

A Review of AAOIFI Standards on Accounting for Sukuk Issuance

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ABSTRACT

This paper reviews the provisions of the three Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)'s standards on Accounting for sukuk issuance; Financial Accounting Standards (FAS) 33 and 34 as well as Governance Standard (GS) 12, with a view to appreciating their major provisions for ensuring high quality financial reporting, their expected impacts to accountability and transparency in accounting for Sukuk issuance. In line with the spirit of total quality management (TQM), the paper highlights areas where improvement could be brought about to the quality of the three standards, which include, presenting a return on investment (ROI) estimate to potential investors, collecting and normalizing IFIs' data, and working on developing Islamic risk hedging tools to improve sukuk performance, among others. The paper concludes that the three standards are avenues for propagating the sanctity of Sukuk as investment instrument whose time has come. The standards are specifically developed by AAOIFI to ensure transparency and accountability on Sukuk issuance in the best interest of stakeholders, as their provisions ensure high quality financial reporting by reporting entities. It is recommended that relevant reporting entities should adhere to the provisions of the AAOIFI standards as they initiate issuance of Sukuk instrument and should be accounting fully for the issuance for furtherance of Islamic finance principles and financial discipline in compliance with Shari'a.

Keywords: Sukuk issuance, financial instrument, governance standard, financial accounting standard, AAOIFI.

1.0 Introduction

An Islamic financial instrument known as a *sukuk* offers investors options and income from asset ownership. One of the Islamic capital market's fastest-growing products, *sukuk* is gaining popularity across all sectors of

society regardless of faith or culture (Ibrahim *et al.*, 2014). *Sukuk* was able to attain a wide geographic dispersion and a market that was least impacted by the global financial crisis (GFC) of 2008, in addition to gaining attention

from the top conventional finance hubs across the world.

Sukuk have gained global acceptance with issuances in various countries including the United Kingdom, France, Hong Kong, United Arab Emirates and South Africa. Sukuk serve as an efficient way for Issuers to fund capital projects. Sukuk are specifically structured to ensure that all funds raised are utilized on a tangible project, and this practice provides efficiency and transparency. Projects to be funded through Sukuk issuance must not be harmful to the society and these projects must also be considered permissible according to Shari'ah principles.

The Shari'ah Standard number 17 of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has defined Sukuk as certificates of equal value, representing undivided shares in ownership of tangible assets, usufruct and services (or in ownership of) the assets of particular projects or special investment activity. Sukuk is an Islamic finance certificate that provides investors with opportunities for wealth creation and accumulation from owning an undivided asset (Sukor, Muhamad & Gunawa, 1970). The Islamic Development Bank however, defines Sukuk as an Islamic equivalent of bonds which falls under fixed income securities, but unlike conventional bonds, it grants the investor a share of profit from an income generating asset or project, along with the scheme (Abdelrahman, 2019).

Following the global financial crisis (GFC) of 2007/2008, government and corporations began searching for alternative means of investment outside the interest-based system of financing, and Sukuk emerged as the best option (Di Mauro et al, 2013; Godlewski et al, 2013). For instance, the increased usage of *Sukuk* for financing various projects during the past ten years has enhanced Islamic banking

prosperity (Alhammadi *et al.*, 2020). The problems with liquidity management that the Islamic financial sector is facing can also be solved via *Sukuk* issuance. Shari'ah scholars, however, stress Maqasid Al-Shari'ah (objectives of Islamic law) fulfilment as a fundamental goal for attaining societal well-being and not as motivations for profit maximization (Hassan & Aliyu, 2018; Alotaibi *et al.*, 2020).

Sukuk can be issued under different structures which include: Salam (spot payment with future delivery of assets), Ijarah (sale and lease-back of assets in existence), Mudaraba (partnership between an investor and a manager), Musharaka (partnership between a special purpose company and obligor to own either ready assets or construct assets), Murabaha (cost plus financing contract whereby the asset is delivered now with a deferred payment), Wakalah (appointing an agent to manage projects on behalf of the certificate holders) and Istisnaa Sukuk (request for construction or manufacture of assets) (Abdelrahman, 2019; Oladunjoye, 2014 and Rezaei, 2013).

In the course of its standardization of financial reporting by Islamic Financial Institutions, the AAOIFI has issued a number of standards for ensuring high quality financial reporting. So far, AAOIFI has issued 41 Financial Accounting Standards (FAS), 13 Governance Standards (GS), 6 Auditing Standards (AS) and 3 Ethics Standards (ES). There are also about 50 Shari'ah Standards issued by AAOIFI. Out of the quality financial reporting related standards, three are specifically related to accounting for Sukuk issuance. These are FAS 33, FAS 34 and GS 12.

FAS 33 (which replaced the previous FAS 25) is entitled: **Investment in Sukuk, Shares and Similar Instruments**. The standard outlines enhanced principles for the classification,

recognition, measurement, presentation, and disclosure of investments made in *sukuk*, shares, and other comparable instruments by Islamic financial institutions (IFIs/the institutions), in accordance with Shari'ah guidelines (Ahmed *et al.*, 2015). In addition to outlining the fundamental types of Shari'ah-compliant investment instruments, the standard also defines the key accounting methods relevant to the characteristics and working model of the institution where the investments are made, handled, and kept. A number of investment types are also described and defined in FAS 33, along with the supervision, presentation, and disclosure rules that Islamic financial institutions (IFIs) must follow (Bhuiyan *et al.*, 2019). The FAS goes into further depth regarding financial reporting and disclosure of different investments to make sure that stakeholders have a genuine and fair understanding of financial reporting.

Similarly, FAS 34, entitled: **Financial Reporting for Sukuk-holders**, aims to establish the principles of accounting and financial reporting for assets and businesses underlying the *Sukuk* to ensure transparent and fair reporting to all relevant stakeholders, particularly including *Sukuk*-holders. This standard prescribes the accounting principles and reporting requirements for underlying assets of a *Sukuk* instrument and addresses the requirements of 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, as described by AAOIFI.

GS 12 entitled: **Sukuk Governance** is a component of a broad *Sukuk* project that was launched by AAOIFI in 2015 to create and update the standards on *Sukuk* in response to

changes in the industry over the last 20 years. It specifies a thorough framework for controlling *Sukuk* issuance, management throughout investment, and maturity / termination phases, and it offers specific guidance on *Sukuk* governance to Islamic Financial Institutions (IFIs) and corporations globally (Biancone & Shakhathreh, 2016). The goal of this governance standard for *Sukuk* is to offer extensive coverage of areas that are important for the transparent issuance of instruments and administration of investments, as well as to establish principles with the intention of harmonizing worldwide standards in this area. The standard lays forth the uniform standards for the different *Sukuk* management phases, including issuance, management, maturity or termination, and restructuring or rescheduling. This extensive coverage will offer a framework that is anticipated to put improved governance into action and boost confidence in *Sukuk* markets (Ab Majid *et al.*, 2011; Amer, 2020).

One major impediment keeping Islamic Finance away from growing at an even faster pace was lack of a comprehensive *Sukuk* governance standard, which has now been removed by AAOIFI through the issuance of GS 12 in January 2020. The standard provides for policy support which will drive greater harmonization of leading investment practices and will strengthen *Sukuk*'s acceptability as a leading investment asset class with its unique risk and return profile (Amer, 2020).

This paper is a review of the provisions of the three AAOIFI standards (FAS 33, FAS 34 and GS 12) with a view to appreciating their major provisions for ensuring high quality financial reporting by relevant reporting entities, their expected impacts to accountability and transparency in accounting for *Sukuk* issuance, and areas where they need improvement as they are being complied with by various stakeholders. The rest of the presentation is in

4 parts. Part 2 is about the major/key provisions of the three standards. Part 3 highlights expected impacts of the standards to high quality financial reporting. Part 4 discusses areas for improvement in the quality of the standards when next they are reviewed, while Part 5 concludes the paper.

2.0 Major Provisions of the Standards

2.1 FAS 33: Investment in *Sukuk*, Shares and Similar Instruments

This standard replaces and improves Financial Accounting Standard (FAS) 25 which was created by AAOIFI in 2010. The standard makes a number of provisions on accounting for various models of *Sukuk* issuance, investments in different types of share and investment in other investment instruments. Some of the key provisions are:

- i. The standard seeks to provide principles for the categorization, recognition, measurement, presentation, and disclosure of investments made in *sukuk*, shares, and other analogous instruments by Islamic financial institutions (IFIs) and other investors.
- ii. The standard outlines the main categories of Shari'ah-compliant investment instruments as well as the fundamental accounting procedures in accordance with the characteristics and business model of the institutions where the investments are made, managed, and retained.
- iii. The standard provides for treatment of investment as per the criteria that apply to Islamic finance institutional investors and other interested investors, regardless of whether or not the investment takes the form of equity-type securities, debt-type instruments, or other investment vehicles.

These provisions and many others are designed to ensure quality financial reports as *Sukuk* transactions are accounted for in the financial reports of *Sukuk* issuer as well as the financial report of the *Sukuk*-holder.

2.2 FAS 34: Financial Reporting for *Sukuk*-holders

The standard makes a number of provisions on quality financial reporting by *Sukuk*-holders, who are expected to establish and maintain the discipline of proper financial reporting that would demonstrate high level of transparency and accountability. Some of the major provisions of the standard are:

- i. It prescribes the accounting principles and reporting requirements for underlying assets of a *Sukuk* instrument, requesting the originator to prepare or cause to prepare financing reports that would make *Sukuk* transactions very precise, concise and transparent.
- ii. It 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. It provides for how a simplified version of financial report following decision useful approach.
- iii. The 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.

The highlighted provisions and all other provisions of the standard are designed to ensure quality financial reports in the best interest of *Sukuk*-holders who are desirous of ensuring that they obtain information about their investment in *Sukuk* as timely and accurately as possible for them to take informed decision on their investment.

2.3 GS 12: Sukuk Governance

The goal of this standard is to offer extensive accounting coverage of areas that are important for the transparent issuance of Islamic Finance instruments for investment and administration of the investments. The standard makes provisions on the best ways to govern Sukuk issuance and the need to fully account for the issuance in the books of both the Sukuk issuer and the Sukuk-holder. Its provisions are geared towards ensuring transparency, accountability and integrity in Sukuk Issuance, especially from the side of the issuer. Some of the key provisions are:

- i. The established accounting and ethics principles that must be complied with in the production of audited financial statements and the need for harmonizing worldwide accounting and ethics standards for financial reporting by all ethical businesses globally.
- ii. The standard lays forth the uniform treatments of financial and non-financial transactions for the different *Sukuk* management phases, including issuance, management, maturity or termination, and restructuring or rescheduling. This extensive coverage offers a framework that is expected to ensure good governance of Sukuk issuance transactions and boost confidence in *Sukuk* markets.
- iii. The implementation of the provided governance framework will lead to an increase in *Sukuk*-holder and other stakeholders' trust, particularly with regard to transparency, accountability, responsibility and conformity with Shari'ah principles, and this would ensure fair and equitable treatment of all parties (Amer, 2020).

3.0 Expected Impact on Quality Financial Reporting

The three Sukuk Issuance-related AAOIFI standards are expected to impact positively on quality financial reporting by Islamic Financial Institutions (IFI) and other ethical businesses

and individuals who may wish to be involved in Sukuk issuance transactions for one purpose or another. Some of the likely positive impacts of the standards are highlighted below:

3.1 FAS 33

- i. **Enhanced openness and financial responsibility:** It is important to highlight that before the issuance of FAS 33 there was no obligation for financial reporting from the parties to Sukuk issuance, endangering the openness that is essential to Islamic finance operations. In order to guarantee a fair and transparent exchange of financial information and to strengthen financial discipline, the standard places a strong emphasis on financial reporting for the benefit of *sukuk*-holders and other stakeholders and their underlying assets. In addition, the standard permits a more straightforward method of financial reporting for various forms of *Sukuk* structures and it does not mandate detailed financial statements for the same (Chan-Jane *et al.*, 2015).
- ii. **High level adherence to the Shari'ah Principles:** The release of FAS 33 is bound to enhance *Sukuk*-holders' financial reporting interest and commitment to timely production of financial statements. By meeting the *Sukuk* holders' informational needs and boosting Shari'ah compliance, the standard contributes to closing the informational gap which truncates good decision making by investors (Chen *et al.*, 2011; Siswantoro, 2018).

3.2 FAS 34

- i. **Raising the level of adherence to the principles of Islam:** Prior to the issuance of this standard, there are no well-established practices of financial reporting in the best interest of *Sukuk*-holders or for accounting to the established Special Purpose Vehicles (SPVs) on the *Sukuk* transactions.

Hence, the issuance of the standard to improve financial reporting practices for *Sukuk*-holders. This will help to fill the identified informational gap by making adequate financial accounting information available to the *Sukuk*-holders and also increase Shari'ah compliance (Chen *et al.*, 2011; Mustafa, 2018).

ii. **Comparability:** This is a fundamental qualitative characteristic of FAS 34 issuance. The standard allows accounting information user to find similar *Sukuk* issuance information which is presented by different companies at different times as they prepare financial reports. Since the process of preparing the reports is the same as provided by the standard, the user could make comparative analysis for informed decision to be taken. Thus comparability means the ability that the information has in explaining and identifying similarities and differences between two common sets of transactions of economic phenomena (Fariba & Mehran, 2016). Comparability could happen as companies use the same accounting procedures, as emphasized by the standard, either from period to period within an entity or in a single period across entities.

iii. **Better financial discipline and transparency:** It is important to keep in mind that the stakeholders are not required to submit financial reports before the issuance of FAS 34, endangering the transparency that is essential to Islamic finance transactions. The standard places a strong emphasis on financial reporting for the benefit of *Sukuk*-holders and their underlying assets as a fundamental requirement, in a way that ensures an equitable and transparent exchange of financial information and enhances financial

discipline (Mustafa, 2018). For various types of *Sukuk* structures, the standard permits a more straightforward method of financial reporting because it does not mandate comprehensive financial statements for the same (Chan-Jane *et al.*, 2015; Siswantoro, 2018).

iv. **Faithful Representation:** This is a fundamental characteristic of FAS 34. It means that all information listed in financial report must be represented faithfully. IASB (2006) stated that in order to accomplish this all information and economic phenomena listed in annual reports must be complete, accurate, neutral and free from bias and errors as prescribed in the Shari'ah law. FAS34 was issued on the premise that all of economic phenomena and transactions are changeable in due course, so the annual report must document every event and transaction carefully and accurately.

3.3 GS 12

i. **Accountability:** This is the ability to give reasons or explanations as to what one does. GS 12 provides for the institutionalization of the type of accountability that allows all the organs of governance, including management, to be accountable for their respective functions and business transactions (Astuti, 2020).

ii. **Fairness and Transparency:** The standard provides for high level fairness and transparency in financial reporting and governance of the affairs of the reporting entities dealing with *Sukuk* issuance. Complying with the provisions of the standard would ensure that all the stakeholders are treated fairly and all affairs of the *Sukuk* issuers are transparent and financial and operational reporting shall be performed in a manner

that nothing of significance is concealed from respective stakeholders.

- iii. **Shari'ah compliance:** The standard provides for all the organs of governance, including management, to ensure that the overall operations of the Sukuk issuers, including the financial reports, are in line with the Shari'ah principles and rules (Siswanto, 2018).
- iv. **Responsibility:** The standard influences IFIs and other corporate organizations that are interested in Sukuk issuance to reflect responsibility towards stakeholders and society/ community at large (Astuti, 2020).

4.0 Suggestions for Improvement on Quality of the Standards

The three *Sukuk* issuance-related AAOIFI standards are expected to be subjected to occasional reviews/revisions to catch up with the advancement in economic activities and the dynamism of the accountancy profession. Again, in the spirit of total quality management (TQM) which suggests that no matter how well you are already doing, you should know that you can do better (Alao, Ibrahim & Esq, 2019). This section highlights areas where improvement could be brought about to the quality of the three standards.

4.1 FAS 33

(a) Present a return on investment (ROI) estimate to potential investors: Despite their belief in the *Sukuk* concept, investors nonetheless invest for financial gain. Therefore, it is always a wise choice to emphasize to them the benefits of investing in *Sukuk*. Although investors want to know what is in it for them, many entrepreneurs/investors choose to concentrate mostly on their company strategy, where they are sure of what return to make. The standard should have provided for need to account for estimated ROI per unit of Sukuk in issue, so that the Sukuk investors could measure whether or not their investment

will be profitable. Clearly accounting for how and when Sukuk investors will receive their expected ROI is the greatest motivation for investment in Sukuk (Amer, 2020).

(b) Speak to the appropriate investors: Each investor has a certain favorite market or markets, a specific quantity of money, and a specific firm size that they are willing to invest in (Alao, Ibrahim & Esq, 2019). Pitching to investors who are "into" the type of project the Sukuk issuer would want to finance will provide the best results on the fundraising. Speaking with an investor who is either too big or too little for the amount of funding needed would make little sense. Issues like these need to be provided for in FAS 33, in one way or another.

(c) Describe possible investment in detail: Investors frequently want to know how the Sukuk issuer plans to utilize the money they would invest for the project. Do they aim to use the invested fund for expansion or diversification of existing business or for executing new projects? Or the money is to be used for expanding workforce (or payment of salaries!), conduct of marketing, advancement of technology of their products, or for paying off debt? The standard would be more encompassing and more effective if it is clear about the accounting treatment of issues like these.

(d) Have an attractive business plan: Creating a business strategy is the first stage in persuading investors to embrace the notion of *Sukuk* issuance (Alao, Ibrahim & Esq, 2019). The business strategy should include information on what *Sukuk* is all about or what it offers, goals *Sukuk* seeks to accomplish, how AAOIFI intends to accomplish those goals, possible clients, and approaches to attracting them, among other provisions. A business plan acts as a roadmap for how *Sukuk* will get off the ground and eventually improve. A detailed

business strategy can also convince potential partners or investors that *Sukuk* are serious investment instruments. These issues need to be taken care of in FAS 33 for their reflection in financial report, accordingly.

(e)The need to provide critical feedback:

The pitches that are most effective in *Sukuk* issuance are those in which the *mudharib* (entrepreneur) has anticipated probable questions and has adequate responses ready in advance on matters of *Sukuk* issuance (Amer, 2020). Investors will still have questions, designed to test their expertise and determine their ability to handle challenging conditions, no matter how in-depth the *Sukuk* issuer is. Investors would want to know who *Sukuk*'s rivals are, what *Sukuk*'s competitive edge is, how qualified the staff is, and how successful the company (*Sukuk* issuer) has been thus far (Amer, 2020). Accounting treatment on all these should be provided for in the standard

4.2 FAS 34

(a)Organize Information: This AAOIFI standard should have defined and provided for accounting treatment of datasets that can be managed through tagging, filters and other metadata controls. Development of financial reporting guidelines or templates that can be applied across IFIs and other halal businesses so as to enhance financial reporting process.

(b)Collect and Normalize IFIs' Data and Reporting: The AAOIFI standard should create flexible templates that enable contributors to *Sukuk* accounting to submit structured and unstructured data in a consistent fashion. As *Sukuk* subscribers are expected to leverage on a consistent collection process, they should not have to worry about adequate disclosure of required information. The standard should have provided for the entries to be made to capture all relevant transactions adequately.

(c) Accounting for Financial Reporting

Environment: A shared yet secure financial reporting environment where users can work concurrently, not one at a time should be created and sustained. How the information is to be processed for disclosure needs to be adequately provided in the standard, including accounting for the cost implication of elimination of time wastage by avoiding processes that involve checkout systems, shared drives and other workflow bottlenecks (Alao, Ibrahim & Esq, 2019).

(d)Centralizing and integrating accounting and reporting processes:

As a good and important step in making FAS 34 instrument more efficient, many organizations invest in centralizing and updating their Enterprise resource planning (ERP) systems (Alao, Ibrahim & Esq, 2019). This creates a solid base for efficient documentation and reporting of financial figures. A bigger step towards a more advanced financial reporting process is centralizing and integrating accounting and reporting processes. This increases the efficiency of financial operations, especially in a multinational context. The standard needs to provide for the accounting treatments of all these, when next it is subjected to review for improvement in its quality.

4.3 GS 12

(a) *Sukuk* instrument represents a promising opportunity for economic growth. This instrument can help the government to afford significant amounts of liquidity to fulfill many large-scale projects, such as infrastructure projects (Ahmad, 2014). It offers an attractive alternative of funding and investment. The introduction of a new financial tool is very risky as the reaction of market players still remains unknown and uncertain (Astuti, 2020). These are issues to be covered by and improved upon GS 12.

(b) The capital market also suffers from the lack of Islamic risk management tools to hedge the risks associated with *Sukuk* (Ab Majid *et al.*, 2011). In addition, GS 12, as an AAOIFI standard, should have provided for government's intervention in ensuring that corporate governance (for the private sector players) and public governance (for public sector players) are effective and adequately accounted for. They should place competitive tax incentives to encourage Islamic finance industry activity, especially the future *Sukuk* market.

(c) The standard should provide for increase in the information disclosure by Islamic financial institutions to stimulate higher interest in their financial reports, especially on *Sukuk* issuance transactions.

(d) The standard should make provision for accounting treatment on *Sukuk* defaults and work on developing Islamic risk hedging tools to improve *Sukuk* performance. The standard should also be innovative enough in making reasonable provision for *Sukuk* structuring and Islamic finance engineering.

(e) As it is expected that governments of various nations would ensure a stable political climate to attract the investment of local and foreign market players (Mohd *et al.*, 2011), GS 12 should have made provisions for demonstrating good governance that would make *Sukuk* to be the most darling investment instrument to choose .

5.0 Conclusion

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) initiated standards for the accounting treatment of several Islamic financial instruments and for the production of timely financial reports by various reporting entities. The standards ensure enhancement of principles for the classification, recognition, measurement, presentation, and disclosure of accounting

information production and specifically information on investments.

This paper reviews three AAOIFI standards that specifically cover issues in accounting for *Sukuk* issuance, *Sukuk* subscription, *Sukuk* governance and *Sukuk* as investment instrument to be patronized, effectively utilized and adequately accounted for. The standards emphasize the need for proper governance and accounting for all aspects of *Sukuk*, as an investment instrument for fund mobilization which is growing very fast globally. They also cover provisions for accounting treatment of similar investment instruments, especially FAS 34.

Apart from providing for accounting treatment of *Sukuk* issuance, the three standards, which are designed in accordance with Shari'ah guidelines, are avenues for propagating the sanctity of *Sukuk* as investment instrument whose time has come. The instrument is for the patronage of fundraising desires of both Muslim and non-Muslim alike, in view of its ethical outlook and prosperity in wealth accumulation to investors. The three standards (FAS33: **Investment in *Sukuk*, Shares and Similar Instruments**; FAS 34: **Financial Reporting for *Sukuk*-holders**; and GS 12: ***Sukuk* Governance**) are specifically developed by AAOIFI to ensure transparency and accountability on *Sukuk* issuance in the best interest of stakeholders, as their provisions ensure high quality financial reporting by reporting entities.

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