MALAYSIAN *SUKUK*: ISSUES IN ACCOUNTING STANDARD

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ABSTRACT

There is a high demand and need for developing alternatives to the traditional debt market, which are acceptable to Islamic law as bonds play a major role in the economy in raising capital. The main objective of this paper is to examine the contemporary accounting regulatory issues on investment in Islamic bonds or Sukuk in Malaysia. Sukuk can be based on various Islamic contracts, namely Muḍārabah, Murābaḥah, Mushārakah, and Ijārah. Due to the growth in the Islamic financial market, namely the Islamic bonds, as well as the growing interest in Islamic banking and insurance, the need for specific accounting requirements that can accommodate these contracts is imperative. This paper is based on the rationale that for the Islamic financial market to prosper, it requires well regulated Islamic financial instruments, as well as appropriate accounting standards and guidelines in recording these instruments. Therefore, a well regulated Islamic financial market requires sound accounting and reporting standards for Islamic financial instruments that meet the requirements of Shari'ah as well as being practical. In addition, this paper also highlights issues raised concerning the accounting practices in Islamic bonds investments.

Keywords: *Islamic Bonds, Sukuk, Islamic Law, Islamic Banking, Islamic Financial Market, Accounting, Reporting Standards*

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INTRODUCTION

In the modern economy, debt market and bonds are an integral part of the financial sector and effectively supplement the funds provided by the banking sector. From the conventional perspective, bonds can be defined as a long-term contract under which a borrower agrees to make payment of interest and principal, on specific dates, to the holders of the bonds.[1] According to Longman, bonds are actually certificates or documents of debt issued by a government or an organization for an amount of money they borrow from the bondholders, promising them that it will pay back the money it has borrowed, usually with interest.[2]

From the preceding discussion, it is clear that the relationship between the issuers of conventional bonds and their holders is simply a relationship between debtors and creditors on a loan-based contract where interest charges are applied as a reward for granting a loan. Hence, it is not acceptable from an Islamic perspective. However, since bonds play a major role in the economy in raising capital, there is a high demand and need for alternatives to the traditional debt instruments that are acceptable to Islamic law. In response to this phenomenon, there has been a rapid growth in *Shari'ah* compliant sovereign and corporate Islamic structured financial instruments known as *Sukuk*. *Sukuk* can be developed based on various Islamic contracts, namely *Muḍārabah*, *Murābaḥah*, *Mushārakah* and *Ijārah*. These concepts will be discussed later in the paper.

Various authors suggest the need for specific accounting treatments to account for Islamic based transactions.[3] Due to the growth in the Islamic financial market, specifically Islamic bonds, as well as the growing interest in Islamic banking and insurance, the need for appropriate accounting standards and guidelines to properly account for these contracts becomes more crucial. In line with this development,

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1 Brigham, E. C. and Ehrhardt, M. C. (2005), *Financial Management*, 11th ed. USA: Thomson South Western Publishing, p. 208.

2 Longman (2000), *Business English Dictionary*. Essex: Pearson Education Limited, p. 54.

3 Hamat, M. (1994), "Accounting Issues in the Operation of Islamic Banking", (International Integrated Course on Islamic Banking and Finance, Kuala Lumpur, 1994), pp. 1-16; Ismail, H. and Latiff, A. R. (1999), "Reporting Islamic Based Transactions: Question of Substance", *The Malaysian Accountant*, February, pp. 38-46; Ismail, H. and Latiff, A. R. (2000), "Financial Reporting of Islamic Banks: Research Highlights", *Akauntan Nasional,* November/December, pp. 14-18; Ismail, H. and Latiff, A. R. (2001), *Survey & Analysis of Financial Reporting of Islamic Banks Worldwide*. Kuala Lumpur: Malaysian Accountancy Research and Education Foundation, pp. 20-25.

AAOIFI has issued Financial Accounting Standard No. 17, a standard on investment in securities.[4]

Performance And Concept Of Islamic Debt Securities In Malaysia

The Islamic Capital Market in Malaysia has emerged as a significant area of growth. At present, it has the full complement of products, infrastructure, institutions, intermediaries and investors, contributing to the development and greater depth of the capital market. The market consists of two main markets, namely the equity market, dealing in corporate stock and shares, and the bond market dealing in public and private debt securities.

The Government's various initiatives and the country's robust economic activity, as seen from the implementation of large infrastructure projects, has successfully boosted the rapid expansion of the Malaysian Private Debts Securities (PDS) market during the 1990s. This is reflected in the amount raised, which has increased significantly from RM5.5 billion in 1994 to RM75.83 billion in 2006.[5] The growth and development of the Islamic bonds market is remarkable. There has been a significant increase in size, from RM0.3 billion in 1994 to RM42 billion in 2006, which accounts for 53 percent of all local bonds issued. Furthermore, the Malaysian bond market represents 67 percent of the world's *Sukuk* issued.[6]

Malaysia is among the first in the issuances of Islamic Debt Securities. The first global sovereign *Sukuk* was issued in 2002 by the Malaysian government, which has successfully attracted a wide geographical distribution of investors. About half are from the Middle East, one-third of them are from Asia, and the rest are from Europe and the US. As part of the effort to provide greater product diversity, the Malaysian government issued another RM2 billion of *Mushārakah* Residential Mortgage Backed Securities in 2005. It represents the world's first rated residential mortgage backed securities to be issued under the Islamic principle. The issuance was oversubscribed by more than 5 times, with a total order book of over RM13 billion. The issuance attracted strong bids from financial institutions, asset managers, insurance companies and corporate bodies, including significant foreign interest.[7]

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[4] AAOIFI (2002), *Exposure Draft: Investment Sukuk (Shari'ah Standard No. 18).* Manama: Accounting and Auditing Organization for Islamic Financial Institutions, p. 1; Rahman, A. R. (2003), "Accounting Regulatory Issues on Investments in Islamic Bonds", *Islamic Financial Services*, Vol. 4, No. 4, pp. 1-8.

[5] Securities Commission (n. d.), "Islamic Debt Securities", http://www.sc.gov.my/Islamicdebtsecurities, 4 January 2008.

[6] Multimedia Super Corridor (n. d.), "Bond Market', http://www.msc.com.my/business/Debt_Capital_ Market.html, 5 January 2008.

[7] Malaysia Treasury (n. d.), "Malaysia. Launch of Dow Jones Citigroup *Sukuk* Index", http://www.treasury.gov.my/index?ch=36&pg=126&ac=1527&tpl_id=93, 5 January 2008.

Sukuk or Islamic bonds can be developed based on various Islamic contracts, namely, *Murābaḥah*, *Bay' Bithaman Ajil* (BBA), *Muḍārabah*, *Mushārakah*, *Ijārah* and *Istisnā'*. *Murābaḥah* debt papers are one of the most popular forms of Islamic financing methods used in Malaysia. The *Murābaḥah* facility involves the purchase of assets by the financiers and the immediate sale of those assets back to the issuer with a mark-up agreed upon by both parties. The issuer's obligation to settle the purchase price is securitized via the issuance of *Murābaḥah* Notes.[8]

In the BBA facility, the issuer sells the assets to the financiers who immediately sell it back to the issuer with a higher price. Payment of the debt is usually on an instalment basis with a longer period compared to the *Murābaḥah* facility. In substance, it works exactly like the long-term *Murābaḥah*, except that payment can be in deferred terms. BBA bonds can be structured to simulate fixed rate bonds.

In *Istisnā'* principle, the issuer and contractor will enter into a contract. This construction contract is in fact an *Istisnā'* order made by the issuer to the contractor. Even though the identified assets projects are uncompleted, ownership already lies with the issuer. Therefore, the issuer can sell the uncompleted asset to the financiers. The financiers will then resell the identified assets to the issuers, based on deferred payment terms. The issuer's obligation to settle the purchase price is securitized via the issuance of *Istisnā'* notes or bonds.

Due to the controversial *Shari'ah* issues surrounding both the concept of *Bay' al-'Īnah* and *Bay' al-Dayn* in Islamic bonds, Malaysia has adopted *al-Ijārah* concept in new issues of Islamic bonds.[9] Unlike lease financing under conventional methods, the responsibility to maintain the underlying asset under the *Ijārah* facility rests on the lessor (i.e. the financiers). The lessee is only responsible for lease payments as long as the asset is operable. *Shari'ah* principles also require that the asset be operable, otherwise the lease will be suspended until the asset is repaired or becomes operable. Thus, the onus is on the lessor to ensure that the asset is insured and maintained. The costs for maintenance and insurance will, however, be passed on to the lessee. In June 2002, Malaysia successfully launched the world's first international Islamic bond issue based on the *Ijārah* concept, namely Malaysia Global *Sukuk* Incorporation.[10]

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[8] Ismail, M. I. (n. d.), "Islamic Private Debt Securities: Issues and Challenges", http://www.ram.com.my, 25 April 2003.

[9] Moustapha, S. K. (2001), *The Sale of Debt: As Implemented by the Islamic Financial Institutions in Malaysia*. Kuala Lumpur: International Islamic University Malaysia, p. 43.

[10] Ismail, M. I. (n. d.), *op. cit.*

Bonds under the *Muḍārabah* and *Mushārakah* concepts were recently applied in Malaysia. In 2006, twenty-seven out of sixty four *Sukuk* issued in Malaysia were based on *Muḍārabah*, *Mushārakah* and *Ijārah* principles.[11] Both the *Muḍārabah* and *Mushārakah* concepts operate on a profit and loss sharing basis. They are considered as high-risk tools because returns to the financier are uncertain as they depend on the performance of the business or project involved. Unlike conventional financing, the financier of Islamic bonds under these two concepts must also bear an equity risk in addition to the credit risk. Therefore, the tax incentives offered by the government will reduce the cost of these types of bonds and make the future cash flow more attractive.[12]

Issues In Accounting Standards For Islamic Bonds And The Malaysian Practice

In response to the emerging interest in the issuances of Islamic asset-backed financial instruments, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has introduced Financial Accounting Standard No. 17 on investments in securities including *Sukuk* or Islamic bonds. According to the standard:

> "Investment in *Sukuk* are certificates of equal value representing, after closing subscription, receipt of the value of the certificates and putting it to use as planned, common title to shares and rights in tangible assets, usufructs, and services, or equity of a given project or equity of a special investment activity."

The purpose of this standard is to differentiate between Islamic accounting practices and conventional practices in recording bond. The examination of AAOIFI FAS 17 shows that AAOIFI has been pragmatic in its approach by considering the requirements to fulfil the need for a codified Islamic accounting standard and the need for Islamic accounting objectives, concepts and principles to be developed based on *Shari'ah* requirements. This is a pro-active step to provide a sound accounting regulation as part of a comprehensive regulation of Islamic financial institutions.[13]

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11 Middle East Business News and Company Directory (n. d.), "Development and Regulation of the *Sukuk* Market in Malaysia", http://www.zawya.com/story.cfm/sidZAWYA20070827115041, 5 January 2008.

12 Bakar, M. D. (2003), "Contracts in Islamic Commercial and Their Application in Modern Islamic Financial System", www.cert.com.my/cert/pdf/contract.pdf, 25 April 2003.

13 Rahman, A. R. (2003), *op. cit.*

In AAOIFI FAS 17, Islamic bonds have been classified into three main categories: bonds held for trading purpose; bonds held for sale; and bonds held to maturity. This is in contrast to the standard for conventional bonds where they are only categorised into short term or long term investment. The difference between these two standards is the AAOIFI standard classification based on the well known *Shari'ah* classification of trade commodities for the purpose of *zakāt*, while the conventional standard is only based on the period of an investment. Nevertheless, the use of AAOIFI's classification of investment into three types would be more desirable and useful to users of accounting information as it provides an additional classification that distinguishes the intention or purpose of investment. However, there is an issue raised in classification of investment adopted by AAOIFI. The issue of intention of the investor is difficult to determine and it may also be subject to change due to changes in the environment and situation. To resolve this issue, the AAOIFI need to develop a specific measurement or some guidelines to conclude whether or not specific intention on the part of investors is established.[14]

There is an imbalance in the financial infrastructures among countries throughout the world. But generally the infrastructure is weak in most emerging economies. In addition, *Sukuk* requires unique *Shari'ah* compliant structures. This creates a state, which can be termed as one of institutional rigidity that cannot be removed in the short run, invariably increasing the risks of *Sukuk*. One notable contribution of AAOIFI FAS 17 is to reduce this institutional rigidity and the provision of uniform accounting, auditing, and income and loss recognition systems.[15]

AAOIFI's FAS 17 has recommended that recognition for investment in *Sukuk* and shares shall be recognized on the acquisition date and shall be measured at cost. Although there is an increasing pressure to use fair market value the standard prefers the historical cost method. It is argued that historical cost does not always provide relevant information, even though it is reliable and is free of bias compared to fair market value principle. Nevertheless, for many financial instruments (including *Sukuk*) quoted market prices may not always be available. Market prices are normally used as the basis of measuring fair market value. Thus, when the market price is not available, generally, the conventional method measures the securities based on the net present value or other valuation techniques. However, these techniques involve uncertainties and are significantly affected by the assumptions used and judgments made regarding risk characteristics of various financial or capital market instruments. The uncertainties include the arbitrary use of discount rates, future cash flows, expected loss and other factors.

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14 *Ibid.*

15 AAOIFI (2002), *op. cit.*

Thus, the idea of AAOIFI's FAS 17 to favour historical cost rather than fair value is to eliminate the uncertainties involved in the use of fair value for capital market instruments. This is also due to the fact that the objective of Islamic valuation should be to provide both relevant and reliable values that are reliable to users of financial statements to make useful judgments and decisions.

However, at the end of the accounting period, investment in *Sukuk* held for trading purposes and available for sale shall be measured at their fair value. This is because there may be an impairment in the value of *Sukuk*. Therefore, it has to be measured at its fair value to take into account profits or losses made from the proceeds. The unrealized gains or losses, as a result of re-measurement, need to be recognized in the income statement under the "investment fair value reserve". This reserve account will reflect the net gain or loss at the end of the year. Moreover, the AAOIFI's FAS 17 mentions that the difference between the book value and the net cash resulted from the sale of the investment are to be measured as the realized profits or losses from the sale of a particular investment. The standard also makes a provision that in case an institution has reserves created by appropriation of profits from previous financial periods to meet future investment risks, it is recommended that unrealized loss resulting from re-measurement of investment at fair value shall be deducted from this reserve.[16]

The standard also requires that the different types of investment must be shown separately according to the three classifications as noted earlier. Again, this is essential in order to give clarification of which type of investment the profit resulted from. As a result, this will enable users to compare profitability between different types of investments and hence, this information will add more value in terms of decision making by users.

In the case of dividends received from investment in shares and *Sukuk*, the standard points out that dividends should be acknowledged at the declaration date in the income statement rather than when the cash is received. Thus, this shows that in case of recording dividends on investment in shares and *Sukuk*, the accrual basis of accounting is used.[17] The use of the accrual basis in this case is required to reflect the actual or fair income at the point when it is realized. Another requirement in realizing profit from sale of investment and dividends received is the need to differentiate between the portion to be shared by owners' equity and depositors or investors. The rationale of this requirement is similar to the case of treatment of profit on re-measurement of investment at fair value, as discussed above, as it ensures sufficient information is provided to users of accounting information, particularly on the distribution of profit between equity holders and depositors so that the clarity and integrity of the information can be maintained.

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[16] Rahman, A. R. (2003), *op. cit.*

[17] *Ibid.*

The main issue highlighted in the preceding discussion is the need to recognise that a portion of income from *Sukuk* requires the application of proper treatment and the disclosure of profit and sharing distribution. In accounting for *Sukuk,* it is important that there is transparency in method, ratio and process to disburse profit as well as to comply with the *Shari'ah* requirement of ensuring fair and just profit sharing and distribution between shareholders and depositors.

In the case of Islamic bond (*Sukuk*) investments, AAOIFI's FAS 17 has clearly specified certain requirements of how *Sukuk* investments should be disclosed. One requirement is to disclose the party guaranteeing *Sukuk* and the nature of the guarantee. Another requirement is that the standard requires the contractual relationship between the issuer and the holders of a particular *Sukuk* to be disclosed. The disclosure shall be made by the issuer of *Sukuk*. Another disclosure required with respect to investment in *Sukuk* is the requirement to disclose the classification of *Sukuk* according to their maturities.

The main idea of the disclosure requirements outlined by the AAOIFI's FAS 17, as stated above, is that Islamic Financial Institutions have to maintain transparency in disclosing financial information relevant to securities investment, especially *Sukuk*. Thus, this will enable users of financial statements to make better judgments as all the necessary information is disclosed. In the case of *Sukuk*, the disclosure of the potential returns and the risks associated with it, as well as the contractual relationships between the parties involved, are equally important to judge whether or not it has complied with *Shari'ah* requirements.

In the Malaysian context, we are analysing the accounting practices for Islamic bonds in one of the Islamic banks. From the interview with the Head of Finance of the bank, it is found that the recognition of profit from *Sukuk* is divided into two categories. First, if *Sukuk* is issued at a discount (zero coupon), the bank will amortize the difference between the face value and the issued amount over the entire period of *Sukuk* tenor. The amortization will be recorded under the 'accretion of discount' account. On the other hand, when *Sukuk* is issued at profit (coupon), the bank will recognize the profit as dividend and it will be recorded under the 'dividend income' account. In summary, we may conclude that there is no significant difference between the accounting practices for *Sukuk* and conventional bonds in Malaysia, except for the name of the account that the bank used. In our opinion, this situation arises because, as yet, AAOIFI FAS 17 is not enforceable in Malaysia.

Prospect, Future Direction And Challenges In Accounting Practices For Malaysian Islamic Bonds

The success of the AAIOFI Financial Accounting Standards has shown that efforts to introduce effective accounting standards that are *Shari'ah* compliant have been accepted globally. We believe that such efforts made by the said organization are able to contribute in spearheading the creation of a benchmark for future Islamic accounting practices for Islamic bonds.

The involvement of global issuers, investors and intermediaries in Islamic bond transactions demand standards of compliance, transparency and governance. As such, Malaysian efforts in ensuring *Shari'ah* compliance have been complemented with efforts to ensure international acceptability and compatibility through benchmarking against international best practices and standards. There are a number of strategic initiatives for the establishment of Malaysia as an international hub for the Islamic capital market such as introducing more products and services, mobilizing funds in an effective manner and establishing a comprehensive accounting, tax and regulatory framework based on *Shari'ah* principles.[18]

Going forward, Malaysia continues to position itself to become a premier international Islamic financial centre. With the supporting infrastructure and regulatory framework already in place, Malaysia has to strengthen investors' confidence that its accounting practices for Islamic financial products is in line with *Shari'ah* requirements. As the path has already been laid for the Malaysian corporate sector to tap the Islamic capital market, the focus of the efforts in the next phase of development will be largely industry-driven. Product innovation, ensuring global compatibility and acceptance, branding and promotion need to be considered. The Malaysian government has to ensure that more corporate bodies come forward to structure new and innovative *Shari'ah* compliant financial products that will contribute to the promotion and growth of the Malaysian Islamic capital market.

In addition, as stipulated in the PDS Guidelines (paragraph 32), IPDS issuers must appoint an independent *Shari'ah* advisor, approved by the SC, to advise on all aspects of IPDS including documentation, structuring and investment. *Shari'ah* scholars have an important role to play to ensure and maintain public confidence in the Islamic Capital Market by ensuring that Islamic bonds issued by the market participants are in full compliance with *Shari'ah* principles, including the accounting practices adopted in recording and reporting the bond. The harmonization and standardization of *Shari'ah* ruling can minimise the divergence of *Shari'ah* interpretations among *Shari'ah* scholars in the country (Securities Commission, 2002; 2003; 2007).

To further develop the country's Islamic accounting practices, professionals and *Shari'ah* experts should be actively involved in the research and development (R&D) to devise appropriate accounting regulations, which can be adapted to

[18] Rosly, S. A. (2001), "Some Issues of *Bay' Al-'Inah* in Malaysian Islamic Financial Markets", *Arab Law Quarterly*, Vol. 16, No. 3, pp. 263-280.

the modern accounting regulatory environment to make it relevant and practical. The knowledge gap between *Shari'ah* experts and finance professionals has to be narrowed down by equipping both the experts and professionals with the required skills and knowledge. This has to be done on a continuous basis if Malaysia wants to be the market leader in the industry.

The education infrastructure is also needed to educate the Islamic bond issuer on the intricacies of Islamic principles in financial transactions. The common complaints made by the market players that methods employed in fixing prices or calculating profits for the Islamic financial instruments are no different from those used in conventional financial tools can be a setback in the progress and development of the market.

Lastly, the *Shari'ah* ruling and taxation system for the Malaysian Islamic capital market should be reviewed to promote standard guidance and speed up the development of the market. The regulators, such as the Malaysian government as well as the Securities Commission, can provide some attractive incentives to the issuers and investors of Islamic bonds.

CONCLUSION

The recent trend shows that the Islamic Capital Market has grown tremendously and has drawn increasing interest from among the market players. This has triggered the need for establishing appropriate measures in recognizing and measuring transactions relating to the issuance and investment of Islamic bonds to ensure compliance with *Shari'ah* Law. Therefore, in response towards this need, AAOIFI has issued a new standard, FAS 17 which covers Islamic investments including *Sukuk*.

According to the standard, Islamic bonds should be classified into three categories according to investment intentions, rather than two categories in accordance to the period of holding as is the practice in the traditional accounting. The classification of Islamic bonds is made to promote public *maṣlaḥah* (interest) as underlies in the determination of *zakāt*. Further, the standard states that the recognition for investment in *Sukuk* and shares shall be made on the acquisition date. In terms of its measurement, Islamic bonds should be measured at historical cost rather than fair market value. The standard also specifies the necessary requirements for *Sukuk* disclosures. The goal of these disclosure requirements is to ensure that adequate disclosure is made by the issuer of *Sukuk* for the purpose of assessing whether or not it complies with *Shari'ah* Law.

In the effort to position Malaysia as a premier international Islamic financial centre, the Malaysian government has to encourage the private sector to be more innovative in developing products and services that are in line with *Shari'ah*. It is also imperative that the accounting practices adopted in the recording and reporting of Islamic bonds fully conforms to *Shari'ah* requirements and principles. Islamic scholars must continue to work with the financial professionals so that the knowledge gap between them can be reduced.

In the future, empirical research should be carried out to compare the accounting treatment adopted and the reporting practices of organizations issuing *Sukuk* in Malaysia. It will also be beneficial to investigate the main differences between the practices adopted to account for *Sukuk* and the conventional bonds under the traditional accounting system.

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