line with AAOIFI FAS on transfer of assets⁵;
 - e. Carrying value adjustments and amortization of gain, if applicable;
 - f. Revenues and expenses according to the nature of contract i.e. each head of revenue and expense shall be disclosed separately even if these are merged or netted off;
 - g. The agency commission or management fee including fixed and variable fee – duly presented as a part of fee and commission income in line with the nature of such income;

⁵ FAS 21 “Disclosure on Transfer of Assets”

- h. Transaction costs incurred duly recognized as expense, as and when incurred, except to the extent reimbursable by the counter parties.
34. An institution shall follow the minimum presentation and disclosure requirements in its financial statements in respect of such instruments as applicable for similar instruments and transactions particularly considering the disclosure requirements of FAS 1.

Off balance sheet Sukuk

Classification as off balance sheet Sukuk

35. Sukuk shall be classified as off balance sheet, and accounted for as such, if they meet the criteria provided in paragraphs ___ and ___ above.
36. In these Sukuk the role and / or involvement of the institution with regard to the underlying assets or business, is primarily that of the manager or agent i.e. in a fiduciary capacity only, and whereby the control entailing risks and rewards incidental to ownership with regard to the underlying assets is transferred to the Sukuk-holders. These may include the following:
- a. whereby the principal accounting defined by the respective FAS for such, or similar products, for the underlying assets, specifically require an off balance sheet treatment e.g. Ijarah⁶;
 - b. whereby the principal accounting defined by the respective FAS for such, or similar products, for the instrument and structured used for issuance of Sukuk, specifically require an off balance sheet treatment e.g. restricted investment accounts (RIA) meeting the definition of off balance sheet investment accounts under FAS 27 and / or the Conceptual Framework for Financial Reporting by Islamic Financial Institutions (the Framework); or
 - c. whereby the principles provided by the Framework, with regard to off balance items are met irrespective of availability of a specific treatment for the asset or the structure accounting defined by a particular FAS.
37. There is a rebuttable presumption that Sukuk structures based on Wakala, restricted Mudaraba and Ijarah etc. will meet the criteria applicable to off balance sheet Sukuk subject to the following conditions:
- a. the institution does not control the asset or business; and

⁶ Accounted for under FAS 8

- b. either the title to such assets / business is transferred to the SPV with all legal requirements or otherwise there is strong ring-fencing enabling direct access of the Sukuk-holders to the assets or business, even if only adverse scenarios (e.g. in case of default by institution); and
- c. there exists substantial evidence that the principal terms and conditions of the structure meeting the criteria mentioned above, are actually implemented.

De-recognition of asset

38. If the asset (including combination of assets, or business) underlying the Sukuk instrument meeting the criteria for off balance sheet accounting is an existing asset of the institution, the institution shall de-recognize the asset from its books.

De-recognition criteria

39. The asset has to be de-recognized once, or as and when, the control is transferred through sale, or otherwise, to another party or diminished, or the asset is destroyed or fully impaired. In view of the same, and in line with the generally accepted accounting principles, an asset shall be de-recognized when:
- a. the control is transferred to another party; or
 - b. when no future economic benefits are expected from its use or disposal.

De-recognition related gain or loss

40. Gain or loss on de-recognition i.e. the difference between the carrying value of assets and the sale consideration shall be recorded as a gain or loss in the period in which such sale is consummated.

Recognition of income and expenses of Sukuk

41. The revenue and expenses shall be recorded according to the nature of contract i.e. each head of revenue and expense shall be recorded separately in the financial statements of the institution .
42. Income from de-recognized assets, even if they are under management, shall not be recognized as income of the institution .

Presentation and disclosure

43. In respect of off balance sheet Sukuk, an institution shall consider the following as minimum disclosure requirements:

- a. Principal terms and conditions of each significant Sukuk issuance and in case of insignificant multiple issuance, on a combined basis;
 - b. Any receivable and payable between the institution and SPV shall be included in assets and liabilities according to their nature;
 - c. Any reserves (including PER, IRR, revaluation reserve etc.), undistributed surplus, undistributed performance incentives (receivable or payable) and other contractual balances shall be adequately accounted for and disclosed according to the contractual terms;
 - d. Any securities, cash or other assets held on behalf of the Sukuk-holders (or SPV) (as the same shall not be included in the assets of the institution and shall be disclosed appropriately, as assets held under management);
 - e. One time, or time to time, transfer of own asset(s) to Sukuk-holders or replacement of asset in line with AAOIFI FAS on transfer of assets⁷;
 - f. Rental on Ijarah assets paid or payable – duly recognized as an operating expense of the institution;
 - g. Gain and loss on de-recognition of assets or business, as applicable;
 - h. Revenues and expenses according to the nature of contract i.e. each head of revenue and expense shall be disclosed separately even if these are merged or netted off;
 - i. The agency commission or management fee including fixed and variable fee – duly presented as a part of fee and commission income in line with the nature of such income;
 - j. Transaction costs incurred duly recognized as expense, as and when incurred, except to the extent reimbursable by the counter parties.
44. An institution shall follow the minimum presentation and disclosure requirements in its financial statements in respect of such instruments as applicable for similar instruments and transactions particularly considering the disclosure requirements of FAS 1. In particular, the disclosure requirements for statement of off balance sheet investments shall be followed.

⁷ FAS 21 “Disclosure on Transfer of Assets”

Accounting by SPV

45. An SPV formed for an off balance sheet Sukuk shall maintain its appropriate books of account and shall issue periodic financial statements to the Sukuk-holders.
46. The institution may also consider, based on the pervasiveness and relevance of information, to include the summarized financial statements of the SPV(s) in notes to its annual financial statements.

Effective date

47. This standard shall be applicable on the financial statements of the institutions for the periods beginning on or after 01 January 2019.

Transitional provisions

48. If, and only if, adoption of this standard results in a change in accounting policy for an instrument which, earlier accounted for on an on balance basis, is onwards to be to be accounted for on an off balance sheet basis, or vice versa, the institution may decide to continue the existing accounting policy with regard to such existing instrument only, provided that:
 - a. the instrument has completed substantial period till maturity as of the date of financial reporting; and
 - b. the remaining period till maturity is not more than 2 years from the date of financial reporting.

Other standards

49. This standard does not make amendment to any other FAS, but shall take precedence to other FAS with regard to the principles specifically described herein.

APPENDICES

Appendix A: Adoption of the Standard

This standard was presented for the approval in the AAOIFI Accounting Board's meeting No. _____ held on _____, corresponding _____ and was duly approved.

Members of the Board

1. Mr. Hamad Abdulla Ali Eqab – Chairman
2. Mr. Mohammad Bouya – Deputy Chairman
3. Mr. Abdelhalim Elsayed Elamin
4. Dr. Abdulrahman M. Alrazeen
5. Mr. Aly Hamed El Azhary
6. Dr. Bello Lawal Danbatta
7. Mr. Firas Hamdan
8. Mr. Hondamir Nusratkhujjev
9. Mr. Khalid E. Al Shatti
10. Mr. Mohamed Ibrahim Hammad
11. Mr. Muhammad Jusuf Wibisana
12. Mr. Nader Yousif Rahimi
13. Dr. Saeed Al-Muharrami
14. Syed Najmul Hussain
15. Mr. Ugur Sacmaciolgu

Reservation

The standard was approved unanimously.

Working group Members

1. Mr. Hamad Abdulla Ali Eqab – Chairman
2. Mr. Hondamir Nusratkhujaev
3. Mr. Irshad Mahmood
4. Mr. Imtiaz Ibrahim
5. Dr. Sh. Osaid Mohamad Kailani

Executive team

1. Omar Mustafa Ansari (AAOIFI)
2. Mohammad Majd Bakir (AAOIFI)
3. Zahra Jassim AlSairafi (AAOIFI)
4. Atif Rashid

Appendix B: Application guidance for classification and key types of Sukuk

AG 1 Following table provides classification guidance of common type of Sukuk followed by a brief description of Sukuk structure.

| Equity | Quasi equity | Financial liability | Non-financial liability |
|-----------|--------------|------------------------|-------------------------|
| Musharaka | Musharaka | Murabaha | Salam |
| Mudaraba | Mudaraba | Musawama | Istisna |
| | | Deferred payment sales | Service Ijarah |

- a. Salam Sukuk represents proportionate ownership of the capital of a Salam transaction, where the Salam capital is constituted by an advance payment to a supplier of a commodity to be delivered at a future date. The return to the Sukuk-holders consists of the spread between the purchase price of the commodity and its selling price following delivery. This results in a liability of goods / services in the books of the IFI.
- b. Istisna` Sukuk represent proportionate shares in the financing of a project to construct an asset (non-financial asset) at a price to be paid in future instalments. This usually totals to the face value of Sukuk plus mark-up. This results in a liability of goods / services in the books of the IFI.
- c. Murabaha Sukuk, the originator (and also, in some cases, the issuer) of the Sukuk is the buyer (on credit) of the Murabaha asset, the Sukuk investors are the sellers (on credit) of that asset, and the credit provided by the Sukuk investors and received by the issuer consists of the selling price of the asset, which the originator sells to obtain the funds it seeks. The Sukuk-holders own the Murabaha and are entitled to receive payment of that receivable (the selling price of the asset) either in instalments or in a lump sum at the end of the Murabaha contract.
- d. Ijarah Sukuk represent the holder's proportionate ownership in leased assets in capacity of a lessor. The Sukuk-holders are entitled to a share of the lease rentals in proportion to their ownership shares in the leased assets. Ijarah Sukuk may be tradable, as the subject matter is a non-financial asset. As a proportionate owner, an Sukuk-holder also assumes a proportionate share of any loss if the leased asset is destroyed, or of the cost of meeting the obligation to provide an alternative asset, failing which the lessee can terminate the lease without paying future rentals.
- e. Musharaka Sukuk represent the direct proportionate ownership shares of the holders in the assets of a project, where the issuance money is normally employed in purchasing

non-financial assets or assets such as real estate or movable assets. This type of Sukuk is of participatory nature i.e. on basis of profit and loss.

- f. Mudaraba Sukuk-holders share the profits and losses arising from the Mudaraba operations (by Sukuk issuer). The returns to the holders are dependent on the revenue by the underlying investment. The underlying investment may be a pool of asset or investment in particular project.
- g. Wakala Sukuk-holders provide the capital for investment activity, and the investment agent undertakes investment of the funds. These Sukuk entitle the holders to a return in proportion to their investment in the underlying assets and a right under a purchase undertaking to buy all or a proportion of the underlying assets if certain conditions are fulfilled. The Special Purpose Vehicle (SPV) acting as the principal on behalf of the Sukuk-holders appoints a Wakil to invest funds provided by the Sukuk-holders into a pool of assets. The manages those investments on behalf of the Sukuk investors While the Wakala structure has some similarities to Mudaraba, the main difference is that unlike Mudaraba, in which profit is divided between the parties according to certain ratios, Sukuk-holders via a Wakala structure will receive the return on the investments less the management fees payable to the Wakil. The tradability of such Sukuk will be based on the underlying assets purchased by the Wakil.
- h. Hybrid Sukuk. Is a type of Sukuk structure in which the underlying pool of assets consists of two or more contracts, such as sale and leaseback where the vendor sells the asset under diminishing Musharaka and leases back the asset under Ijarah.

Appendix C: Basis for Conclusions – accounting

Definition of control

- BCA1 The Board, in line with the new strategy of accounting standards development, considered the definition of control according to the generally accepted accounting principles as well as Shari'ah requirements whereby an institution controls an asset or business when it has substantially all risks and rewards incidental to ownership of such asset or business and it is exposed to or has rights to the variable returns from asset or business along with the ability to affect those returns through its power. The Board, however, was of the view that any power to control only is not sufficient either the power is held in a fiduciary capacity or the variable returns are primarily for the counter party and a portion thereof can be attributable to the entity, not contractually, but rather at the discretion of the counter-party.
- BCA2 The discussions held by the Board on several occasions in determining whether an institution controls an asset or business were to conclude whether to consolidate such asset or business with the institution or to keep them on balance sheet.
- BCA3 The Board however, decided that assets or business managed by an institution only in a fiduciary capacity i.e. as a manager or as an agent are not a valid basis for consolidation or for keeping them on balance sheet, particularly where the nature of the contract itself is of principal-agent, and not of partnership per se. This is because the institution only manages the asset on behalf of the stakeholders rather than to affect variable returns for its own benefit.

Basis of classification of Sukuk

- BCA4 The Board discussed several possible bases of classification of Sukuk issued by institutions. It was decided that Sukuk shall be classified principally on the basis of its governing structure and as for accounting it shall follow respective FAS.
- BCA5 The Board concluded that Sukuk according to its structure may be classified as off balance sheet Sukuk or on balance sheet Sukuk; which shall further be sub-classified as equity, quasi-equity or liability (which includes financial liability and non-financial liability). For discussion with regard to the off balance sheet Sukuk classification kindly refer to BCS ___ to BCS ___. The discussion for on balance sheet classifications is provided in the ensuing paragraphs.

Classification and presentation of Sukuk as equity

- BCA6 The Board, according to AAOIFI's conceptual framework and generally accepted accounting principles has decided to classify Sukuk as equity where the structure of the Sukuk is participatory in nature i.e. whereby the instrument represents a residual interest on entity's asset and the instrument is perpetual and / or convertible in nature and that issuer of such

Sukuk has an unconditional right to avoid delivering cash or any other asset to the Sukuk-holder. Another condition is that these must be subordinate to all the liability and quasi-equity instruments of the entity excluding only the share capital and / or any other similar instrument. The Board also noted that this is also in line with the guidance provided by IFSB and Basel.

Classification of Sukuk as quasi-equity

- BCA7 Quasi-equity instruments are those financial instruments which have characteristics of both equity and liability. Primarily they are sharing the profits and losses and have a right on the net assets. However, since they have a put option in the hand of the holder i.e. they are redeemable on a due date or on demand, hence they also have the liability characteristics. Earlier when AAOIFs conceptual framework was developed a category named as “Equity of investment account holder” was introduced. In this category the investor and institution share the risk and rewards in a particular asset / investment, and consequently the institution is not obliged to guarantee to return the funds it has received from the investor (or profit thereon) unless there is negligence/ misconduct/ breach of contractual terms by the institution. Accordingly it is not a liability in the books of the institution.
- BCA8 The Board concluded that the definition given in the conceptual framework may be referred to as a quasi-equity product. At that time, it was not named as quasi-equity because there was only one such product. Now, equity of investment account holder may account for as one product under the umbrella of multiple quasi-equity products.
- BCA9 In case of Sukuk, it includes funds provided by Sukuk investors which are of participatory nature yet are not considered to be owner’s equity because they are at times payable on demand or on a due date and additionally are neither subordinate to all liabilities nor enjoy the power and ownership rights in the institution. If an institution issues Sukuk where there is a put option with the Sukuk-holders, the same is classified as quasi-equity in the books of the institution.

Classification of Sukuk as liability

- BCA10 The Board discussed at length AAOIFI’s definition of liability and was of the view that it is not principally different from generally accepted accounting principles. Generally accepted accounting principles define liability as a present obligation against past events embodying a future outflow of economic benefits. While AAOIFs conceptual framework defines liability as “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 a present obligation and a future commitment”. The Board decided that, where Sukuk is structured in such a way that it creates a present monetary obligation for the issuer, it is classified as financial liability in the books of the issuer. However, where the institution has an obligation to deliver goods or services, the same may be classified as non-financial liability Sukuk in the books of the

issuer. However, any instrument which is not considered a liability in line with the respective FAS e.g. Ijarah in the hand of the lessee, shall be considered off balance sheet.

Effect of guarantees, purchase undertakings, managerial functions and similar instruments on the accounting for de-recognition of assets

- BCA11 The Board acknowledges that the transfer of control of an asset for a Sukuk transaction requiring de-recognition has certain complexities in contemporary Sukuk structures. These structures may include purchase undertaking to buy back the assets, or guarantees in the capacity of a third party, as well as, managerial or agency based involvement with the maintenance, operations or recovery of the assets. Most generally accepted accounting principles tend to consider these factors as continuing involvement with the assets requiring an objective assessment of the economic substance of the transaction. If as per the assessment, it is established that the entity continues to control the asset or the entity has failed to transfer substantially all the risks and rewards incidental to ownership of such assets the entity shall refrain from de-recognizing such assets from its books.
- BCA12 The Board referred to the concept of substance and form under the Framework whereby, if information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with its substance and economic reality as well as the legal form. Accordingly, it proclaims that the financial reporting involves consideration of the substance of an economic phenomenon as well as its legal form.
- BCA13 The Board established its view through the Framework and defined accounting treatment of each product as mentioned below:
- a. Purchase undertakings – are not contracts and are rather future commitments and are considered to be independent of the base contract. If these become a part and condition of the base contract, this tantamount a Shari’ah non-compliance. Accordingly, a purchase undertaking is not a contract and shall be considered as a commitment only, and disclosed accordingly. However, if it is expected that a purchase undertaking needs to be executed in a manner that may result in form of a loss to the entity, in such situation a provision against such expected loss shall be created.
 - b. Guarantees – a guarantee permissible from Shari’ah perspective is provided in a capacity of a third person, or by a third person, independent of the contract of sale or transfer of sale, duly executed after consummation of sale and cannot be made a condition thereto. Accordingly, if the Shari’ah rules are followed in this respect, the existence of an independent guarantee arrangement does not contravene the essence of sale per se, in line with Shari’ah principles. Accordingly, a guarantee in such

arrangements does not affect the recording of sale or transfer of assets independently. A provision shall be made against a guarantee to the extent of best estimate of the amount of losses guaranteed, if any.

- c. Management or agency arrangements – are independent of the sale or transfer of asset contract and are executed separately. Additionally, these contracts entail a principal – agent relationship, and accordingly, do not tantamount to continuing involvement with the assets. It is relevant to note that the term control has two elements i.e. the power to control the asset (which exists in such arrangements), and for the variable economic benefits of the entity (which does not exist in such arrangements are the economic benefits of the assets vest with the principal). Accordingly, existence of a management or agency contract of the underlying assets in Shari’ah compliant transactions does not constitute a control of such assets.

Carrying value adjustment – gains and losses

BCA14 The Board discussed at length the situations whereby the creation of Sukuk instrument results in transfer of assets from the institution to the SPV for the benefit of the Sukuk-holders. These transfers may result in a gain or loss because the value at which these are transferred (fair value or agreed upon value) might be different from the carrying value in the books of the institution.

BCA15 The Board concluded that if assets are transferred to create an off balance sheet Sukuk, any gain or loss shall be taken to profit and loss immediately, as the entity loses control and hence any gain or loss is an event of the period.

BCA 16 The Board further discussed the impact of gains and losses in case of on balance sheet classification of Sukuk based on existing asset of an institution resulting in transfer of risk and rewards from the issuer / institution to the Sukuk-holder e.g. where a Sukuk is issued on quasi-equity basis and the relevant assets are revalued at fair value before transfer to the SPV for benefit of the Sukuk-holders. The Board concluded that any change in carrying value of a current nature asset resulting in either a gain or loss shall be charged to profit and loss. Where the asset is of long term nature, the loss shall be charged in the current period because it will be an indication of impairment in value as well. However, only in case of a gain on an asset(s) of a long term nature shall be taken to equity or other comprehensive income (as applicable) as it is assumed that it is not a performance related gain and shall not affect the bottom line of the institution. Such effect shall reverse through amortization / release over a period to average out the financial impacts over the period.

Appendix D: Basis for Conclusions – Shari’ah

Issuance of Sukuk and tradability

BCS1 Issuance of Sukuk by way of subscription is permissible on the basis of Shari’ah nominated investment and financing / trading contract. Sukuk certificates that represent share in tangible asset or usufruct are tradable due to the fact that it is similar to the trading in assets only. However, those Sukuk which represent a financial liability (Dain) e.g. a Murabaha are not permissible to trade. Shari’ah ruling is that these cannot be traded other than face value either on discount or premium and are subject to the rules of debt trading.

Off balance sheet Sukuk and de-recognition of assets

BCS2 As discussed earlier with regard to the definition of control (refer BCA1) where the institutions role is primarily of a manager or agent in a fiduciary capacity only and does not control the underlying asset or business, these Sukuk shall classified as off balance sheet Sukuk. Shari’ah principally has a strong view on this issue.

BCS3 The Board discussed at length that the AAOIFs Framework, in line with the Shari’ah principles, defines asset as a resource controlled by the entity (whether financed by the equity or the investment account holders) as a result of past transaction, event or condition which provides the institution an enforceable right over the resource and gives it an economic benefit, present or future. The Board decided that the acid test for de-recognition of an asset in case of a transfer to another party is the transfer of control, which is also the requirement of Shari’ah. Accordingly, the asset has to be de-recognized from the balance sheet once the control is transferred to another party or diminished, or the asset is destroyed or fully impaired. Here it is important that from Shari’ah perspective, a partnership (whether Musharaka or Mudaraba based) creates a joint control whereas a principal-agent relationship (i.e. Wakala or service Ijarah) does not create a joint control, unless other evidence of control is available from a different perspective.

BCS4 The Board further discussed and concluded that principally sale of an asset tantamount to immediate de-recognition of such asset in the books of the seller and should be transferred to the purchaser. However, there are certain Sukuk structures where the legal ownership is transferred yet, the seller keeps the asset in the books on trust basis i.e. in a fiduciary role only. The seller keeps the asset in its books because they are to be transferred back to the obligor / seller (on basis of a separate agreement) and hence following the substance over form criteria the, the asset remains in the books of the seller. The Board in light of Shari’ah requirements in this respect and AAOIFI’s conceptual framework concluded that such assets are de-recognized from the books of the obligor and placed off balance sheet.

Appendix E: Brief History of the Preparation of the Standard

- H1 Sukuk are among the most important Islamic finance tools that have achieved significant growth and wide application – and are even considered to be a distinct sector, per se. The evolution of Sukuk sector, with emergence of diverse array of Sukuk structures and types, has called on AAOIFI to reconsider its existing Standards on Sukuk. The revision is also necessary to reflect changes in the areas of accounting, law and regulations, and such others, which relate to Sukuk. AAOIFI initiated a comprehensive project on the revision of Shari’ah and accounting standards on Sukuk in line with the developments in the field over the last two decades. The project aims to review the existing standards and define the accounting treatment to be applied by the Sukuk issuer.
- H2 The overall approach and plan for the standard were discussed in the first meeting of the newly formed AAOIFI Accounting Board (AAB) , held on Tuesday and Wednesday 6th and 7th of Jumada al Thani 1437 H, corresponding to the 15th and 16th of March 2016 at Ramee Grand Hotel, Seef District, Kingdom of Bahrain.
- H3 The second meeting of the Board was held on Saturday and Sunday 25th and 26th of Shawwal 1437 H, corresponding to the 30th and 31st of July 2016 at the head office the Al Baraka Banking Group, Bahrain Bay, Kingdom of Bahrain. In this meeting the Board reviewed and approved Sukuk standard project update and key considerations. The members highlighted areas to be considered such as purchase undertaking and presentation and disclosure requirements. The members also stressed that the Shari’ah standards shall be used as a base for the standard development.
- H4 The Board held its third meeting on Saturday and Sunday 22nd and 23rd of Dhu al-Hijjah 1437 H, corresponding to the 24th and 25th of September 2016 at AAOIFI Offices, Nakheel Tower, Seef Area, Kingdom of Bahrain. In this meeting, the Board discussed the status of the standard and requested the working group to address all of the questions of the consultation notes among themselves, to be presented to the board in the next meeting.
- H5 AAOIFI held a Sukuk workshop in cooperation with King Fahd University of Petroleum and Minerals on Wednesday and Thursday 25th and 26th Muharram 1438 corresponding to 26th and 27th of October 2016 where a group of accounting experts from regulatory and supervisory bodies, Islamic financial institutions, national accounting bodies and academics attended the workshop. The attendees emphasized the need for development of the Shari’ah and the accounting standards on Sukuk to address the issuer’s perspective, which shall primarily be for the IFIs that issue Sukuk. In addition, experts have stressed that issuers and investors should fully comply with Shari’ah rules and principles 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 quasi-

equity. Finally, the participants stressed the need to set up a governance mechanism for Sukuk and other instruments.

H6 AAB held its fourth meeting on Sunday and Monday, 16th and 17th Rabi al-Thani 1438 H, corresponding to the 15th and 16th of January 2017 at the premises of Islamic Development Bank (IDB), Jeddah, Kingdom of Saudi Arabia. In this meeting, the Board members deliberated on the concept of 'control' as discussed in the draft standard. They discussed the negative and positive effects of control an entity may encounter. They also tended to the definition of quasi-equity and agreed to its components. Finally, the members agreed that the working group should finalize the standard after obtaining comments from the Board members by circulation

[Further updates to be added before issuance of final standard.]