Sukuk: Definition, Structure and Accounting Issues

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In the name of Allah, the most Gracious, the most Merciful

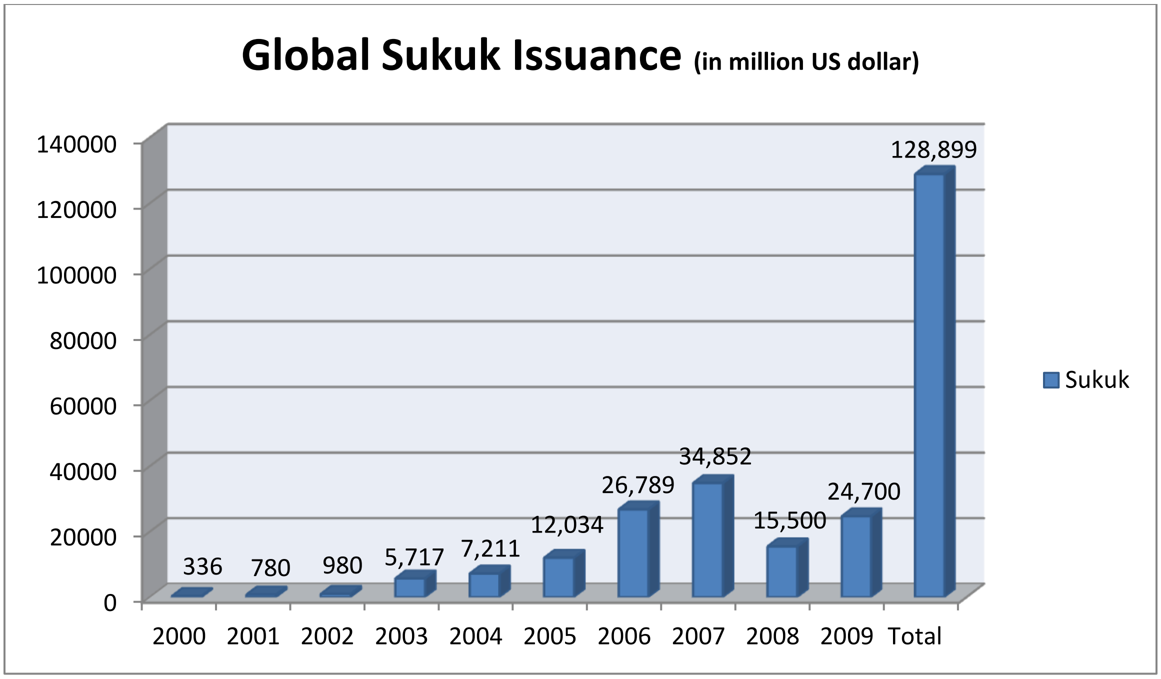
Abstract

Recent innovations in Islamic finance have changed the dynamics of the Islamic finance industry especially, in the area of *sukuk* or Islamic securities. *Sukuk* have become increasingly popular in the last few years, both as a means of raising government finance through sovereign issues, and as a way for companies to obtain funding through offering corporate *sukuk*. In this paper an attempt is made is to define *sukuk* and show the structure of *sukuk*. Furthermore, the paper shades some light on some accounting risk issues of *sukuk*. Finally, the paper presents benefits of *sukuk* for shareholders. However, this paper is a humble attempt to explain certain issues of *sukuk*. Certainly, for further information about *sukuk*, there are many publications that may assist the reader to derive the knowledge about *sukuk*.

Key words: *Sukuk*, structure, recognition, measurement and risk.

Introduction

Sukuk is a plural of *sakk*. *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 (AAOIFI, 2008). However, this is true after the receipt of the value of the *Sukuk*, the closing of the subscription and employment of funds received for the purpose for which the *Sukuk* were issued (AAOIFI, 2008). *Sukuk* holders claim an undivided beneficial ownership in the underlying assets. On the other hand bond is a contractual debt obligation whereby the issuer is contractually obliged to pay to bondholders, on certain specified dates, interest and principal. A distinguishing feature of *sukuk* is that the holders are entitled to share revenues generated by the *sukuk* assets as well as being entitled to share in the proceeds of the realization of *sukuk* assets.

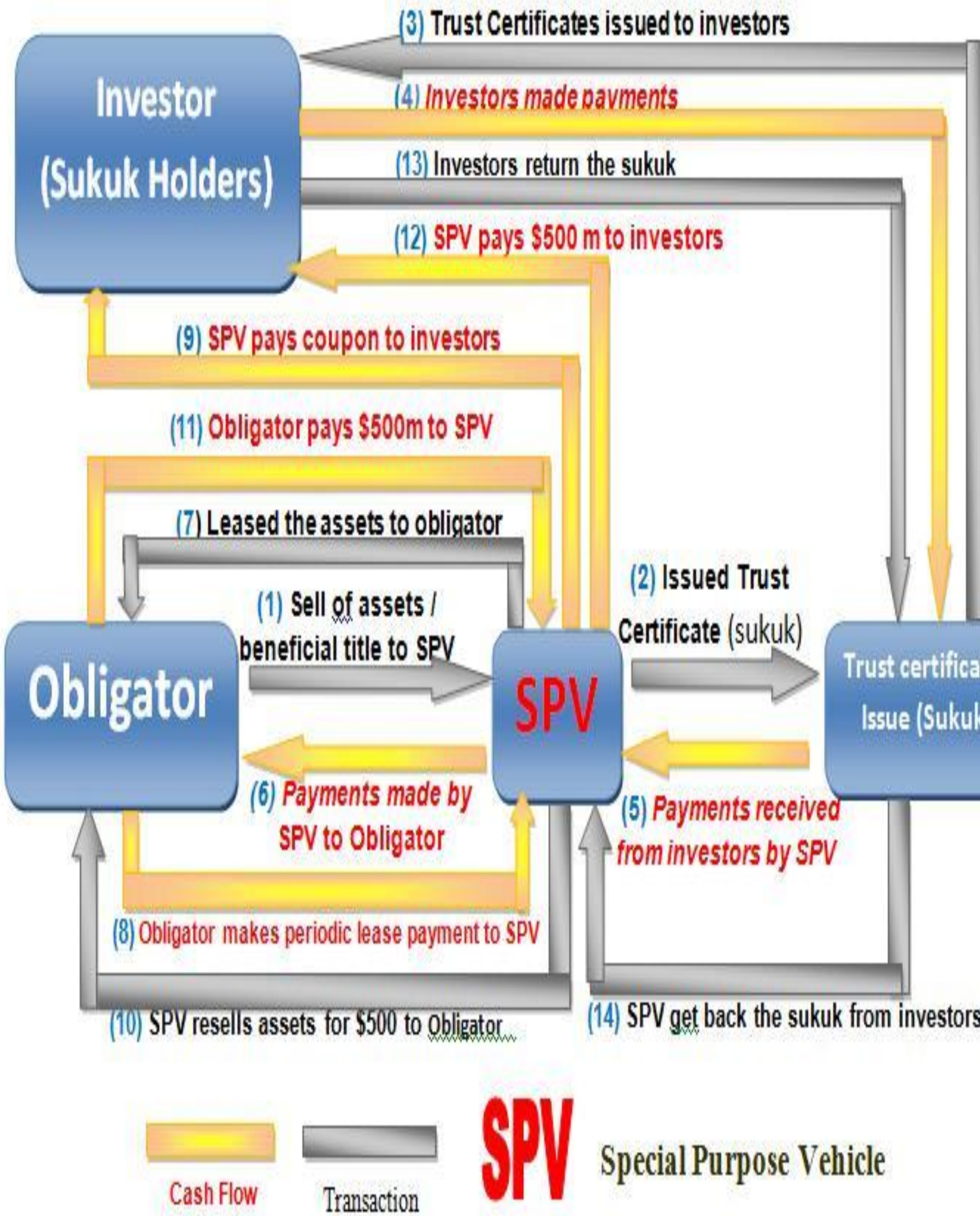


Source: IFIS

Above diagram shows growth in *sukuk* issuance from year 2000 till 2009. In 2000 total size of the *sukuk* was only US$ 336 million with no sovereign *sukuk* in the market. We can see from the above table that the size of total *sukuk* issued in

2001 issuance was only US$ 336 million and in a short span of just six years the total size of *sukuk* has crossed US$ 34 billion. The growth achieved in 2003 has been most impressive at 483%. The *sukuk* has achieved the largest growth in 2007, but in 2008 the issuance of *sukuk* has significantly, declined by 55.4% due to global credit crisis. In 2009, global *Sukuk* issuances surged by 58.8 percent to $24.7 billion compared to the $15.5 billion raised in 2008.

***Sukuk* Structure**


(3) Trust Certificates issued to investors
Investor
(Sukuk Holders)
(4) Investors made payments
(13) Investors return the sukuk
(12) SPV pays $500 m to investors
(9) SPV pays coupon to investors
(11) Obligator pays $500m to SPV
(7) Leased the assets to obligator
(2) Issued Trust
Certificate (sukuk)
(1) Sell of assets /
beneficial title to SPV
Obligator
SPV
Trust certificates
Issue (Sukuk)
(6) Payments made by
SPV to Obligator
(5) Payments received
from investors by SPV
(8) Obligator makes periodic lease payment to SPV
(10) SPV resells assets for $500 to Obligator
(14) SPV get back the sukuk from investors
Cash Flow
Transaction
SPV
Special Purpose Vehicle

Types of *Sukuk*

Sukuk can be of many types depending on the type of Islamic modes of financing and trades used in the structure. The most important and common among those are *ijarah, musharakah, mudarabah*, hybrid, *salam* and *istisna*.

Accounting Issues

Classification of Investment

One notable contribution of AAOIFI FAS 17 is the classification of investment in *sukuk* into three types namely, *sukuk* for trading purposes; *sukuk* available for sale; and *sukuk* held to maturity. The AAOIFI's classification is based on the well-known shari'ah classification of trade commodities for the purpose of zakat. For example, the jurists of Maliki School have classified trading assets into the following: (a) assets that are meant for buying and selling (*Aorud Altijarah*); (b) assets that are held for sale in the expectation of making profits through price appreciation in the future; and (c) assets acquired not for trade, but for personal use.

Recognition

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. However, at the end of accounting period, investment in *sukuk* and shares held for trading purposes and available for sale shall be measured at their fair value. The unrealized gains or losses as a result of re-measurement need to be recognized in the statement of financial position under "investment fair value reserve". The additional requirement is the share of portion of income related to owners' equity and portion related to unrestricted equity investment account holders must be taken into consideration. This is considered crucial as no proper treatment and disclosure of this transaction of profit sharing and distribution may lead to confusion as to the method, ratio and process to disburse profit that have been taken place. This is to ensure transparency in profit and loss sharing on re-measurement of investment at the end of the year to be properly disclosed to the users. At the same time it fulfills the shari'ah requirement of ensuring fair and just profit sharing and distribution between shareholders and depositors (investors). Any unrealized gain or loss resulting from re-measurement at fair value, according to AAOIFI FAS 17, shall be recognized in the statement of financial position under the “investment fair value reserve”. This reserve account will reflect the net gain or loss at the end of the year. The standard also makes a provision that in case the institution has reserves created by appropriation of profits of previous financial periods to meet future investment risks, it is recommended that unrealized loss resulted from re-measurement of investment at fair value shall be deducted from this reserve.

Measurement

Sukuk held to maturity should be measured based on historical cost except if there is impairment (damage or injury) in the value. In this case, *sukuk* should be measured at fair value. The difference in value will then need to be recognized in the income statement, and the information related to the fair value is then needed to be disclosed in the notes to the financial statements. For securities held for trading and available for sale, AAOIFI FAS17 recommends the measurement to be based on the fair value. Fair value is normally defined as the amount which the instrument could be exchanged or settled between knowledgeable and willing parties in a length transaction, other than forced or liquidation sale. The objective of Islamic valuation should be to provide both relevant and reliable value that can be relied on by the users of financial statements to make useful judgment and decision. The rationale of AAOIFI’s FAS 17 to recommend historical cost rather than fair value is that the inherent uncertainties in relation to the use fair value for capital market instruments. Another reason could be because there is no intention to trade in the securities before maturity, thus, there is no apparent need to measure the securities at the end of the year at fair value. The AAOIFI’s FAS 17 also lays down the realized profits or losses resulting from sale of any investment shall be measured at the difference between the book value and the net cash proceeds from the sale of investment. The standard also makes recommendation that different types of investment must be shown separately according to the three classifications mentioned earlier. This is important to give a better picture of profit resulted from different types of investment. This recommended treatment is also necessary to assist users in determining and comparing profitability between different types of investment. Furthermore, the standard requires recognizing dividends received from investment in shares and *sukuk*, in the income statement at the declaration date not at the date of receiving cash proceeds. This indicates the use of accrual basis of accounting to ensure that the institution recognizes income when it is realized based on the contract or the right to receive that income. The use of accrual here is required so that to reflect the actual or fair income at that point when it is realized. The additional requirement of realized profit from sale of investment and dividends received is the need to distinguish between the portion of owners' equity and depositors (investors). The rationale is similar to the case of treatment of profit on re-measurement of investment at fair value as discussed above, as it will ensure sufficient information provided the equity holders and depositors.

Disclosure

AAOIFI's FAS 17 has made special requirements for disclosure in *sukuk*. Among the requirements are that disclosure shall be made by the issuer of *sukuk* regarding to the material, face value, and percentage of *sukuk* acquired by each party issuing the *sukuk* and each type of *sukuk*. There is also a requirement to disclose the party guaranteeing the *sukuk* and the nature of the guarantee. Another useful disclosure requirement is the need to disclose the contractual relationship between the issuer and/or manager of *sukuk* and the holders of such *sukuk*. The additional disclosure with respect to investment in *sukuk* is the requirement to disclose the classification of *sukuk* according to their maturities. All the above disclosure requirements urged Islamic institutions to be more transparent in disclosing financial information. The fundamental rationale is to provide useful information for users to assist them making a right decision regarding investment in *sukuk*. Disclosure should be made to the contractual relationships between all involved parties involved to ensure that all parties fulfill the sharia'h requirements particularly social accountability.

Risks of *Sukuk*

Risks adverse effect the competitiveness of an asset's pricing. The innovation of *Sukuk* inherently entails a higher exposure to certain market and financial risks.

1. Market Risk

An important distinction is made between market risks and other types of risk factors. Market risk is defined as the risk on instruments traded in well-defined markets (Heffernan, 2003). Two categories of market risks are identified: general (systematic) and firm specific (idiosyncratic). Systematic risks can arise due to governmental and economic policy shifts whereas idiosyncratic risk arises due to different firm specific instruments which are priced out of correlation with other firms' instruments. Market risk is composed of interest rate risks, foreign exchange risks, equity price risks and commodity risks.

2. Foreign Exchange Rate Risk

Currency risk arises from unfavorable exchange rate fluctuations which will undeniably have an effect on foreign exchange positions. In the event of a divergence between the unit of currency in which the assets in the *sukuk* pool are denominated, and the currency of denomination in which the *sukuk* funds are accumulated, the *sukuk* investors are rendered to an exchange risk. A clear manifestation of this situation arises with the IDB prospectus. The unit of account of the IDB is an Islamic Dinar (ID), and is equivalent to one Special Drawing Right (SDR) of the IMF that is weight-composed of 45% in US$, 29% in Euro, 15% in Japanese Yen and 11% in Great Britain Pounds. However, the *sukuk* certificates are denominated in US$ and consequently there is a currency disparity. Although recently this disparity has resulted in a profit for the IDB because of the weakness of the US$ relative to the Islamic Dinar, any appreciation of the US$ against the ID will invariably result in a currency loss.

The IDB serves as a guarantor and thus protects the investors from any exchange rate fluctuations. Indeed, the investors in all the *sukuk* prospectuses are shielded through similar provisions. However, this does not eliminate the exchange risk faced by the originators. In truth, exchange rate risks are compounded with a rapidly growing industry and increasingly multi-national investment arrangements. The challenge for *sukuk* issuing corporate entities and sovereigns becomes to devise an effective exchange risk management strategy congruent to Shari'ah principles.

It is noticeable that the Chinese government has implemented a simple method of eliminating such a risk. They divide the issue into two parts. Suppose the issue is $1 billion. The first part of $ 400 million will be in US Dollars and the second part of $ 600 million will be in Euro. Indeed, the *sukuk* issues can be based on this simple principle and can be based on multi currencies instead of creating a contingency claim on the issuer's balance sheet in terms of the guarantees.

3. Credit and Counterparty Risk

Credit risk refers to the probability that an asset or loan becomes irrecoverable due to a default or delay in settlements. If the relationship involves a contractual arrangement than the counterparty risk, it would have probability that the counterparty retracts on the conditions of the contract. The consequences can be severe with a decline in the value of a bank's assets. The credit and counterparty risks inherent in Islamic finance are unique owing to the nature of Islamic financial instruments that become foundation of *sukuk* asset pools. Unlike conventional financial institutions, Islamic banks do not have access to derivative instruments and other credit risk management mechanisms due to Shari'ah considerations.

4. Operational Risk

There are numerous other risks specific to the operation of the *sukuk*. These risks mirror those existent in conventional bond markets and are operational in the sense that they are inherent to the structure of the issuances rather than the underlying Islamic principles.

A. Default Risk: Each prospectus has provisions for the termination of the certificate in the event of a default by the obligor. In case the obligor fails to pay the rentals on the *Ijarah* agreements that form the coupon payments, the certificate holder can exercise the right to nullify the contract and force the obligor to buy back the assets. Furthermore, in the event that the obligor fails to repay the principal amount, the certificate holder can exercise the right to take legal action and force the obligor to enter into debt rescheduling procedures.

B. Asset Redemption Risk: The originator has to buy back the underlying assets from the certificate holder. The principal amount paid may not be equal to the *sukuk* issue amount and, as a result, there is the risk that the assets may not be fully redeemed.

C. SPV Specific Risks: The Special Purpose vehicle is generally designated to be a standalone institute that is bankruptcy remote from the originator. However, there may be a notion of settlement risk involved with the SPV in that the originator will have to channel the payments through a clearinghouse. The certificate holders will then be reimbursed through the clearinghouse.

D. Investor Specific Risks: The certificate holder is rendered to several risks pertinent to *sukuk* structures. These are primarily regarding liquidity issues. The *sukuk* structures, as welcome as they are in dealing with liquidity management issues in Islamic finance, are exposed to a liquidity risk because there is no a well-structured and secondary market. The certificates are listed on several local markets but this alone does not signify their liquidity. The sukuk certificates are medium to long term in maturity and their continued success will largely depend on their ability to evolve into highly liquid means of fund investment with adequate risk management mechanisms. As is this is the case, most of the certificates tend to be held until maturity.

F. Risks Related to the Asset: The underlying assets of the *sukuk* certificates are subject to numerous risks as well. Primarily, there is a risk of losing assets for example in *ijarah* parcel. However, in the case of equipment and large scale construction typifying some of the underlying IDB assets. The risk of loss may not be so negligible. Nevertheless, Islamic finance has Shari'ah compliant provisions for insurance claims in the form of Takaful and these arrangements will have to be utilized to mitigate the risks of asset losses. Furthermore, another aspect of risk is the need to maintain the structures of assets. Proper maintenance will ensure adequate returns to the certificate holder. According to Shari'ah principles, the SPV will usually be required to bear the responsibilities on ensuring asset structure maintenance.

Profitability of *Sukuk*

1. *Sukuk* as shari'ah-compliant instruments provide medium to long- term fixed or variable rates of return. Assessed and rated by international rating agencies, which investors use as a guideline to assess risk/return parameters of a *sukuk* issue.
2. Regular periodic income streams during the investment period with easy and efficient settlement and a possibility of capital appreciation of the *sukuk*.
3. Liquid instruments, tradable in the secondary market.

Concluding remarks

The market for *sukuk* is now maturing and there is an increasing in the issuance of *sukuk* but the financial crisis hit this increasing. *Sukuk* have confirmed their viability as an alternative means to mobilize medium to long-term savings and investments from a huge investor base. There are many types of *sukuk* and their structures may slightly differ from each other. The structure of leasing *sukuk* has been discussed in this paper since this *sukuk* is the most famous type which is practiced now. The need for Islamic accounting that deals with Islamic financial instruments has prompted AAOIFI to introduce Financial Accounting Standard No.17 on investments in securities. The need for a codified Islamic accounting standard are primarily stemmed from the need of Islamic accounting objectives, concepts and principles to be developed based on sharia'h requirements. This effort from AAOIFI enables Muslim to have a sound accounting which is sharia'h compliant. Moreover, this effort is a pro-active step to provide a sound accounting regulation as part of a comprehensive regulation for Islamic financial institutions. In terms of *sukuk* risk, *sukuk* as any financial instruments have different risks. These risks should be taken into account when issuing *sukuk*. The risks which have been discussed earlier are Market risk, Interest Rate Risk (rate of return risk), Foreign Exchange Rate Risks, Credit and counterparty risk and operational risk. *Sukuk* have profitability for the shareholders such as regular periodic income and liquidity instruments that tradable in the secondary market.

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