ACCOUNTING REGULATORY ISSUES ON INVESTMENTS IN ISLAMIC BONDS

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The main objective of this paper is to examine contemporary accounting regulatory issues on investments in Islamic bonds or sukuk. Investments on Islamic bonds (sukuk) give rise to a number of accounting and reporting issues related to recognition, measurement and disclosure. The underlying rationale of this paper is that proper development of Islamic financial market requires a well regulated Islamic financial instruments and one of the key elements of regulation is accounting regulation. Therefore, a well regulated Islamic financial market requires a sound accounting and reporting standard of Islamic financial instruments that, first, meet the requirements of syari'ah, and, second, relevant to be practiced in our time.

The need for Islamic accounting that deals with Islamic financial instruments has prompted AAOIFI recently to introduce Financial Accounting Standard No.17 on investments in securities (AAOIFI FAS 17, 2003). The need for a codified Islamic accounting standard are primarily stemmed from the need that Islamic accounting objectives, concepts and principles to be developed based on syari'ah requirements. However, the Islamic accounting regulation also needs to adapt to the modern accounting regulatory environment to make it relevant to be practiced in our time. The examination of AAOIFI FAS 17 shows that AAOIFI has been pragmatic in its approach by considering both requirements when developing its standard. This is a pro-active step to provide a sound accounting regulation as part of a comprehensive regulation of Islamic financial institutions.

1. Introduction

The growth of Islamic financial market and institutions, culminating in the growing interest in Islamic banking, finance and insurance reiterates the need for different accounting requirements. Islamic accounting is needed to serve different principles of financial instruments that are founded on the Islamic worldview and syari'ah requirements. The efforts of Accounting and Auditing Organizations of Islamic Financial Institutions (AAOIFI) in the 1990s to develop accounting standards for Islamic financial institutions are commendable as a positive contribution towards harmonizing accounting practices of Islamic financial institutions. The standards developed by AAOIFI are also expected to facilitate the needs of the users of accounting information of Islamic financial institutions who, in theory, demand different sets of information.

The main objective of this paper is to examine contemporary accounting regulatory issues on Islamic bonds or Islamic Private Debt Securities (IPDS) or sukuk. Investments on Islamic bonds (sukuk) give rise to a number of accounting and reporting issues. These issues relate to recognition, measurement and disclosure. This study also highlights and discusses the requirements made by AAOIFI's Financial Accounting Standard No.17 (FAS 17) on accounting for investments in Islamic bonds or sukuk.

The underlying rationale of this paper is that proper development of Islamic financial market requires a well regulated Islamic financial instruments and one of the key elements of regulation is accounting regulation. Therefore, a well regulated Islamic financial market requires a sound accounting and reporting standard of Islamic capital market instruments that, first, meet the requirements of syari'ah, and, second, relevant to be practiced in our time.

The paper will be structured accordingly to address the above objectives, by first, introducing how the Islamic worldview influences the objectives and concepts of modern accounting and reporting. Secondly, the paper examines accounting objectives and concepts from an Islamic perspective. Thirdly, accounting issues on investments in Islamic securities particularly Islamic bonds or sukuk are discussed to highlight contemporary accounting issues on providing a sound accounting regulation for Islamic financial market instruments.

2. Islam and Accounting

Islam literally means 'peace' and 'obedience', and adherence to Islam have to be 'obedient' to God and to appreciate the purpose of their existence in this world (Al-Faruqi, 1982). God is said to have proclaimed that, *"I have only created… men that they may serve me"* (*al-Qur'an*, 51:56). The nature of this service is taken to have been spelled out clearly when God, upon creating men, declared, *"I will create a vicegerent on earth"* (*al-Qur'an,* 2:30). Muslims consider humans to be vicegerents of God. Thus, whatever worldly possession a Muslim has is to be held in a stewardship capacity – that is simply in trust from God (Abu-Sulayman, 1994). According to Islam, Muslims are trustees (or stewards) for God: Man therefore agrees to assume this great responsibility in a covenant with God.

In a Muslim society, accounting is expected to be influenced by the way the economic system is organized and the philosophy underpinning its system. If we examine the role of economic activities in Islam we will find that the philosophy of human activity should be directed towards the achievement of *Falah* a comprehensive human welfare in this life and also in the hereafter. According to Siddiqi (1972) *Falah* is a tangible quality towards the achievement of God's pleasure. Human welfare as believed by Muslims can be achieved without any conflict in the genuine interest of this worldly life and the Hereafter.

To achieve this *Falah*, economic activities must be morally directed. In any economic decisions, including financial reporting upon economic activities, the ethical values should act as a norm and economic relationship must be regarded as moral relationship. The achievement of *Falah* is neither dependent on nor related to maximization of wealth or profit nor to the size of the individual business enterprise and quantity of output. Therefore, to a profit making organization their activities should serve as a means for them to function in the economy. The worldview should be that they provide service to the public by manufacturing and/or trading goods or providing services and in return profit is only aim to ensure they can operate and grow.

Accounting functions to discharge the accountability of enterprise as a result of separation of ownership and the management. The users might be shareholders, creditors, potential investors and the public. In the Muslim society, the concept of accountability is ingrained in the basic creation of Man as a vicegerent of God on the earth. Man mission on earth is to fulfill the purpose of its existence in the universe. Man is thus created as trustees and accountable for all their actions (Abu-Sulayman, 1994). In Islam, accounting should function not only as a service activity providing financial information to the users and to the public at large but more important accountants should discharge their accountability by providing information to enable society to follow God's commandments.

The Muslims also believed that Men are vicegerents on earth and directly accountable for all their actions as they are only trustees of God. Therefore, in this sense, accountants should lay formal claim to the status of moral arbiters to ensure the responsibility and transparency of an organization's internal procedures, so that issues of policy and governance are properly debated and recorded, at the point where the moral problems arise in the first place (Gambling and Karim, 1991).

In the light of the above worldview of Islam, some ethical notions assume a broader and more holistic significance to the accountant. In terms of responsibility, the accountant in Islam is not merely responsible to human superiors, the management/client or shareholders. He/She is a servant and trustee of God in all situations, is simultaneously responsible to God the Owner of his very self and the resources he is utilizing and managing. To forget or to neglect this fundamental aspect of this responsibility is tantamount to a betrayal of divine trust with all the attending consequences in this world and in the next (Hassan, 1995).

The accountant in Islam is not only required to maintain good relationship with superiors, client or the management but also maintain, improve and strengthen his relationship with his Master by fulfilling the religious obligations. In fact the relationship with the Master (*Hablun Min'Allah*) will determine the mode of relationship with fellow servants (*Hablun Min'An-Nas*) (Hassan, 1995). Guided by the proper relationship with God, the human Accountant and public relations would then be inspired by value of truthfulness, fairness, tolerance and uprightness etc.

The accountant in Islam is motivated to provide work and excellent service because as a holder of *Amanah* (Trustee of God) on earth he must search for the bounties of God. His/Her work is a form of *Amal Salih* (virtuous deed) which is then the key for the attainment of *Falah* (true success in this world and in the hereafter). His/Her work is also a form of *Ibadah* (servitude to God) in so far as it is in conformity with the divine norms and values. The Accountant who is imbued with the world-view of *Tawhid* (oneness of God) is not anti profit or anti-worldly gain within the limits provided by religion. His vision of success and failure however extends beyond worldly existence to the life in the hereafter.

3. An Islamic Perspective of Accounting Objectives and Concepts

According to conventional accounting, accounting objectives and concepts are needed to guide existing accounting practice; prescribe future accounting practice; and define key terms and fundamental accounting issues (Miller, 1985). According to AAOIFI's Statement of Financial Accounting No.1 (AAOIFI SFA 1), the need for accounting objectives for Islamic financial institutions stemmed from the role of accounting. Since the role of financial accounting is to provide the information which users of the financial statements of Islamic banks depend on in assessing the bank's compliance with the precepts of syari'ah, therefore, in order for the Islamic financial institutions to perform the role effectively, accounting standards need to be developed and complied with by Islamic banks. The development of such standards must be based on clear objectives of financial accounting and agreed upon definitions of its concepts.

Allah SWT said:

"We shall set up justice scales for the day of judgement, not a soul will be dealt unjustly in the least. And if there be (no more than) the weight of mustard seed, we will bring it (to account); And enough are We to take account" (Al-Qur'an Chapter 21, verse 47).

"O you who believe! When you deal with each other, in transactions involving future obligations in a fixed period of time, reduce them to writing" and "Let a scribe write down faithfully as between the parties" (Al-Qur'an Chapter 2, verse 282)

Based on the above verses we can deduce that the objectives of accounting should be to ensure fair and just financial transactions between human beings. Accounting information is expected to fulfill the needs of those who are in need or expected to require such information. However, the primary objective of accounting information must be to fulfill the ultimate accountability to Allah SWT.

In addition to fulfilling the ultimate accountability to Allah SWT, the preparers of financial information must know the common information needs of users of financial reports. Common information needs of the users are normally consist of the needs for information which can assist in evaluating the entity's ability in using its economic resources and fulfill its obligations. In this respect AAOIFI's SFA 1 has broaden the scope beyond just economic responsibilities to encompass information that can assist in evaluating the entity's compliance with the principles of syari'ah and its ability to carry out social responsibilities specified by Islam

Some scholars have also argued that accounting objectives can be derived from the way one account for his or her zakat obligations (Adnan & Gaffikin, 1997). Adnan and Gaffikin (1997) argue that by making zakat the primary objective, one tend to avoid the unwanted practices of cheating or 'window dressing' because he or she believes that accountability to Allah SWT is of utmost important and Allah SWT always watches him or her.

On the other hand, accounting concepts are variously referred to as principles, axioms, postulates, assumptions and rules. One of the basic accounting principles is the use of historical cost for asset valuation that basically derived from the concept of conservatism. Many Islamic accounting writers (e.g. Gambling and Karim, 1991; Adnan and Gaffikin, 1997) cast doubt on the relevance of the concept of conservatism. Many refer to the principles of zakat where trade assets subjected to zakat must be based on current market value (Qardawi, 1999) or cash equivalent value (AAOIFI FAS 9). Adherence to the cost principles leads to the conventional accounting practice that is lower of cost or market value. This will lead to understatement of trade assets to be subjected for zakat. Thus, the cost concept cannot be acceptable in Islam.

The preparation of financial information in Islam should be aimed among others for zakat purposes. Thus, the aim for zakat purposes may lead to the need of periodicity assumption as zakat is only paid once a year. The periodicity assumption has led to the development of accruals accounting, and the principles of income recognition and matching. Therefore, accounting statements would, therefore, be prepared for that particular period, showing the amount of which zakat would be levied (Gambling and Karim, 1991).

4. Islamic Accounting Concepts on Recognition, Measurement & Disclosure

Accounting recognition refers to recording the basic elements of the financial statements. The concepts of accounting recognition define the basic principles that determine the timing of revenue, expense, gain and loss recognition in the entity's income statement and, in turn, the basic principles that determine the timing of assets and liabilities recognition. AAOIFI's SFA 2 recommends that "revenues should be recognized when realized". Realization of revenue shall take place when one of the three conditions are met: (1) The entity has the right to receive the revenue; (2) There is an obligation on the part of another party to remit; and (3) The amount of revenue should be known and collectible with reasonable degree of certainty.

The above recommendation indicates the use of accrual basis accounting which has been claimed to be better than the alternative cash basis accounting. Accrual basis of income recognition does meet the requirement of Islamic objectives to determine the 'real' wealth of an entity. Contrary to cash accounting, it likely provides an underestimate value of wealth as the recognition is based on actual cash received and paid.

In addition, according to the matching principle, expense recognition is realized either because the expense relates directly to the earning of revenues or because it relates to the period when the expense is incurred. From the Islamic perspective, the matching principle which allocates expenses to their related revenues, provides fairness and justice simultaneously to the shareholders and other stakeholders (El-Tegani,undated)

The conventional accounting measurement is based on the cost principle that considers the acquisition cost or historical cost as the appropriate measurement basis. However, this principle is questionable from the Islamic point of view due to it conflicts with the concept of fairness and justice. In the case of zakat determination, majority scholars recommended the use of current prices on the due date of zakat (Al-Qardawi, 1999). The argument for the use of current market value has been based on the needs for the most accurate valuation of wealth to be subjected for zakat in order to serve justice to both the zakat recipients and zakat payers.

AAOIFI, however, asserts that the measurement attributes should be guided by the relevance, reliability, understandability and comparability of the information to be provided to the users. AAOIFI has recommended the use of cash equivalent value that indicates the value that would be realized if an asset was sold for cash in the normal course of business as at the date of the financial statement. In order to ensure the reliability and comparability of the cash equivalent value, it must be supported with objective indicators; logical and relevant valuation methods; consistency of the use of valuation methods; expert valuation; and conservatism in the valuation process (AAOIFI SFA 1). AAOIFI also recommends an alternative method i.e. historical cost that refers to its fair value at the date of its acquisition including amounts incurred to make it usable or ready for disposition.

In terms of disclosure requirements, it is of interest to examine Baydoun and Willet's (1997) proposed objectives of accounting disclosure. They argued that there are at least four objectives of accounting disclosure for an Islamic firm, whereby the first two are specific requirements laid down by syari'ah for the firm to avoid riba' and pay zakah. The second two objectives are based on inferred general requirements which can be referred to as 'social accountability' and full disclosure'.

While the first two objectives i.e. prohibition of riba' and payment of zakat have extensively been covered by many past literature, the second two objectives require special attention. Baydoun and Willet (1997) viewed the Islamic concept of social accountability to encompass the accountability ultimately to God. The fundamental concept of Islamic accountability is where Muslims believed that all resources are made available to individuals in a form of trust. The success of individuals in the life hereafter depends upon their performance in this world.

The implications of Islamic accountability on accounting is that the management and providers of capital need to be accountable for their actions (or in-action) both within and outside the firm by providing proper accounting and reporting. Thus, the Islamic concept of social accountability departs clearly from the western attitudes toward accountability which are most applicable to the concept of private accountability.

The concept of social accountability in Islam is also related to the principle of full disclosure. According to Baydoun and Willett (1997) full disclosure does not mean to disclose everything down to every minute detail of transactions. There is, however, the need for the preparer of account to disclose everything that is believed as importance to users for purposes of serving God. In a more precise word, AAOIFI's Statement of Financial Accounting No. 2 on Concepts of Financial Accounting for Islamic Banks and Financial Institutions (SFA 2) made it very clear that the Islamic concept of disclosure revolved around the concept of 'adequate' disclosure. Here, adequate disclosure means that the financial statements should contain all material information necessary to make them useful to users.

AAOIFI's SFA 2 elaborated the concept of adequate disclosure into two aspects namely optimal aggregation and appropriate descriptions and clarifications. Optimal aggregation means the financial statements should provide sufficient details to meet the users' need for information. However, too much detail can contribute to confusion. Therefore, it needs appropriate descriptions and clarifications to make the information provided to be useful to users and sufficient additional notes become necessary.

5. Aaoifi Fas 17 & Accounting Issues On Investments In Islamic Securities

Background of the Standard

The AAOIFI Financial Accounting Standard No. 17 (AAOIFI FAS 17) shall apply to the institution's investments, whether in the form of direct investment funds or investment portfolios, in sukuk (Islamic bonds), shares, and real estate. The standard is relatively new that is it shall only be effective for financial periods beginning 1 Muharram 1424H or 1 January 2003. Thus, it makes the discussion of this standard necessary especially for institutions that have investments in Islamic capital market instruments. There is lack of academic writings in this area that require special attention to ensure proper accounting for complex instruments such as Islamic bonds (sukuk).

AAOIFI FAS 17 classifies Islamic bonds (sukuk) into at least four types:

(a) Mudaraba (Muqaradah) sukuk

These are investments in sukuk that represent ownership of units of equal value in the Mudaraba equity and are registered in the names of holders on the basis of undivided ownership of shares in the mudaraba equity and its returns according to percentage of ownership of share. The owners of such sukuk are the rabbul-mal (capital provider).

(b) Musharaka sukuk

These are investments in sukuk that represent ownership of Musharaka equity. It does not differ from the Mudaraba sukuk except in the organization of the relationship between the party issuing sukuk forms a committee from the holders of the sukuk who can be referred to in investment decisions.

(c) Ijarah sukuk

These are sukuk that represent ownership of equal shares in a rented real estate or the usufruct (benefit) of the real estate. These sukuk give their owners the right to own the real estate, receive the rent and dispose of their sukuk in a manner that does not affect the right of the lessee, i.e. they are tradable. The holders of such sukuk bear all cost of maintenance of and damage of the real estate.

(d) Salam or Istisna' sukuk

These are sukuk that represent a sale of a commodity on the basis of deferred delivery against immediate payment. The deferred commodity is a debt in-kind against the supplier because it refers to a commodity which is accepted based on the description of the seller. The Istisna' sukuk is similar to Salam sukuk, except it is permissible to defer payment in an Istisna' transaction, but not in a Salam. In both Salam and Istisna', the subject matter of the sale is an obligation on the manufacturer or builder in the case of Istisna' and the seller in the case of Salam. Hence both instruments can neither be sold nor traded before their maturity date if either the buyer or the seller of the commodity issues them. Accordingly, these sukuk are treated as investments held to maturity.

Classification of Investment

One notable contribution of AAOIFI FAS 17 is the classification of investment in sukuk into three types namely: for trading purposes; available for sale; and held to maturity. The basis of AAOIFI classification is based on the well-known syari'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; (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.

However, if we examine the conventional classification of investment in securities, normally it is only classified into 2 types i.e. either dealing (short-term); or investment (long-term). 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, the main problem of classifying the investments is to objectively determine the intention of the investors and intention may also subject to change overtime due to the changes in economic climate.

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 income statement.

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 fulfils the syari'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

In the case of sukuk held to maturity, it needs to be measured based on historical cost except that if there is impairment in value it 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 need to be disclosed in the notes to the financial statements. For securities held for trading and available for sale, AAOIFI FAS 17 recommends the measurement to be based on fair value.

Fair value is normally defined as the amount which the instrument could be exchanged or settled between knowledgeable and willing parties in an arm's length transaction, other than forced or liquidation sale. Quoted market price, when available, normally are used as the measure of fair values. However, for many financial instruments and it may include Islamic bonds (sukuk), quoted market prices may not available. In the case of unquoted securities, conventionally the estimate is 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 used of discount rates, future cash flows, expected loss and other factors.

The determination of fair value for unquoted securities requires the availability of objective indicator and expertise, as well as conservatism in the valuation process. 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 (El-Tegani, undated).

In the case of securities held to maturity, the rationale of AAOIFI's FAS 17 to recommend historical cost rather than fair value could be because of 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 prescribes that 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 as defined 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.

In the case of dividends received from investment in shares and sukuk, the standard requires it to be recognized in the income statement at the declaration date rather than at the date when the cash proceed is received. This indicates the use of accrual basis of accounting to ensure that the institution recognized income when it is realized based on the contract or the right to receive that income. The use of accrual here is required in order 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 to be shared by 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 to be provided to users of accounting information particularly on the distribution of profit between equity holders and depositors.

Disclosure

AAOIFI's FAS 17 has made special requirements of disclosure in the case of investments in sukuk. Among the requirements are that disclosure shall be made by the issuer of sukuk, if material, the face value of sukuk, the percentage of sukuk acquired from 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 indicates the need for the Islamic institutions to be more transparent in disclosing financial information pertaining investment in securities especially sukuk. The underlying rationale is to provide useful information for users to make informed judgement especially about institution's investment in securities. The users are expected to require all the above information and disclosure not only with respect to the risks of investment undertaken and the potential return (full disclosure) but the contractual relationships of the parties involved that is expected to fulfill the syari'ah requirements (social accountability).

6. Concluding Remarks

The need for Islamic accounting that deals with Islamic financial instruments has prompted AAOIFI recently 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 that Islamic accounting objectives, concepts and principles to be developed based on syari'ah requirements. However, the Islamic accounting regulation also needs to adapt to the modern accounting regulatory environment to make it relevant to be practiced in our time. The examination of AAOIFI FAS 17 shows that AAOIFI has been pragmatic in its approach by considering both requirements when developing its standard. This is a pro-active step to provide a sound accounting regulation as part of a comprehensive regulation of Islamic financial institutions.

The development of modern accounting has shown that accounting itself is an emerging and pragmatic discipline. Another paramount challenge and conventional accounting is of no exception, is compliance of the standard. For the standard to be adopted by commercial participants, the regulatory agencies of respective Muslim states at least must be convinced not only for the need of such standard but the necessity to adopt it as a mandatory requirement.

Another pre-requisite for a sound accounting regulation is the credibility of standard setter. In the case of AAOIFI, the credibility of its standard will be subjected to 'acid' test of acceptance by commercial participants especially Islamic financial institutions. In addition, another challenging task would be the acceptance of juristic rules made by AAOIFI's board of syari'ah scholars by Islamic financial institutions worldwide. As syari'ah opinion can be subjected to vast differences among scholars, this leads to another need that is a standard or a codified syari'ah rules based on consensus of credible Muslim scholars of our time that transcends beyond geographical boundaries of nation states.

Finally, the development of a new discipline called Islamic accounting establishes an urgent need for the accounting academics and practitioners to undertake studies that attempt to understand how accounting is influenced by and adapted to the way the economic system is organized and the philosophy underpinning its system. The interests on Islamic accounting has been growing for the past two decades, however, the development of Islamic accounting is still at the infancy stage. This paper is just a small contribution to the literature on contemporary accounting regulatory issues on investments in Islamic bonds or sukuk.

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