

Ref. 1217/7017/AR
12th December 2017

Dr. Hamed Hassan Merah
Secretary General
Accounting & Auditing Organization for
Islamic Financial Institutions (AAOIFI)
Al Nakheel Tower
10th Floor, Office 1001
Building 1074
Road 3622
Manama
Kingdom of Bahrain

Dear Dr. Merah,

السلام عليكم ورحمة الله وبركاته،،

**CIBAFI Comments on the AAOIFI Exposure Draft on Financial Accounting
Standard (FAS) No. 34: “Financial Reporting for Sukuk-holders”**

The General Council for Islamic Banks and Financial Institutions (CIBAFI) presents its compliments to the Accounting & Auditing Organization for Islamic Financial Institutions (AAOIFI) and takes this opportunity to express its appreciation of the work that the AAOIFI does to promote and enhance the Islamic financial services industry (IFSI).

CIBAFI is the official umbrella for all Islamic financial institutions, whose services and products comply with the Shariah rules and principles. CIBAFI acts as the voice of the Islamic finance industry, where our members comprise Islamic banks and non-bank financial institutions, both large and small, and reach more than 120 members from 32 countries and jurisdictions.

We have noted the request for comments on the AAOIFI Exposure Draft on Financial Accounting Standard (FAS) No. 34: “**Financial Reporting for Sukuk-holders**”, and welcome this opportunity to offer our comments and recommendations. The comments contained in this letter represent the views of CIBAFI Secretariat and feedback received from our members. We are also attaching more detailed comments in the Appendix of this letter for AAOIFI’s kind consideration.

Firstly, the title of the ED has misled many of CIBAFI’s members. CIBAFI believes that the title may mislead into thinking that the ED is about financial reporting by sukuk-holders i.e. how investors in sukuk should account for their investments in their accounts. Therefore, AAOIFI may revise the ED title to reflect more the purpose of the ED, and make clear in the introduction for which reporting entities this is intended.

Secondly, we note that the ED classifies Sukuk structures based on the nature of investment as “business sukuk” and “asset sukuk” (in paras 6 & 7). The explanations in the ED are extremely short and on the basis of this text, it would be very difficult to assign many of the sukuk practically in issue to one category or the other. CIBAFI members believe that more detail about this classification should be provided, preferably with examples of its application to different types of sukuk currently used in practice and familiar to users of the standards.

Thirdly, it is hard to see how this proposed standard would be adopted as a part of most national frameworks. ED-34 states in the appendix B (in paras BC1-BC3) that the originator of the sukuk should make the disclosures as part of its own accounting. However, the originators of sukuk are not, in general, financial services firms, and would therefore not be required to use AAOIFI standards in those jurisdictions which apply them to their Islamic financial institutions (IFIs). For example, if a telecom company is required to apply IFRS in its normal business, but then originates sukuk, it is difficult to imagine that its national accounting standards body would expect it, in that role, to apply AAOIFI standards, or indeed that it would have the expertise to do so.

We would like to express our thanks to the AAOIFI for its great effort and commitment with respect to developing standards that accommodate the interest of the global Islamic finance industry.

We remain at your disposal should you need any further clarifications on the above or on the attached Appendix.

Yours sincerely,



Abdelilah Belatik
Secretary General

Appendix

Comments on Exposure Draft of the AAOIFI Exposure Draft on Financial Accounting Standard (FAS) No. 34: “Financial Reporting for Sukuk-holders”

CIBAFI’s analysis has identified the following comments with regards to the specificities in the FAS 34 Exposure Draft.

Definitions

1. The ED defines “fair value” as: “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”. However, the ED of FAS 30 presented a different definition of “fair value” as “the amount for which an asset could be exchanged, or an obligation settled, between well informed, willing parties (seller and buyer) in an arm’s length transaction”. CIBAFI believes that it is important that AAOIFI standards should use consistent definitions of underlying concepts such as this, preferably based on IFRS standards (in this case IFRS-13).
2. The ED states that “Sukuk entity is a real or virtual entity having the Sukuk-holders as owners and owning the underlying Sukuk assets” (in para 6/e). The word “virtual” in this statement has raised some confusion. We believe that it should be replaced with a clearer term.
3. The ED provides (Para 3/c) definition of the “Special Purpose Vehicle (SPV) in definitions and states that “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.” However, as the purposes of having SPV for the Sukuk might be, the same, similar or different from the purposes of conventional SPV. The AAOIFI may remove this sentence to avoid confusion.

Financial reporting responsibility

4. The ED brings requirements (in para 4) regarding the financial reports of the Sukuk entity. However there is no reference to the auditing of the financial statements, without which it is difficult to see that investors will be able to place much reliance on them. We believe that the word “**audited**” should be included in the paragraph 4 such as follows: “The originator of Sukuk

shall prepare or cause to prepare the audited financial reports of the Sukuk entity, for each Sukuk issuance...”

5. The ED states (in para 4) that “Interim financial reports may preferably be prepared and issued on a quarterly or half yearly basis”. However the ED is unclear as to the circumstances in which interim reporting should take place. CIBAFI members believe that AAOIFI should give more guidance and clarification on this.

Presentation and disclosure

6. The ED provides presentation and disclosure requirements (in para 12) in addition to those in FAS-1¹. However, it is difficult to see how this regime could be applied to some sukuk which appear to be “business sukuk” within the definition. For example, IFIs have been issuing regulatory capital sukuk typically under Musharaka or Mudaraba, with the proceeds being invested in the whole business of the bank. It is very hard to see what disclosures would be made under 12b, c, and d in such a case. Further details and clarification would be highly appreciated.

7. The ED (in paras 12-19) provides presentation and disclosure requirements for different types of sukuk (in paras 12 and 19). Several of these disclosures are ones which should have been made in the sukuk offer document and which are unlikely to change within the lifetime of the sukuk. We therefore see little purpose, and a material administrative burden, in repeating them in each periodic financial statement. At most, any changes should be reported. On the other hand, CIBAFI members believe that the disclosures should include a short description of the sukuk, with its purpose, the place of incorporation of the SPV, and its relationship with the originator.

8. CIBAFI members believe that the disclosures in the case when the SPV is owned by the Sukuk originator shall be highlighted in this standard.

Accounting treatment and financial reporting in business Sukuk and Assets Sukuk

9. The ED states (in para 8) that “All assets and liabilities underlying the Sukuk and related revenues and expenses shall be recognized and measured in the books of the Sukuk entity

FAS-1: General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions

applying the accounting principles in accordance with respective FAS, and in absence thereof, in line with generally accepted accounted principles applicable to such transactions and balances”. It is clear from the definition that the Sukuk entity would normally be a Special Purpose Vehicle (SPV). However, the ED indicates that (in para BC3) the responsibility of the disclosures on behalf of SPV rests with the originator, implying that this ED is not a standard for the SPV, but rather a set of additional disclosures to be made by the originator. AAOIFI may wish to clarify this matter within the main body of the standard, rather than within the commentary.

10. The ED refers to “managed assets” in different parts of the ED (paras 14, 15, 17). However, introducing the concept of “management”, rather than simply “the assets of the sukuk” raises questions and confusion about what it is intended for. For example, is this treatment intended only for sukuk, like some under Wakala, where a changing portfolio of assets is managed, like a fund under an agency agreement? If so, what will be the appropriate treatment for sukuk in which a group of assets - for example, power generating equipment - is transferred by the originator but continues to be used by it as part of its normal business? AAOIFI may add some clarification on this point.

11. In addition, tangible business assets of this kind, generally, will not have a value established by trading in a market, though they can of course be valued on the basis of cost minus depreciation. However, their value in practice will depend heavily on the originator, continuing to be a going concern and making the payments expected under the sukuk. If not, and even if the investors can take full possession of the assets, their sale value is likely to be much less than their value in continuing use. It is difficult, in such a situation, to see how the recommended disclosures assist investors. This ED may provide more clarification regarding this matter.

Application to sovereign and quasi-sovereign sukuk

12. Many sukuk are originated by sovereigns or quasi-sovereigns, which (to the extent that they publish accounts) do so within a different framework from either FAS or IFRS; if the proposed disclosures are needed by holders of sukuk generally, then it could be argued that they are equally important for sukuk of this kind. We therefore suggest that AAOIFI should consider whether and how the proposed standard might be applied to sukuk of this kind.

Drafting matters

13. ED states (in PR3) that “the Sukuk market will have an improved level of transparency and financial discipline, as well as, enhance the level of compliance with Shariah will also”. It should be revised along the lines “the Sukuk market will have an improved level of transparency and financial discipline, as well as, enhanced level of compliance with Shariah”.

14. The ED states (in para 2) that “The Sukuk which are kept on-balance sheet by the originator ... may opt not to apply this standard”. Sukuk themselves have no decision-making capacity, and the sentence would therefore better read “The originator of sukuk which it keeps on balance sheet ... may opt not to apply this standard to them.”

15. There is a drafting problem in para 10 (line 4) such as “the institutions other than Islamic finance transactions”. It should be corrected.

16. The ED requires (in para 12/c) “disclosure regarding the transfer of legal ownership from the issuer to SPV. If only beneficial ownership has been transferred, the same shall be disclosed along with reasons.” The reference to “issuer” in this para is advised to be replaced to “originator”, as technically the SPV itself will be the issuer.