A critical analysis of Islamic bond: A case study on Sunway Treasury Sukuk

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Abstract

Sukuk has been playing a significant role in developing Islamic finance, more specifically, Islamic capital market. Islamic financial institutions have very limited number of liquid investments other than hard cash to hold as conventional short-term bonds, commercial papers and notes are interest based and prohibited in *Shari'ah*. The rapid growth in *Sukuk* market not only in Malaysia but also internationally indicates huge potential of this innovative financial instrument. In this paper, an attempt has been made to study accounting issues connected with Sunway treasury *sukuk* and we discussed in details financial performance of Sunway group, accounting disclosure needed for *Sukuk* issuance, model accounting treatment of *Mudarabah sukuk* in general and Sunway Treasury *Sukuk* in specific, in depth analysis of *Shari'ah* issues related with the *Sukuk*, various risks associated with it. Our analysis shows that Sunway Group is a one of the leading construction and development in company in Malaysia and it has presence in other south-east Asian country also in India. The slowing down in real-estate industry has put a lot of pressure on Sunway and it has been evident in the financial statements of the company. We found that accounting of *Sukuk* is not necessarily different from conventional bond, even though, we consider Sukuk to be closer to equity but in reality it is closer to debt. Analysis shows that IFRS and AAOIFI accounting have different objectives and perspectives. Subsequently, IFRS is more concerned with the substance, while AAOIFI focuses on legal form while considering accounting transactions, however, *Sukuk* in both cases are shown as a liability in the balance sheet. It is found that some authors argue that in addition to preparing its own accounts as SPV, accounts should be prepared for the investment fund represented by the *sukuk* in accordance with Financial Accounting Standard 14 "Investment Funds". Capital guarantee, fixed rate Mudarabah, later payment charge, promise to buy back are found to be critical *Shari'ah* issues in Sunway Treasury *Sukuk*. Default risk in Treasury *sukuk* is very low considering company reputation and its huge fixed asset back of more than 3000 acres of land. The *sukuk* has some sort of market risk, namely interest rate/profit rate risk in rising interest rate environment. Shari'ah risk found to be the main problem of this *Sukuk*.

Key words: AAOIFI, IFRS, Islamic finance, *Shari'ah*, *Sukuk*,

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1. Introduction

Islamic finance has been growing rapidly for the last two decades owing not only to Islamic banking development but also *Sukuk*, Islamic funds and *Takaful* (Islamic insurance). Islamic finance assets grew at double-digit rates during the past decade alone, from about USD 200 billion in 2003 to an estimated USD 1.8 Trillion at the end of 2013. In spite of this tremendous growth, Islamic Finance assets still concentrated in the Gulf Cooperation Council (GCC) countries, Iran and Malaysia and represents approximately 1% of the global financial market of $127 Trillion in assets. According to the Ernst & Young and the Malaysia Islamic Financial Centre, *sukuk* market size would be USD 3.4 Trillion by end of 2018.

In the past few years, the global *sukuk* market had witnessed solid growth, as annual issuances almost tripled from USD45 billion in 2011 to USD118.8 billion in 2014. Of significance, growth was driven by both the key markets of Malaysia, Saudi Arabia and the United Arab Emirates (UAE), as well as emerging frontiers such as Turkey and Indonesia. More recently in 2014, landmark issuances were recorded from the UK, Hong Kong, Senegal, South Africa and Luxembourg – cementing the *sukuk* market's status as a viable and competitive source of funding.

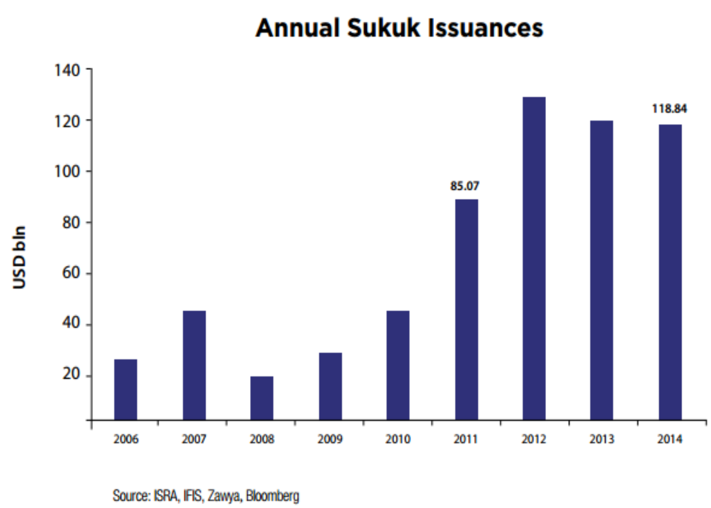

Figure 1 Annual Sukuk Issuance

In addition, a few positive trends emerged in the past year, signalling more cross-border activity in the *sukuk* market. The market had witnessed increased issuances in foreign currency *sukuk*, especially in USD; while Malaysia attracted issuances from other domiciles such as Singapore and Turkey. Apart from issuances, *sukuk* listings also pointed to more cross-border activity as issuers increased listings on key stock exchanges particularly in Europe – namely the London Stock Exchange, Irish Global economic uncertainties weighed on the *sukuk* market in 1Q 2015. Another notable trend in 2013 to 2014 were the issuances of *sukuk* which to support Islamic financial institutions' compliance with Basel III liquidity and capital requirements. Overall, the *sukuk* market had reached new heights over the past few years, accompanied by a wider issuer base, more cross-border activity and more innovative issuances.

2. What is *Sukuk*

Sukuk is the Arabic name and is derived from the word sakk for the singular and *sukuk* for the plural one. The term is used to be referred to legal instrument, check and deed. In classical practice, *sukuk* was used as papers representing financial obligations originating from trade and other commercial activities. However, *sukuk* as applied in the capital markets pertains to the process of securitization and is generally defined as an Islamic bond (Kamil, 2008).*Sukuk* are referred to as 'Islamic bonds' but the correct translation of the Arabic word of *Sukuk* is, 'Islamic Investment Certificates'.

Sukuk are defined by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) as certificates of ownership in a pool of underlying assets, in which the certificates are of equal value. *Sukuk* are issued with the aim of using the mobilised funds for establishing a new project, developing an existing project, or financing a business activity as per the respective shares. Under *Sukuk* structure, the *Sukuk* holders (investors) each hold an undivided beneficial ownership in the "*Sukuk* assets'(Thomas et al, 2005, p.154)

These *Sukuk* represent the proportional ownership of an existing asset or a pool of diversified assets, and a pledge against existing or future cash flows generated from these assets for a specified period of time. The risk and return associated with underlying assets and these cash flows are passed to *sukuk* holders. These assets may be tangible or intangible, existing or described with deferred delivery, usufruct or services. Under *Sukuk* structure the investors, *sukuk* holders each hold an undivided beneficial ownership in the underlying assets.

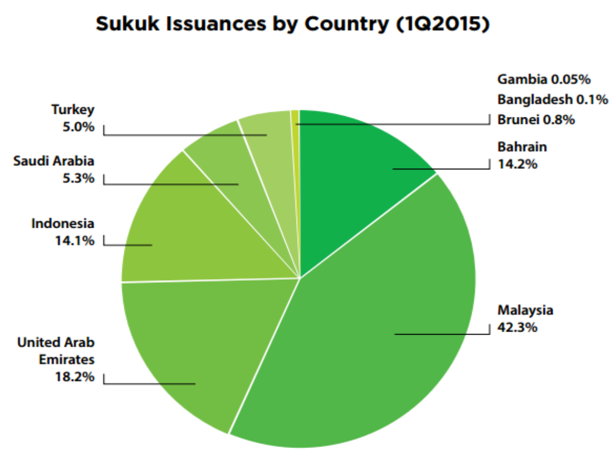

Figure 2 Sukuk Issuance by country

The interest-based system prevalent in the world today regularly issues bond that yield interest from capital from capital-intensive enterprises that bring great profits and regular revenues. The holder of such certificates are no more than lenders to the sponsors of enterprises and their earnings come from the interest on their loans in a percentage that accords with the price of interest in the marketplace. The profit of the enterprises after deduction of costs, including interest payments, return exclusively is to the sponsors.

There are different kinds of *sukuk* of different maturities that can be issued in a *shari'ah*-compliant manner. In our case, *mudharabah sukuk* is directly related to further discussion. In the following paragraph we discuss this type of *sukuk* and its salient features.

2.1. *Mudharabah Sukuk*

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI, 2004) has defined *mudharabah sukuk* as certificate represents ownership of units of equal value in *mudharabah* equity and registered in the names of holders on the basis of undivided ownership of shares in *mudharabah* equity and its returns according to the percentage of ownership of share. The owners of such *sukuk* are the rabbul maal.

This *sukuk* give its owner the right to receive his capital at the time the *sukuk* are redeemed, and an annual portion of the realized profits as mentioned in the issuance publication. The *sukuk* can play a vital role in the process of development financing, because it is related to the profitability of the projects. Financing through *mudharabah* is more efficient in term of the allocation of resources compared with financing based on interest rate, which does not reflect the profitability of the projects.

According to Al-Bashir (2001), *mudharabah sukuk* is a tool for investment to raise funds, which is based on dividing *mudharabah* capital by equal value units, which are registered under *sukuk* holder's name (recorded bonds), which reflect the common asset in *mudharabah* capital. In other words, *mudharabah sukuk* mean the document of definite value issued in the name of their owner against funds they pay to the owner of the project. *Sukuk* owners acquire a definite proportion of the project profit, which is set out in the *sukuk* issuance publication (prospectus). *Mudharabah sukuk* neither yield interest nor entitle owner to make claims for any definite annual interest. This means that *mudharabah sukuk* are like shares with regard to vary returns, which are accrued according to the profits made by the project.

Besides that, *mudharabah sukuk* must represent a common ownership and entitle their holder to shares in a specific project for which the *sukuk* have been issued to fund. A *sukuk* holder is entitled to all rights, which have been determined by *shari'ah* upon his ownership of the *mudharabah sukuk* in matters of sale, gift, mortgage, succession and other. The contract in *mudharabah sukuk* is based on the official notice of *sukuk* sale. Subscription in these *sukuk* is considered as an offer from the investor and approval of the issuer is then regarded as acceptance of the contract. Official notice of sale must contain all the conditions which are required by *shari'ah* in *mudharabah* contract and the distribution of profit should be in conformity with *shari'ah* rules.

On the other hand, *sukuk* holder is given the right to transfer the ownership by sale or trade in the securities market at his discretion on the expiry of the specified time period of the subscription. Then, the disposal or sale of the *sukuk* must follow the rules that stated below (Saiful, 1999):

- If the *mudharabah* capital after the subscription period is over and before the operation of the specific project still in the form money, therefore, the trading of *sukuk* would be based on the exchange of money for money and it must satisfy the rules of sarf.

- If such capital is still in form of debt, it must be based on the principle of Islamic debt trading or exchange debt for debt.
- If such capital is in the form of money, debt, assets and benefits, trade must be based on the market price evolved by mutual consent.

With regard to distribution of profit, the following rules must be observed (Saiful, 1999):

- The *mudharib*, the person who has received the fund also been charged with the duty to run the affairs of the specific project or business, profit realized from investment in *mudharabah sukuk* will be distributed between the *mudharib* and investor according to the agreement.
- *Mudharib*'s share with the investor, the ownership of the assets in accordance with his participation to the total value of the company/project assets.
- It is not permissible to guarantee him a fixed lump sum amount of profits
- The issuer has the right to purchase *sukuk* offered for the sale by others according to the prices declared from time to time by the issuer.
- The *mudharib* is considered as the depositary of the common fund and the project assets entrusted to him. If he is negligent or has committed dishonesty leading to losses, he shall be liable for the losses.

In matter of concerning the guarantee of *mudharabah sukuk*, the following points must be observed (Saiful, 1999):

1. It is permissible for the third party (the government) to promise to compensate any losses sustained in the specific project. However, this guarantee should be concluded in a separate contract and not included in the main contract of *mudharabah sukuk* between issuer and the investor.
2. It is not permissible for the issuer to guarantee the capital of the *mudharabah* (the investor would not bear any loss in the value of the *sukuk*) or to guarantee the investor a fixed amount paid as profit.
3. It is permissible for the *mudharib* and the investor to agree to put aside a specific or certain portion of the profit as reserves to provide for protection or to meet any losses arising during the implementation of the project.

The Figure 3: A typical *Mudharabah Sukuk* Structure contains structure of *mudharabah sukuk* and its detail explanations:

1. Setting up a *mudharabah* venture – issuer shall invite the investors to participate in the *mudharabah* venture. Under this venture, the issuer shall be the entrepreneur (*mudharib*) whereas the investors shall be the capital providers (rabbul maal).
2. The Issuer shall issue the *Sukuk Mudharabah* to investors ("*Sukuk*holders")

3. Proceeds from the *Sukuk Mudharabah* represent 100% of the *Sukuk*holders' capital contribution in the said *Mudharabah* Venture.
4. The Issuer shall subsequently make a declaration of trust ("Declaration of Trust") over the undivided rights and entitlements of the *Sukuk*holders under the *Mudharabah* Venture ("Trust Assets") for the benefit of the *Sukuk*holders. The *Sukuk Mudharabah* hence represents each of the *Sukuk*holders' undivided proportionate beneficial interests in the *Mudharabah* Venture.

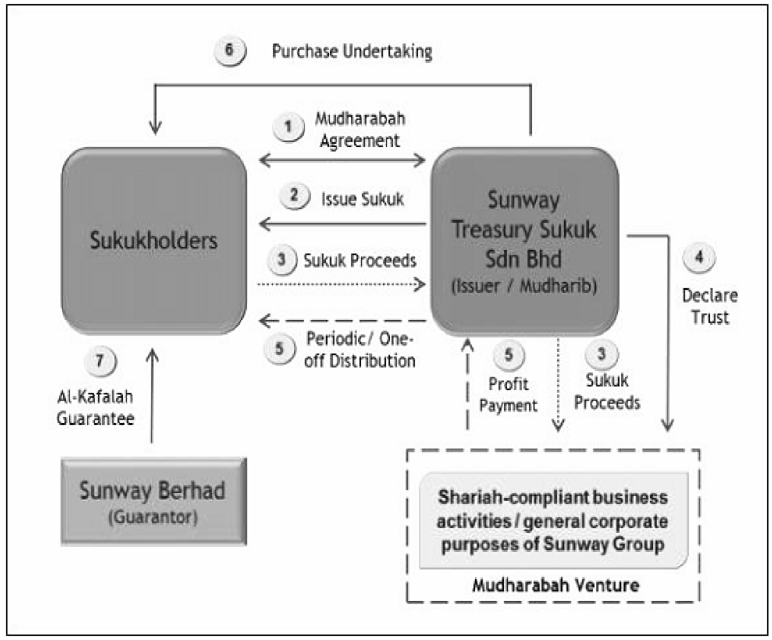

Figure 3 Sunway Mudarabah Sukuk Structure

5. Profits generated from the *Mudharabah* Venture will be shared and distributed between the Rabb al-mal and the *Mudharib* according to a pre-agreed profit sharing ratio ("PSR") of 99:1, while losses will be borne solely by the Rabb al-mal. In respect of *Sukuk Mudharabah* with periodic distributions, the payment of profits shall be distributed semi-annually or such other period to be agreed ("Periodic Distribution(s)") to the *Sukuk*holders. In respect of *Sukuk Mudharabah* without Periodic Distribution(s), the payment of profits shall be distributed to the *Sukuk*holders on a one-off basis (the "One-off Distribution") on the respective maturity dates of such *Sukuk Mudharabah*.
6. The Issuer shall undertake to purchase the Trust Assets from the Trustee (acting on behalf of the *Sukuk*holders) via a Purchase Undertaking upon occurrence of the earlier of the respective maturity dates of the *Sukuk Mudharabah* or declaration of a Dissolution Event or on Early Redemption.
7. Sunway Berhad (as "Guarantor") shall guarantee the obligations of the Issuer under the Purchase Undertaking. The Guarantor shall enter into a separate Kafalah Agreement with the Issuer to provide the guarantee, which is an independent arrangement from the *Mudharabah* Agreement.

3. A Brief overview of Sunway Treasury *Sukuk*

Issue Facts	
Sukuk Name	Sunway Treasury *Sukuk*
Tradable	Malaysia
Status	Closed
Type of Structure	*Mudharabah*
Issuer Type	Corporate
Currency	MYR
Tenor	7 Years
Market Type	Domestic
Feature	Fixed
Key Dates	
Maturity Date	06Jun22
Closing Date	05Jun15
Restrictions & Legal	
Securities/Guaranties	Sunway Berhad
Parties	
Trustee	Pacific Trustees
Paying Agent Malaysia	Bank Negara
Legal Advisor Allen & Gledhill	Lee Hishammuddin

Issue Size	ICPs and IMTNs Tranches (appendix-?)
Program Size	MYR 2,000,000,000
Profit Rate Details	
Profit Rate	7.25 %
Issuer Facts	
Issuer Name	Sunway City Berhad
Sector	Conglomerates
Country	Malaysia
Advisors	
Lead Manager	Kenanga Investment Bank Berhad
Arranger/ Advisor	Kenanga Investment Bank Berhad
Related Debt	
Name (Size)	Sunway City MMTN *Sukuk* (MYR 215,000,000)
Rating	
Agency	Rating (Date) MARCAA- 14 Sep 2015 **(later RAM has withdrawn its rating**

Use of proceeds	The proceeds will be used to finance investment activities, capital expenditure, working capital requirements and repay future borrowings.

3.1. Company overview

The Issuer is a wholly-owned subsidiary of Sunway Treasury Sdn Bhd (STSB), which in turn is a wholly-owned subsidiary of Sunway. STSB was incorporated in Malaysia as a private limited company on 5 June 1997 as Alpine Angle Sdn Bhd. On 24 March 1998, Alpine Angle Sdn Bhd changed its name to Sunway Monorail Sdn Bhd and subsequently to Sunway Treasury Sdn Bhd on 5 July 2011. STSB has acquired the status of a treasury management centre on 29 March 2013. Sunway, the Guarantor in respect of the *Sukuk* Programme was incorporated in Malaysia as a private limited company on 10 November 2010 as Alpha Sunrise Sdn Bhd and subsequently changed its name to Sunway Sdn Bhd on 23 November 2010. On 30 November 2010, Sunway converted into a public limited company and assumed its current name. On 23 August 2011, Sunway was officially listed on the Main Market of Bursa Securities.

3.2. Financial performance of Sunway Sdn Bhd

Year over year, Sunway Berhad has seen revenues fall from 4.7B MYR to 4.6B MYR. This along with an increase in SGA costs has led to a reduction in the bottom line from 1.5B MYR to 734.0M MYR. In the mean time, net interest expense has decreased from -92.30M MYR to -28.30M MYR.

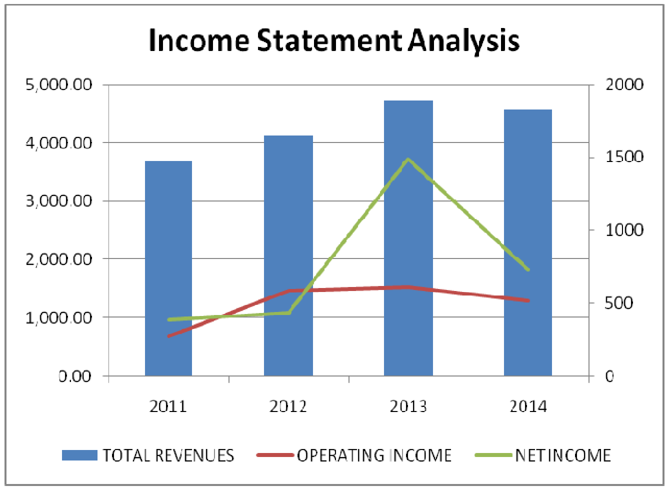

Figure 4 Income Statement Analaysis

Sunway's balance sheet shows that although debt as a percent of total capital increased over the last fiscal year to 38.33%, it is still in-line with the Real Estate Management and Development industry's norm. Additionally, even though there are not enough liquid assets to satisfy current obligations, Operating Profits are more than adequate to service the debt. Cash Collection is a strong suit as the company is more effective than most in the industry. As of the end of 2014, its uncollected receivables totaled 1.2B MYR, which, at the current sales rate provides a Days Receivables Outstanding of 92.04. Last, Sunway Berhad is among the least efficient in its industry at managing inventories, with 228.36 days of its Cost of Goods Sold tied up in Inventories.

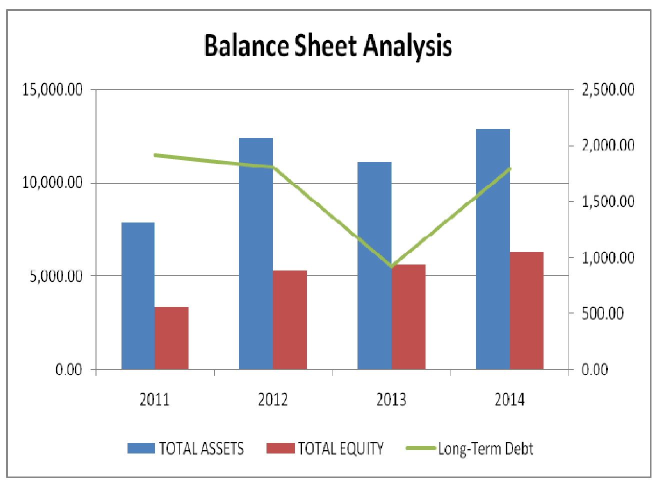

Figure 5 Balance Sheet Analysis

Now that we understand the anatomy of an income statement, we can deduce from the above data that between the years 2013 and 2014,Sunway group can't managed to increase sales, it was reduced by 4%, while increasing its cost of sales 10 percent. Consequently, gross income in 2014 decreased significantly, which is negatively affect for the company's profitability. Also, general operating expenses haven't been kept under strict control, increasing by 45 million.

As a result, the bottom line - net income - for the Sunway group has decreased from 1490.4 in 2013 to 734.0 in 2014.The negative inter-annual trends in all the income statement components, both income and expense.

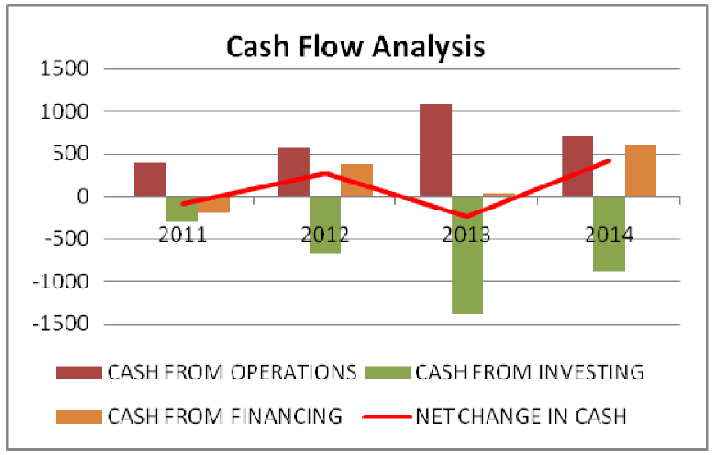

Figure 6 Cash Flow Analysis

The cash flow statement for the Sunway group shows there was a 230.6 cash shortfall in 2013 and positive cash change 421.2 in 2014 . As can be seen from the cash flow statement, the cash drain is primarily from the investment of 1377.4. The statement also shows the cash flow from financing activity was a positive 421.2 in 2014.

3.3. Ratio analysis of Sunway Group:

The Sunway group has an ROA of 2.89%, indicating that for every $1 of company assets, the company is generating $0.0289 in net income. The ROE in our example of 14.59% suggests that for every $1 in shareholder's equity, the firm is generating $0.1459 in net income. Gross profit margin is simply gross income (revenue less cost of goods sold) divided by net revenue. The ratio reflects pricing decisions and product costs. The 33.06% gross margin for the sunway company shows that 33.06% of revenues generated by the firm are used to pay for the cost of goods sold. The debt-to-assets ratio is the most basic solvency ratio, measuring the percentage of a company's total assets that is financed by debt. The ratio is calculated by dividing total liabilities by total assets. A high number means the firm is using a larger amount of financial leverage, which increases its financial risk in the form of fixed interest payments. In this company's total liabilities accounts for 65.51% of total asset.

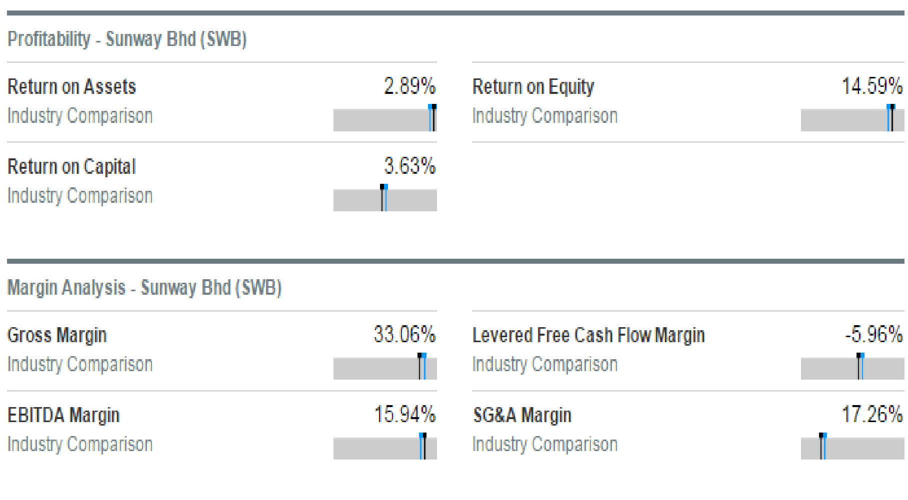

Figure 7 : Profitability Ratio Analysis

The current ratio measures a company's current asset against its current liabilities. The current ratio indicates if the company can pay off its short-term liabilities in an emergency by liquidating its current assets. A low current ratio indicates that a firm may have a hard time paying their current liabilities in the short run and deserves further investigation. A current ratio under 1.0x, means that even if the company liquidates all of its current assets, it would still be unable to cover its current liabilities. The firm is operating with a good current ratio of 1.3x. The quick ratio is a liquidity ratio that is more stringent than the current ratio. This ratio compares the cash, short-term marketable securities and account receivable to current liabilities. The thought behind the quick ratio is that certain line items, such as prepaid expenses, have already been paid out for future use and cannot be quickly and easily converted back to cash for liquidity purposes. In our example, the quick ratio of 0.9x indicates that the company can only cover 90% of current liabilities by using all cash-on-hand, liquidating short-term marketable securities and monetizing accounts receivable.

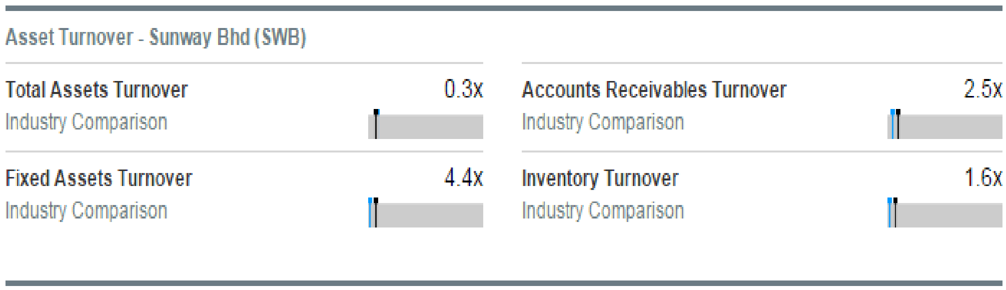

Figure 8: Asset Turnover Ratio

4. Accounting of *Mudharabah Sukuk*

4.1. Financial disclousres for the *sukuk* transaction

Financial statement disclosures refers to provide internal and external business stakeholders with additional information regarding a company's financial operations. Larger business organizations often use disclosures to provide additional information to lenders and investors. Disclosures can be required by generally accepted accounting principles or voluntary per management decisions.

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.

IFRS are published by the International Accounting Standards Board (IASB). In 2001 the IASB adopted its "Framework for the Preparation and Presentation of Financial Statements." Paragraph 12 states:

"The objective of financial statements is to provide information about the financial position, performance and changes in financial position of an entity that is useful to a wide range of users in making economic decisions."

In paragraph 33 and 34 the framework emphasises the need to faithfully represent the transactions that have taken place:

To be reliable, information must represent faithfully the transactions and other events it either purports to represent or could reasonably be expected to represent. Thus, for example, a balance sheet should represent faithfully the transactions and other events that result in assets, liabilities and equity of the entity at the reporting date which meet the recognition criteria.

Most financial information is subject to some risk of being less than a faithful representation of that which it purports to portray. This is not due to bias, but rather to inherent difficulties either in identifying the transactions and other events to be measured or in devising and applying measurement and presentation techniques that can convey messages that correspond with those transactions and events. In certain cases, the measurement of the financial effects of items could be so uncertain that entities generally would not recognise them in the financial statements; for example, although most entities generate goodwill internally over time, it is usually difficult to identify or measure that goodwill reliably. In other cases, however, it may be relevant to recognise items and to disclose the risk of error surrounding their recognition and measurement.

Paragraph 35 emphasises the importance of substance over form:

If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality and not merely their legal form. The substance of transactions or other events is not always consistent with that which is apparent from their legal or contrived form. For example, an entity may dispose of an asset to another party in such a way that the documentation purports to pass legal ownership to that party; nevertheless, agreements may exist that ensure that the entity continues to enjoy the future economic benefits embodied in the asset. In such circumstances, the reporting of a sale would not represent faithfully the transaction entered into (if indeed there was a transaction).

The above questions illustrate that the two standard-setting organisations have different priorities. The implications will be seen when the accounting for *sukuk* transactions is considered in detail. As accounting issues are much easier to understand when illustrative numbers are available, this chapter considers two transaction scenarios.

4.2. Accounting treatment according to AAOIFI

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.

Sunway Treasury *Sukuk* Sdn Bhd establishes an intermediary namely Pacific Trustee's Berthad as a (SPV) to issue the *sukuk* on behalf of the Sunway Treasury and transfers the functions of finance and executing the project. SPV sells the *mudharabah sukuk* to the investors to raise the fund and pays its debt to the contractor. SPV undertakes to execute the project and it is paid in form at *mudharabah sukuk* with certain maturity dates.

Investments on *mudharabah sukuk* give a number of accounting and reporting issues like, Recognition, Measurement & Disclosure.

4.2.1. Recognition

AAOIFI's FAS 17 has recommended that recognition for investment in *mudharabah 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.

4.2.2. 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.

4.2.3. Disclosure

AAOIFI's FAS 17 has made special requirements of disclosure in the case of investments in *mudharabah 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.

4.3. Classification of Investment and *sukuk* under AAOIFI FAS' 17

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. On the other hand Islamic bond is classified into- sale based, leased based, partnership based and agency based *sukuk*.[2]

After analyzing IFRS and AAOIFI we can argue that, IFRS analyses the *sukuk* transaction entirely on the basis of its economic substance and sees it as a financing transaction. Fundamentally, this derives from the requirement to repurchase *Sukuk* at a fixed price irrespective of the market value. On the other hand, the main purpose of AAOIFI accounting is to satisfy the religious needs of the users of the accounts. Accordingly AAOIFI does not allow substance to determine the presentation of the accounts but instead gives significant weight to the legal form of contracts and *Shari'ah* requirements are overriding.

5. Accounting issues on *mudharabah sukuk*.

5. 1. Measurement of asset and liability

FAS 17, *Mudharabah sukuk* Financing is a standard for the provision of *mudharabah* financing by
the Islamic bank and does not deal with the deposit side of receiving the funds on *mudharabah* basis.

I. When the capital is paid to the *mudharib* or placed in his disposition (for example, credited to his account) then *Mudharabah sukuk* capital is recognized by debiting cash and *Mudharabah sukuk* credit.

II. If the capital is paid in installments, each installment is recognized as capital when paid. If payment of capital is conditional of an occurrence of a future event or delayed to a future time, capital is recognized only when it is paid to the *mudharib*.

III. If capital provided by investor is in kind (trading assets or non-monetary assets), the capital shall be valued at fair value of the assets. Any difference between fair value and book value shall be recognized as profit or loss to the bank. .

IV. If a partial loss of the capital occurs (e.g. theft or fire) before the work on the contract is started (and this is NOT caused by negligence of the *mudharib*, this should also be deducted from *mudharabah sukuk* account and debited to profit and loss account.

V. If the whole of the mudarba *sukuk* capital is lost, (not due to mudraibn then the investor or *sukuk* holders must bear the loss, and terminate the contract.

[2] Islamic Financial System, Principle and Operation, ISRA, page-399.

VI. Any unpaid amounts remaining become a receivable of investors from the trustees.

5.2. Measurement of profit and losses

I. If a *mudharabah sukuk* starts and finishes within the financial year, profit and losses (investrs's share) should be recognized by the trustees in that financial year.

II. If a mudraba *sukuk* transaction carries on after the financial year end, the profit or losses should be recognized in the accounts for that period. To the extent that profits are distributed.

III. If the mudraba *sukuk* is terminated or settlement is made and the trustee has not paid the profits to the investors, this will be treated as a receivable from the trustee.

IV. Any misconduct or negligence of the *mudharib* or trustee resulting in losses will be borne by him and it becomes a receivable due from him or trustee.

5.3. Measurement of valuation of the assets.

Basically there are two terms first, assists based and second, assets back. In term of the assets, the *sukuk* holder ultimate owner of the asset on the other hand in case of the asset back, they (*sukuk* holders) need to return the assets after particular time.

5.4. Disclosure

Any provision made for the decline in the value of *Mudharabah* assets should be disclosed in the notes to the account.

6. Journal entries of the *mudharabah sukuk* transaction

6.1. Recognition of Asset and Liability

Mudharabah sukuk issue	Cash……………………….DR. *Mudharabah sukuk*………...CR (being issued *sukuk* and received cash)

6.2. Recognition of Profit/ Income or Loss/ Expense

Income or profit generated from Sunway Treasury *Sukuk* Sdn Bhd	Cash ……………..……….DR *Mudharabah sukuk*………..CR (being received profit)
Income or profit distributed to *sukuk* holders.(IMTN)	*Mudharabah sukuk* ……..…DR Cash………………………CR (being distributed profit to the *sukuk* holders)
Income or profit distributed to the *sukuk* holders.(one month ICP profit with principle)	*Mudharabah sukuk* …………DR Cash(profit)…………………CR Cash (principle)…………….CR (being distributed income and principle to the holders of the Islamic commercial paper)
Loses from the transaction but it is due to the negligence of *mudharib.*	*Mudharabah* issuer account …DR Cash………… ……………..CR (being losses from the transaction)
Trustee fees	Fee expense………………....DR Cash ………………………...CR (being paid the fee of the SPV)

6.3. Valuation of Asset

Termination of the contract	*Mudharabah sukuk* …………….DR. Cash……………………..…...CR (being terminated the contract)
Termination of the contract with lower amount	*Mudharabah sukuk*………....DR Account payable …………CR Cash………………………CR (being terminated the contract with lower amount then the book value)

6.4. Balance sheet and income statement.

Balance sheet:-	
Liability *Sukuk mudharabah*	**(XXX)**
Income statement:-	
Income from *mudharabah sukuk*	**XXX**
Profit attributable to the *Mudharib* and	**(XXX)**
Profit attributable to *Sukuk* holders	**(XXX)**
SPV fee	**(XXX)**

In summary, there are two parts in Mudarabah *sukuk* namely accounting treatment and reporting issues in the financial transaction of the organization. Accounting reporting like recognition, measurement and disclosures that will ensure transparency and accountability of the issuers, on the other hand, it creates faithfulness to *sukuk* holders or investors as well. Accounting treatment indicates enrolment of the particular transaction on the basis of the category of the transaction like measurement of the profit and losses, liability, valuation of the asset estimation of the income statement balance sheet on the basis of the periodic assessment. Finally, it is also indicate the social responsibility.

7. Asset based vs Asset backed

There are two types of *Sukuk*, asset based and asset backed. Under the asset based *Sukuk*, the *Sukuk* holders have beneficial ownership in the asset. The *Sukuk* holders have recourse to the originator if there is a shortfall in payments. The beneficial ownership is a legal term where specific property rights, such as its use and title belongs to a person even though legal title of the property belongs to another person. A common example of beneficial owner is the owner of funds held by a nominee bank or for stocks held in the name of brokerage firm.

Under asset backed *Sukuk*, the *Sukuk* holders owned the asset and as a result do not have recourse to the asset but to the originator if there is a shortfall in payment (Afshar, 2013).

Table 1 Asset Based Versus Asset Backed *Sukuk*

Asset based	**Asset backed**
1. No right over assets	1. Recourse to assets
2. Risk with originator	2. Risk with assets

3. Assets are used as security interest	3. Securitization
4. *Sukuk* holders are creditors	4. Assets are ownership interest
5. Assets remain on originator's book	5. *Sukuk* holders are owners
6. In case of sales of assets, investors receive their face value, all excess goes to the originator	6. Financial and legal due diligence are detailed because investors are paid from the asset's cash flow and redemption
7. Recourse to originator	7. Recourse to assets

Source: Afshar, 2013

In conventional financing, asset-backed securities are issued pursuant to a securitisation transaction involving the transfer of assets or risks to investors by fulfilling certain criteria on the securitised assets, originator and tme sale. For example, the assets must generate cash flow, and the originator must have a valid and enforceable interest in the assets and in the cash flows of the assets prior to any securitisation transaction. Moreover, there must be no impediments (contractual or otherwise) that prevent the effective transfer of the assets or the rights in relation to such assets from an originator to an SPV, and the assets must be transferred at fair value.(Lahsasna et al., 2013).

Therefore, *sukuk* that are asset-backed should ideally mirror the securitisation practice in the conventional space whereby *sukuk* holders are the owners of the asset and the performance of the asset is the driver of the payment to *sukuk* holders. However, asset-based *sukuk* are said to behave more like a bond issuance whereby *sukuk* holders may (or may not) have security interest (but not the ownership interest that is mandatory for asset-backed *sukuk*) i.e., collateral over the assets only (Lahsasna et al., 2013).

According to Moody's definition, asset-backed *Sukuk* are those whose "investors enjoy asset backing; they benefit over some form of security or lien over the assets, and are therefore in a preferential position over other, unsecured creditors. In other words, in the event the issuer were to default or become insolvent, the *Sukuk* holders would be able to recover their exposure by taking control of and ultimately realizing the value from the asset(s). It also requires the element *of securitisations to be present—true sale, bankruptcy remoteness and enforceability of security"*.

On the other hand, Moody's describes the features of asset-based *Sukuk* structure, "the originator undertakes to repurchase the assets from the issuer at maturity of the *Sukuk*, or upon a predefined early termination event, for an amount equal to the principle repayment. In such a repurchase undertaking, the true market value of the underlying asset (or asset portfolio) is irrelevant to the *Sukuk* note holders, as the amount is defined to be equivalent to the notes. In this case, note holders have no special rights over the *asset(s) and rely wholly on the originator's* creditworthiness for repayment, either from internal sources or from its ability to refinance. Thus, if the originator is unable to honour its obligation to repurchase the assets, the noteholders are in no preferential position to any other creditors, or indeed in no weaker position to any other unsecured creditor, stressing the importance that the purchase undertaking *ranks pari passu with any other of the originator's senior unsecured obligations."*[3]

Under an asset backed structure, the investors or *Sukuk* holders can only expect the returns from the cash flows of the underlying assets and there is no right of recourse to the originator or Issuer. This is because asset-backed *Sukuk* would require the originator or issuer to sell their asset to the *Sukuk* investors on a 'True-Sale' basis without having neither a purchase undertaking nor any right to recourse from the originator or issuer in the case the asset fails to generate the expected income to the *Sukuk* investors. In short, asset-backed *Sukuk* only allow recourse to the underlying assets which form the sole source of pofit and principal payments.

Many *Shari'ah* scholars are of the view that asset backed *Sukuk* is perfectly in adherence to the *Shari'ah* requirement on ownership in *Sukuk* origination.

Even in the event of default, the *Sukuk* holders being the beneficial owner cannot outrightly sell the asset to recover their capital but rather they have to exercise the purchase undertaking given by the obligor at the onset. Therefore, the transaction does not focus on asset risk, but rather on the credit worthiness of the originator/obligor of the *Sukuk*.

From the *Shari'ah* perspective, the *Sukuk* holders should be able to deal freely with the underlying asset as they are the owners of the asset. This is to conform to the gist of (milkiyyah) ownership and (qabadh) possession from the *Shari'ah* perspective which comprises principles of tamkin wa takhliyah, which denotes that the buyer as owner must have full access to the object of sale without any encumbrances.[4]

The OIC Fiqh Academy has resolved that both legal and beneficial ownership are recognized from *Shari'ah* perspective. In this concern, the *Shari'ah* Advisory Council of Bank Negara Malaysia has taken the same opinion with the Academy. [5]

The majority of *sukuk* issued in Malaysia are asset-based. There is a need to understand the reason for this practice. In countries of the GCC, the regulatory framework for securitisation is not yet developed. One of the main legal challenges is the restriction on foreign ownership of certain assets in the GCC and whether an offshore SPV can own an asset in these jurisdictions. In Malaysia, where clear guidelines on tme sale are clarified, asset-backed *sukuk* have still not taken off (Dusuki & Mokhtar, 2010).

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[3] As cited in Asyraf Wajdi Dusuki and Shabnam Mokhtar, Critical Appraisal of Shari'ah Issues on Ownership in Asset based Sukuk as Implemented in the Islamic Debt Market (Research Paper No. 8/2010), 2010, p.7.

[4] Al Kasani, Al Bada'ie al Sana'ie, vol 5, p 244, Ali Haydar, Durar al Hukkam, vol. 1, 216

[5] Cited from Shariah Resolutions in Islamic Finance of BNM, 2010, p.6, OIC Fiqh Academy, Majallah Majma` al-Fiqh alIslami, 1990, no. 6, v. 1, p. 771.

7.1. Is Sunway *Sukuk* asset based or asset backed?

Sunway *Sukuk* is an equity based *sukuk*, not a sale or rent based *sukuk*. Unlike Murabaha or Ijara *Sukuk* it does not have underlying assets. Rather, it represents a joint venture of multiple projects, from which the profits will be shared between the issuer and the *sukuk* holders respectively, according to their profit sharing ratio.

However, as understood from the Trust deed, the *sukuk* holders don't have recourse to the underlying *Mudharabah* assets. Rather, they only can claim the capital they've contributed, since the capital is somewhat guaranteed by the issuer and a purchase undertaking has been carried out. Also a fixed expected income is guaranteed to the *sukuk* holders, and any less than the expected income will be topped up by the issuer from their profit reserve.

Based on those characteristics, we opine that, it is more likely to be an asset based *sukuk*.

8. Islamic finance principles and key *Shari'ah* Issues in Sunway *Mudharabah Sukuk*:

AAOIFI has defined *mudharabah sukuk* as certificate represents ownership of units of equal value in *mudharabah* equity and registered in the names of holders on the basis of undivided ownership of shares in *mudharabah* equity and its returns according to the percentage of ownership of share. The owners of such *sukuk* are the rabbul maal.

This *sukuk* give its owner the right to receive his capital at the time the *sukuk* are redeemed, and an annual portion of the realized profits as mentioned in the issuance publication. The *sukuk* can play a vital role in the process of development financing, because it is related to the profitability of the projects. Financing through *mudharabah* is more efficient in term of the allocation of resources compared with financing based on interest rate, which does not reflect the profitability of the projects.

Besides that, *mudharabah sukuk* must represent a common ownership and entitle their holder to shares in a specific project for which the *sukuk* have been issued to fund. A *sukuk* holder is entitled to all rights, which have been determined by *shari'ah* upon his ownership of the *mudharabah sukuk* in matters of sale, gift, mortgage, succession and other. The contract in *mudharabah sukuk* is based on the official notice of *sukuk* sale. (Kamil, *et al*, 2010)

The following are the key *shari'ah* issues we found in Sunway *Sukuk*:

8.1. Purchase Undertaking (*Wa'*ad)

As stated in the Sunway *Sukuk* agreement, the Issuer shall undertake to purchase the Trust Assets from the Trustee (acting on behalf of the *Sukuk* holders) at the Exercise Price via a Purchase Undertaking, upon the occurrence of the earlier of the respective maturity dates of the *Sukuk Mudharabah* or declaration of a Dissolution Event or on Early Redemption.

This is the most controversial issue in this *Sukuk* is, the wa`d or undertaking by the manager or partner in *Sukuk Mudharabah* to purchase the underlying asset upon event of default or at maturity date at a pre-determined formula.

The agreed purchase or exercise price formula for the purchase undertaking ensures that the principal amount invested by the *Sukuk* holders will be returned to them at the dissolution date. Thus, no matter how the venture goes, profitable or not, the return of investors' capital is assured.

The practice of Issuer granting such purchase undertaking has been heavily criticized by the scholars and perhaps the most notable one is by Shaykh Taqi Usmani, chairman of the AAOIFI *Shari'ah* Board. Later this had been the subject of scrutiny by the AAOIFI *Shari'ah* Board which led to the prohibition of such practices in February 2008. The AAOIFI *Shari'ah* Board ruled out that: It is permissible for a partner to issue a binding promise to buy, either within the period of operation or at the time of liquidation all the assets of the partnership as per their market value or as per the agreement at the date of buying. It is not permissible, however to promise to buy the assets of the partnership on the basis of face value.[6]

However, in the context of Malaysian market practice, SAC of Securities Commission accepted the purchase undertaking at a price representing the face value of the *Sukuk* at maturity or following an event of default. The common clause of purchase undertaking in principal and terms in *Sukuk* Musharakah as below stated;

*"Pursuant to the purchase undertaking for the IMTN Programme granted by the Obligor in favour of the Issuer (acting on behalf of the Sukukholders) ("**Purchase Undertaking**"), the Obligor shall irrevocably and unconditionally undertake to purchase the Sukukholders' interest in the Musharakah Venture via a "**Sale Agreement**" at the Exercise Price on either the maturity date of the Sukuk Musharakah or the Mandatory Redemption Date or the Dissolution Date, whichever is the earlier. The Obligor will be entitled to set-off the Exercise Price with any Topup payment(s) made."*

The following justifications are provided for the above ruling:

i. Both parties (i.e. Obligor and the *Sukuk*holders) have agreed to adopt a certain formula based on the concept of mutual consent (al-Taradhi).
ii. The *Sukuk*holders are not devoid of all risks as the performance of the *Sukuk* is still subject to the operation and performance of the *Mudharabah* and in case of dissolution event, to the credit standing of the Issuer; and
iii. The principle of 'Urf or customary practice in the industry whereby *Sukuk* is deemed as fixed income instrument regardless of its underlying *Shari'ah* concept.

[6] AAOIFI, 2010, Shariah standard No. 12, item 3/1/6/2, p.209

However the above justifications are not sound from the *shari'ah* point of view. The essence of *Mudharabah* and Musharakah is risk sharing. In case of Musharakah, both parties share the profits and loss. Profits are distributed as per pre-agreed ratio, and loss is borne according to the ratio of capital contribution. Whereas in *Mudharabah*, profits are distributed according to pre-agreed ratio, and loss is solely borne by Rabb-al-Maal, unless negligence is proven in the *Mudharib*'s part. *Mudharib* is deprived of any earning, thus the time and effort he has put is regarded as his loss.

In the case of *Mudharabah Sukuk* arrangement, the *Sukuk* holders (Rabb-al-Maal) are entitled to profits generated by the *Mudharabah* venture (according to pre-agreed ratio). Loss, if any, is to be passed to the *Sukuk* holders (unless negligence by the *Mudharib*/ Trust is proven). This translates into risk of losing capital. However, if *Mudharib*/ Manager undertakes to purchase the *Mudharabah* certificates from the *Sukuk* holders at a specific date at a pre-agreed price, it ensures the security of the capital against any amount that is covered in that price. Thus the element of risk-sharing is removed, *Mudharabah* is void and a serious *shari'ah* issue is triggered.

8.2. Foregoing one's Rights (Tanazul)

As per the Sunway *Sukuk* agreement, the *Sukuk* holders have agreed upfront that they shall receive profits up to the Expected Return. Any amounts in excess of the Expected Return shall be given to the *Mudharib* as an incentive fee for successfully managing the *Mudharabah* Venture. A partner may waive his/its right under the *Shari'ah* principle of Tanazul on the profit payments from the *Mudharabah* Venture, if that partner desires so.

If, on any Periodic Distribution Date, the income generated from the *Mudharabah* Venture is insufficient to meet the expected Periodic Distribution, the Issuer shall make advanced profit payments during the tenure of the *Sukuk Mudharabah* ("Advance Profit Payments") equal to such deficiency. For the avoidance of doubt any Advance Profit Payments made by the Issuer shall be offset against the Exercise Price.

The first part of Tanazul, form the *Sukuk* holders' part, is recognized by AAOIFI. This is evident in the AAOIFI resolution in *Shari'ah* Standard No. (12) on Sharikah (Musharakah) and Modern Corporations, regarding the outcome of Sharikah investments (profit and loss):

"It is permissible to agree that if the profit realized is above a certain ceiling, the profit in excess of such a ceiling belongs to a particular partner." [7]

However, the second part of Tanazul (from the *Sukuk* manager's part), majority of contemporary Islamic jurists denounce this exercise as it is deemed to be not in line with the essence of partnership contract which is based on profit and loss sharing principle. Sheikh Taqi Usmani opined that it is unlawful to include any text or condition that leads to the possibility that the

[7] AAOIFI,2008, Shariah Standard No 12, p.207.

sharing of profits will be interrupted.[8] If this happens, the partnership contract is void as this is contrary to the concept of profit sharing in Musharakah which shall be based on an agreed portion; and losses shall be based on the ratio of capital contribution.[9]

This is in line with the AAOIFI *Shari'ah* Standard which states; Item 3/1/5/7:

"It is unlawful for the conditions of partnership or for the basis of profit distribution to include any text or condition that leads to the possibility that the sharing of profits will be interrupted. If this happens, the partnership will be void." [10]

According to AAOIFI, it is not allowed to the issuers to waive their right to a share of the profit until the *sukuk* holders get their expected rate of profit. The AAOIFI *Shari'ah* Standard as below; Item 3/1/5/3 :

" It is a requirement that the proportions of losses borne by partners be commensurate with the proportions of their contribution to the Sharika capital. It is not permitted therefore to agree on holding one partner or a group of partners liable for the entire loss or liable for a percentage of loss that does not match their share of ownership in the partnership. It is however; valid that one partner takes without prior condition the responsibility of bearing the loss at the time of the loss." [11]

Another significant issue is upfront Tanazul. Tanazul upon realizing profits is less controversial, however promising or agreeing to provide upfront Tanazul or making the Tanazul binding is disputable (Noor, Haron, & Mohammad).

8.3. Guarantee by *Mudharib*

Under the concept of purchase undertaking, one party guarantees the investors that the business venture will be profitable and if any losses are incurred that the guarantor shall acquire the investors' ownership in the venture for redemption at par (i.e. the investors' initial capital) or based on a pre-agreed formula (that effectively covers the investors' initial capital and the expected profit for 6 months). In retum, the investors reciprocate by tanäzul or 'rebate' of profits in any 6 months of the venture by limiting their retum to a conventional reference rate plus spread or any other benchmark they agree on. If their share of profit exceeds the benchmark, the excess profit goes to the other party as incentive fees.

The trust deed states that Sunway Berhad shall issue an irrevocable and unconditional Al-Kafalah Guarantee, which shall be applicable in respect of all series of the *Sukuk Mudharabah* in favour of the Trustee to guarantee all payment obligations of the Issuer under the Purchase

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[8] Usmani, Taqi, Sukuk and their Contemporary Applications, p.9.
[9] Usmani, Taqi, An Introduction to Islamic Finance, p.38
[10] AAOIFI, 2008, Shariah Standard No 12, p.208.
[11] AAOIFI, 2010, p.207.

Undertaking. Sunway shall enter into a separate Kafalah Agreement with the Issuer to provide the guarantee, which is an independent arrangement from the *Mudharabah* Agreement.

Sunway Berhad is owned by Sunway Group, of which Sunway Treasury *Sukuk* Sdn. Bhd. (the issuer of the *Sukuk*) is a subsidiary. One owns the other company and thus like a same entity. This translates providing capital guarantee from one of the partners in *Mudharabah* to the other, which triggers a serious *shari'ah* issue. AAOIFI *shari'ah* standard has detailed on the issue. It states:

"A third party may provide a guarantee to make up a loss of capital of some or all partners. This guarantee is circumscribed with the conditions that (a) the legal capacity and financial liability of such a third party as a guarantor are independent from the Sharika contract, (b) the guarantee should neither be provided for consideration nor linked in any manner to the Sharika contract; (c) the third party guarantor should not own more than a half of the capital in the entity to be guaranteed, and (d) the guaranteed entity should not own more than a half of the capital in the entity that undertakes to provide a guarantee. In case of a third party's undertaking to guarantee, the partner benefiting from such an undertaking is not, however, entitled either to claim that the Sharika contract becomes null and void or to refuse to meet his obligations under the contract if the guarantor fails to meet his voluntary promise to cover the loss of his capital, on the grounds that he (the beneficiary) entered into the Sharika contract taking into account the state of such a third party's undertaking to guarantee the loss of his capital." [12]

In general, AAOIFI's *Shari'ah* Standards as well as the resolutions issued by the Islamic Fiqh Academy and the SAC of the SC permit the provision of a third-party guarantee on the capital of the mudärabah and musharakah. However, there is no mention on the redemption price of the capital. AAOIFI, which represents the consensus of leading scholars, prefers that these redemption features be executed at a market price. Theoretically, the market price purchase removes the certainty of a guaranteed return of capital at a profit (Lahsasna et al, 2013).

The Council of the Intemational Fiqh Academy resolved that neither the prospectus nor muqäradah certificate should contain a guarantee from the manager of the funds for the capital nor for a fixed profit based on the percentage of the capital. If such a clause is stipulated implicitly or explicitly, the guarantee condition is voided and the mudärib is entitled to a profit equal to that of a similar mudärabah. [13]

The SAC of Bank Negara Malaysia has resolved that, *a third party guarantee on the capital and/or expected profit in a mudharabah transaction is allowed on the condition that the third party who will provide the guarantee shall be an independent party and does not have any kind of relationship, whether directly or indirectly, with the mudharib. In the event whereby the third*

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[12] Sharia StandardNo.(12) Sharika (Musharaka) and Modern Corporations, Clause: 3/1/4/3

[13] International Islamic Fiqh Academy Jeddah, Resolution No. 30 (5/4), regarding "Mudaraba certificates and Investment certificates", dated January 1988/ Jumada Al- Ukhra 1408

party guarantor is allowed to claim the guaranteed amount from a sukuk issuer if there is a loss, or he is charging a fee for such guarantee, such a guarantor will be classified as a limited third party, thus, the abovementioned condition has not been satisfied. [14]

8.4. Compensation for late and/ or Default Payment (s) (Ta'widh)

The *sukuk* agreement states "In the event of any delay in payments of any amounts due under the Purchase Undertaking, the Issuer shall pay to the Trustee for the benefit of the *Sukuk*holders compensation on such overdue amounts at an amount and manner prescribed by the SC's SAC from time to time in accordance with the *Shari'ah* principles."

In Malaysia, late payment or default by issuers of Islamic securities, including *sukuk*, are required to compensate investors with late penalty payment that is stipulated upfront in the financing agreements.

The SAC of the Securities Commission agreed to allow the imposition of to 'wïd (compensation) on the late repayment of Islamic financing. [15] Subsequently, in another later meeting, the SAC resolved that ta 'wid payment for (i) arrears and (ii) failure to pay after the due date is permissible for Islamic financing formulated on the basis of 'uqüd al-mu 'äwadät (exchange contracts) including Islamic debt securities. Ta'wid can be imposed after it is found that mumätalah (deliberate delay in payment) is utilised on the part of the issuer in settling the payment of the principal or profit. The rate of ta 'wïd on late payment of profit is one per cent per annum of the arrears and it cannot be compounded. While the ta 'wïd rate on failure to settle the payment of the principal is based on the current market rate in the Islamic interbank money market, it too cannot be compounded.[16]

The SAC of BNM decided that ta'wïd may be imposed on late payment of financial obligations arising from exchange contracts (such as sales and hire purchase) and qard (loan). Nevertheless, ta 'wïd may only be imposed upon the lapse of the repayment period agreed by both contracting parties. The amount of ta'wid received may be recognised as income by the seller/ financier/creditor on the basis that it is imposed as compensation for actual loss incurred by the seller/financier/creditor. The rate of ta 'wïd shall be determined by the authority, namely BNM.[17]

However, the practice in the Middle East differs, whereby the penalty proceeds are given to charity instead and cannot become a source of income for the investors. According to AAOIF, any compensation due to delay in late payments is considered Riba in *shari'ah*.

"It is not permitted to stipulate any financial compensation, either in cash or in other consideration, as a penalty clause in respect of a delay by a debtor in settling his debt, whether or not the amount of such compensation is pre-determined; this applies both to compensation in

[14] SAC's 91st meeting dated 1 October 2009.
[15] SAC of the Securities Commission (SC) at its 12th meeting, dated 14 July, 1999
[16] SAC of the Securities Commission (SC), at its 30th meeting on 8 November, 2000
[17] SAC's 95 meeting, dated 28 January, 2010

respect of loss of income (opportunity loss) and in respect of a loss due to a change in the value of the currency of the debt."[18]

9. Risk exposures in Sunway *Sukuk*

The risk that *Sukuk* encounter varies according to their structure. In addition, certain types of risk are only applicable to either conventional bond or *Sukuk* and yet certain risks are common among them.

Various types of risks that Sunway *Mudharabah Sukuk* are facing as follows:

9.1. Business/Financial risk: The *Sukuk Mudharabah* represents the direct obligations of the Issuer and shall be payable out of the Issuer's own funds. In this regard, the redemption of the *Sukuk Mudharabah* depends on the cash flow availability at the Issuer's level. In particular, the *Sukuk Mudharabah* will not be the obligations or responsibilities of, or guaranteed by any of the Principal Adviser/Lead Arranger, Lead Manager, the Facility Agent, the Trustee or any subsidiary or affiliate thereof or any other person involved or interested in the transaction envisaged under the *Sukuk* Programme. None of such persons will accept any liability whatsoever to the holders of the *Sukuk Mudharabah* in respect of any failure by the Issuer to pay any amount due under the *Sukuk* Programme. The *Sukuk Mudharabah* are, however, secured by a Al-Kafalah Guarantee by the Guarantor.

9.2. Call risk: risk that a *Sukuk*holder is obligated to sell the outstanding *sukuk* back to the *sukuk* issuer. The conventional bonds are usually subject to this risk when a big market interest rate occurs. This creates a big problem for bondholders since they will be deprived from the higher original interest rate. Even though, this type of risk is only applicable to the conventional bonds only but we cannot rule out possibility tehat *Sukuk* would not be affected. Some researchers argue that bond and *sukuk* yield are correlated so their market expectation among *sukuk* holders. On the other hand, *sukuk* are not susceptive to the fluctuation in market interest rates as the conventional bonds.

9.3. Liquidity risk: The *Sukuk Mudharabah* comprises a new issue of securities for which no secondary market for the *Sukuk Mudharabah* currently exists and in the event that a secondary market for the *Sukuk Mudharabah* does develop, there can be no assurance that it will continue.

Furthermore, there can be no assurance regarding the future development of a market for the *Sukuk Mudharabah*, the liquidity or sustainability of any market that may develop, the ability of the holders of the *Sukuk Mudharabah* to sell their *Sukuk Mudharabah*, or the prices at which such holders may be able to sell their *Sukuk Mudharabah*. There is also no assurance that the price of the *Sukuk Mudharabah* will not be adversely affected by similar issues of private debt securities.

[18] Sharia Standard No.(3) Default in Payment by a Debtor, Clause 2/1/b

Accordingly, the purchaser who purchases or subscribes to the *Sukuk Mudharabah* bears the risks associated with a lack of liquidity in the *Sukuk Mudharabah* apart from the financial and other risks associated with an investment in the *Sukuk Mudharabah*.

9.4. Interest rate risk: As the *Sukuk Mudharabah* is a fixed income security, the price of the *Sukuk Mudharabah* may fluctuate due to the fluctuations in the expected yield applicable to relevant private debt securities at that time. Generally, the expected yield may rise in tandem to a rise in interest rates and accordingly price of the *Sukuk Mudharabah* may fall. Conversely, when interest rates fall, the expected yield may fall and the price of the *Sukuk Mudharabah* may rise.

9.5. Rating: It is a condition for the establishment of the *Sukuk* Programme that the *Sukuk* Programme be rated. The rating accorded to issuances to ICPs is P1(s) and IMTNs is A2(s). The *Sukuk* Programme is subject to rating reviews by the rating agency annually. A rating is not a recommendation to buy, hold or sell the *Sukuk Mudharabah* and there can be no assurance that such a rating will not be revised on a periodic review basis by the said rating agency during the tenure of the *Sukuk* Programme or that such a rating will not be withdrawn entirely if circumstances in the future warrant.

Further, such a rating is not a guarantee of repayment or that there will be no default by the Issuer under the *Sukuk* Programme. If the ratings initially assigned to the *Sukuk* Programme are subsequently lowered or withdrawn for any reason, no person or entity will be obligated to provide any additional credit enhancement with respect to the *Sukuk Mudharabah*. Any downgrade or withdrawal of a rating may have an adverse effect on the liquidity and the market price of the *Sukuk Mudharabah*. Any reduction or withdrawal of a rating will not constitute an event of default or an event obliging the Issuer to repay the *Sukuk Mudharabah*.

9.6. Each Issue Carries Different Risks: The purchase of the *Sukuk Mudharabah* may involve substantial risks and is suitable only for sophisticated investors who have the knowledge and experience in financial and business matters necessary to enable them to evaluate the risks and the mitigating factors of an investment in the *Sukuk Mudharabah*. Each issue of *Sukuk Mudharabah* under the *Sukuk* Programme will carry different risks and all potential investors are strongly encouraged to evaluate each *Sukuk Mudharabah* issuance on its own merit.

9.7. Investors to make their own evaluation of *Shari'ah* compliance: The *Shari'ah* Adviser, by way of his *Shari'ah* Pronouncement has confirmed that the *Sukuk Mudharabah* are *Shari'ah*-compliant. However, the interpretation and application of *Shari'ah* principle is a matter of opinion and debate, and may be subject to differing interpretations by *Shari'ah* scholars, *Shari'ah* supervisory and advisory boards and the courts (or any arbitral tribunal). Therefore, there can be no assurance that the transaction structure or issue and trading of the *Sukuk Mudharabah* will be deemed to be *Shari'ah*-compliant by any other *Shari'ah* board or *Shari'ah* scholars. Potential investors are advised to obtain their own independent *Shari'ah* advice as to whether the *Sukuk* Programme structure meets their individual standards of compliance with *Shari'ah* principles and make their own determination as to whether to subscribe for the *Sukuk Mudharabah*. If the *Sukuk Mudharabah* is deemed not to be *Shari'ah*-compliant by potential investors' standards of *Shari'ah* compliance, they may be prohibited from investing in the *Sukuk Mudharabah* by virtue of their own constitutional restraints or otherwise.

9.8. Other risks: A *Sukuk*'s prospectus often defines events that can cause a *Sukuk* to be null and void from a *shari'ah* viewpoint. For e.g. when the cash portion of the underlying asset becomes larger than the tangible portion. Or in cases where a *Sukuk* involves more than one contract, e..g. a combination of Istisna and Ijarah. The *Sukuk* could be null and void if the Istisna portion is higher. Where sale/purchase price of the underlying asset exceeds the acceptable bounds, for e.g. in Malaysia, the SAC has set an upper limit of 1.3 times market price and a lower limit of 0.67 times.

In additional to the above, other possible risks for *Sukuk*s could be operational risks (arising from management of *Sukuk*s payments or the SPV), and regulatory risks (risks arising from changes in the regulatory framework).

10. Benefits of the chosen structure to the issuer and *Sukuk* holder

Benefits of the chosen structure to the issuer, Sunway Group are multifold: first of all, Malaysia, which is the leading *Sukuk* market in the world and is taking advantage of improved investor sentiment and strong liquidity in the Islamic bond market to raise financing for its state entities at relatively cheaper rates. Secondly, the *Sukuk* comes up with a new and innovative form of financing in response to growing demand for construction project that would bring in new investors who do not lend to Sunway on a daily basis or through its conventional credit facilities. Thirdly, it provides short-term and long-term financing diversification. And finally, as *Mudharabah sukuk* are different from conventional bond financing, which is considered as debt financing, they do not increase the company's leverage. Consequently they do not affect the credit worthiness of the company. On the other hand, the main lure for investors is the prospect of a large, highly rated and local currency denominated *Sukuk* — something lamentably rare in the Islamic bond market. *Sukuk*holders, in this case mostly institutional investors, found new asset class for investment with reasonable return, more specifically, Islamic financial markets, specially Islamic banks are in great demand for *Shari'ah*compliant investment. This also helps in portfolio diversification for Islamic and conventional *Sukuk*holders. The *Sukuk* is likely to offer a tenor longer than some traditional *Sukuk* buyers are used to. In addition, banks are big buyers in the *Sukuk* market, which because of limited liquidity is largely dominated by the buy and hold approach. However, longer-dated *Sukuk* often may not suit banks liabilities.

10.1. Debt to equity continuum and risk profile of the issuer

If we look at the structure of the *Sukuk*, we can argue that theoretically the *Sukuk* should lie close to equity continuum. As we know profit in *Mudharabah* must be shared among *mudharib* and rab-al-mal (*sukuk* holders). Moreover, as per *Shari'ah* rules, issuer can't guarantee a fix income in Mudarbah transactions as it will trigger the issue of Riba and concept of risk sharing will be violated. However, conditions articulated in the prospectus clearly indicate that the issuer, Sunway Group, has simply issued a low-cost debt like instrument with little or no risk sharing elements to take advantage of strong liquidity in the Islamic bond market to raise financing for its working capital management, paying off debt, expanding its land development function and construction projects. At the same time, for *Sukuk*holders, institutional investors, perspective they are looking for stable cash flow over the period of time with little or no risk to manage their liquidity mismatch as currently there are very few *Shari'ah*-compliant investment opportunities for them. Against this backdrop, we can conclude that the fixity of profit payment is a vital issue in *Sukuk Mudharabah*, but no or little risk sharing elements, capital guarantee and originator assurance put the *Sukuk* almost close to debt in the continuum of debt to equity.

11. Recommended Sukuk Structure

After analyzing trust deeds, prospectus and other related documents of Sunway Treasury Sukuk, we can argue that the structure they chose to issue Sukuk is somewhat not appropriate. First of all, even though Sukuk is called Mudarabah but Sukuk yield is fixed. Secondly, even though the Sukuk structure shows that there is Mudarabah venture, which would be operated by SPV, but in depth analysis indicates that originator, Sunway group, is actually using Sukuk proceeds for short term financing needs, capital requirements. Thirdly, several Shari'ah issues have been identified: capital guarantee, late payment charge, waivers to Sukuk holders, fixed rate Mudarabah and others. It is not unfair to claim that Sunway issued this Sukuk in order to gain easy access to Islamic capital market, where supply of Sukuk is in short and players in Islamic financial markets do not have enough liquid instruments to invest, moreover, lower interest rate environment encourage the company to lock into short (ICPs) and medium term (IMTNs) financings with relative lower financing cost.

Therefore, we would recommend Sukuk Ijarah for Sunway group as Ijarah Sukuk are the latest product in the market that is rapidly gaining ground in the capital market. It has emerged as a different asset class among the Islamic financial products. It has gained acceptance among Shari' ah scholars and high in demand by large investors and Islamic financial institutions. On the supply side, not only sovereign but also corporate entities are also finding it useful to generate funds for their project specific needs, specially capital requirements, working capital management, and restructuring financing.

Economic features of Shariah nominate Ijarah contaract (Khaf, 1997):

1. Flexibility of sale: Ijarah contract in Shari‘ah does not restrict the right of lesser to sell the leased asset.

2. Independence of ownership: Persons who share the ownership of a leased asset can dispose of their property by, say, selling it to new owners individually or collectively as they may desire.

3. Flexibility in timing of inflows and outflows: It is not necessary that the flow of usufruct benefits should coincide with the timing of rent payments.

4. Flexibility in initiation: Shari‘ah does not require that the assetsubject of ijarah contract, should be in existence at the time of the contract.

5. Flexibility in length of term: The ijarah contract can be of any length as long as the asset which is the subject of the ijarah contract remains in existence and renders its usufruct.

6. Flexibility in determination of rent: In an ijarah contract, it is necessary that rent must be known. But it can be determined by a variety of flexible ways.

7. Possibility of hybrid with wakalah: An ijarah contract is open for combination with the wakalah contract.

8. Restriction on liability for maintenance: Maintenance expenditures related to the basic characteristics of the asset are the responsibility of the owner, while maintenance expenses related to its operation are to be taken care of by the lessee.

9. Ijarah contract is amiable to securitization in the form of a bond. The idea of an ijarah bond stems from the ability of transforming leased assets into financial assets.

10. Decision No.5 of the 4th Annual Plenary Session of the OIC Fiqh Academy, held in Jeddah 18-23/6/1408H (6-11/2/1988G), asserts that (a) any combination of assets can be represented in a written note or bond, and (b) this bond or note can be sold at a market price provided that the composition of the group of assets, represented by the bond, consists of a majority of physical assets and financial rights, as compared to a minority of cash and interpersonal debts. Furthermore, the decision clearly mentions that assets that can be grouped together for the purpose of securitization may consist of any combination of the following four types of assets: i) physical assets, ii) financial rights (such as the usufruct in ijarah), iii) interpersonal debts, and iv) money.

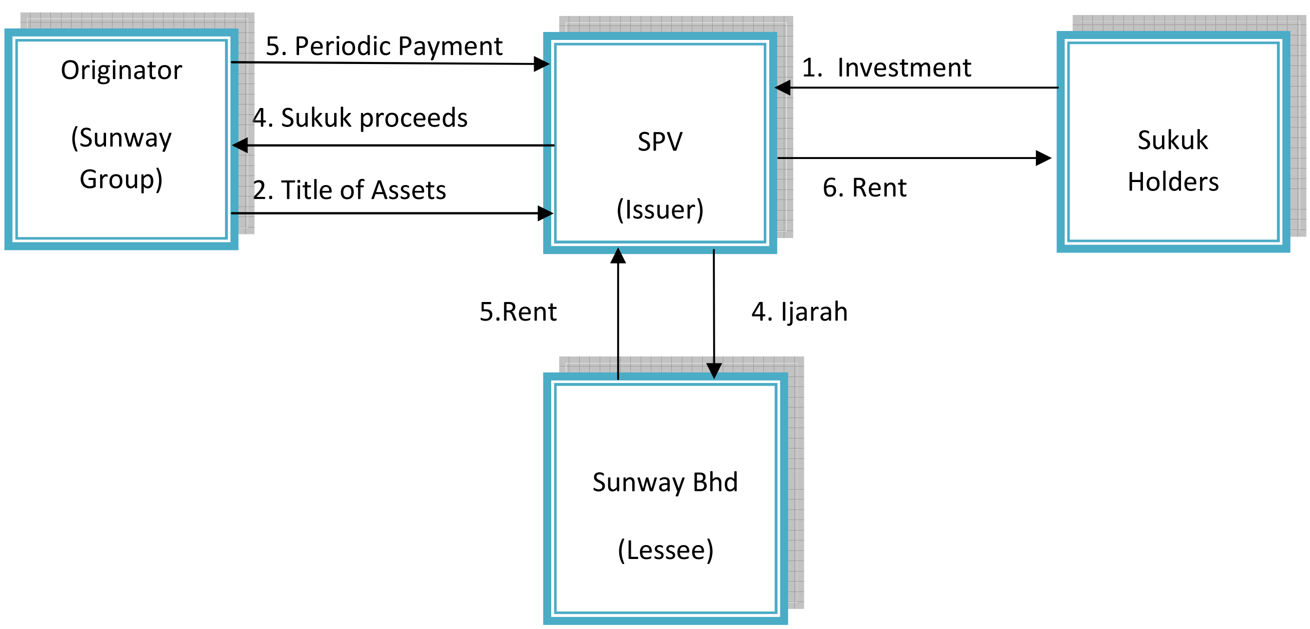

Figure 9 : Proposed Ijarah Sukuk for Sunway

Steps involved in our proposed sukuk structure:

1. The Sukuk Holders feed the SPV, issuer of the sukuk, with their investment
2. The originator (Sunway Group) sells the Asset to the SPV in return for the Sukuk Proceeds (investment).

3. The SPV leases the Asset to Lessee, it can be the originator (Sunway Group) – cashes the rent, the net amount of which is passed on to the Sukuk Holders (fixed income)
4. At maturity, the Asset is sold to the Originator (Sunway Group), who at start often promised to buy back at certain price at maturity or default of the lessee, and the proceeds of the sale are distributed to the Sukuk Holders as repayment investment.

12. Conclusions

Sukuk has been playing a significant role in developing Islamic finance, more specifically, Islamic capital market. Islamic financial institutions did not have any liquid investments other than hard cash to held as conventional short-term bonds, commercial papers and notes are interest based and prohibited in *Shari'ah*. The rapid growth in *Sukuk* market not only in Malaysia but also internationally indicates huge potential of this innovative financial instrument. However, exist many controversies regarding *Sukuk*. Many people ask questions like how *Sukuk* is different from conventional bond. As various *Sukuk* structure have emerged very recently, a comprehensive research is required to answer all the unanswered questions. In this paper, we have studied Sunway Treasury *Sukuk*. It is based on *Mudarabah* contract. Even though the initial focus of our study is to find accounting issues connected with this *sukuk* and we discussed in details financial performance of Sunway group, accounting disclosure needed for *Sukuk* issuance, model accounting treatment of *Mudarabah sukuk* in general and Sunway Treasury *Sukuk* in specific, in depth analysis of *Shari'ah* issues related with the *Sukuk*, various risks associated with it.

Our analysis shows that Sunway Group is a one of the leading construction and development in company in Malaysia and it has presence in other south-east Asian country also in India. The slowing down in real-estate industry has put a lot of pressure on Sunway and it has been evident in the financial statements of the company. All most half of its financing are coming from debt and it has been growing but the company has solid fixed assets namely it has already acquired more than 3000 acres of land for development. Accounting of *Sukuk* is not necessarily different from conventional bond, even though, we consider Sukuk to be closer to equity but in reality it is closer to debt. Analysis shows that IFRS and AAOIFI accounting have different objectives and perspectives. Subsequently, IFRS is more concerned with the substance, while AAOIFI focuses on legal form while considering accounting transactions, however, *Sukuk* in both cases are shown as a liability in the balance sheet. Some authors argue that in addition to preparing its own accounts as SPV, accounts should be prepared for the investment fund represented by the *sukuk* in accordance with Financial Accounting Standard 14 "Investment Funds". Capital guarantee, fixed rate Mudarabah, later payment charge, promise to buy back are found to be critical Shari'ah issues in Sunway Treasury Sukuk. Default risk in Treasury sukuk is very low considering company reputation and its huge fixed asset back of more than 3000 acres of land. The *sukuk* has some sort of market risk, namely interest rate/profit rate risk in rising interest rate environment. Shari'ah risk found to be the main problem of this *Sukuk*. Therefore, we proposed and justified an alternative model, *Ijarah Sukuk* for Sunway Group by considering the financing needs of the company and also to be complaint with *Shari'ah.*

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Appendix 1

AAIOFI standards on *Sukuk*

To ensure the sharia compliance of newly issued *Sukuk*, the AAIOFI issued a six standards resolution in February 2008 as follows:

1. *Sukuk* to be tradable, must be owned by *sukuk* holders with all the rights and obligations of ownership in real assets, whether tangible, usufruct or services. The transfer of ownership should not be shown as the assets of seller or manager.
2. *Sukuk* to be tradable must not represent receivables or debts.
3. It is not permissible for the manager of *Sukuk* to offer loans to *Sukuk* holders when actual earnings are smaller than expected ones. It is permissible to establish reserve account for the purpose of covering such shortfalls, provided the same is mentioned in prospectus.
4. It is not permissible for the investment manager to repurchase the assets from *Sukuk* holders for its nominal value when *Sukuk* is terminated. It is permissible to purchase on the basis of net value of assets, its market value, fair value or price to be agreed at the time of their actual price.
5. It is permissible for a lessee in *Sukuk* al-ijara to undertake to purchase the leased assets when the *Sukuk* are extinguished for its nominal value, provided lessee is not a partner, investment manager or investment agent.
6. Sharia supervisory boards should not limit their role to the issuance of fatwa on the structure of *Sukuk*,
   but should also oversee its implementation and compliance at every stage of the operation.

Appendix 2

Bond vs *Sukuk*

Item	Bond	Sukuk
Tenor	Short, Medium and Long Term	Short and Med-Term (≤5 yrs)
Financing Category	Debt	No debt but ownership of specific asset and its cash flows
Underlying	Not necessary, unless collateralized	Necessary underlying asset, usually tangible asset
Claim	Fixed in time, and amount	Ownership claim on specific asset and its cash- flows
Pricing	Depends on rating, yield environment and demand (book-building)	Use of indicative yields- benchmarked on reference rates
Total Returns	Fixed income (known/predetermined cash flows)	No guarantee in returns
Funding Purpose	Unrestricted	Restricted for use in Shariah compliant assets, in a predetermined manner.

Source: Obiyathulla I. Bacha(2015). Islamic Capital Market Slide, INCEIF. Slide No. 43

Appendix 3

Source: Obiyathulla I. Bacha(2015). Islamic Capital Market Slide, INCEIF. Slide No. 18

Appendix 4

Type of Sukuk, Characteristics, and Underlying Contracts

Type of Sukuk	Characteristics	Underlying Contract
Pure Ijarah Sukuk	• Issued on stand-alone assets identified on the balance sheet. • The rental rates of returns on these *Sukuk* can be both fixed and floating.	Ijara
Hybrid/Pooled Sukuk	• The underlying pool of assets can comprise of *Istisna'*, *Murabahah* receivables as well as *Ijarah* • The return on these certificates can only be a pre-determined fixed rate of return.	*Istisna'*, *Murabahah* receivables and *Ijarah*.
Variable Rate Redeemable Sukuk or *Musharakah Term Finance Certificates* (MTFCs)	• Redeemable in nature. • Has relatively stable rate as compared to dividend payouts. • The floating rate of return on these certificates would not depend on benchmarking with market references such as LIBOR but would instead be contingent on the firm's balance sheet actualities.	*Musharakah*
Zero-coupon non-tradable Sukuk	• The primary asset pools to be generated would be of the nature warranted by *Istisna* and installment purchase/sale contracts that would create debt obligations. • Non-tradable	Istisna'
Embedded Sukuk	• These could be Sukuk whether zero-coupon, pure-Ijara or hybrid. • Has embedded option to convert into other asset forms depending on specified conditions.	pure-Ijara or hybrid

Source: summarized from Tariq, 2004. *Managing Financial Risks of Sukuk Structures.* A dissertation at Loughborough University, UK.

Source: Obiyathulla I. Bacha(2015). Islamic Capital Market Slides, INCEIF. Slide No. 20

Appendix 5

***Sukuk* Type, Underlying Contracts and Cash Flow characteristics**

Underlying contract	***Originator (Mudharib)***	***Investor (sukuk holder)***	***Interim cash-flows (to sukuk holders)***	***Cash-flow at maturity***
Ijarah *(lease)*	*Leasee of asset. Pays lease payments*	*Lessor*	*Periodic Lease Payments*	*At maturity from sale of asset*
Wakalah *(Principal-agent relationship)*	*Agent undertaking investment in underlying asset*	*Principal Owner of invested asset*	*Cash Flows generated by investment*	*Dependent on type of invested asset and/or economic life of project. No fixed return.*
Bai Bithaman Ajil *(sale based on deferred payments)*	*Purchaser of underlying asset*	*Owner/seller of underlying asset*	*Payment of purchase price in installments*	*May and may not have a final balloon payment*
Mudaraba	*Mudharib (entrepreneur in need of financing)*	*Rab-ul-Mal (provide capital)*	*Periodic cash flows from asset as determined by PSR*	*Unlikely. Final payment could simply be the last periodic payment given tenor of Mudharabah contract*
Salam *(Contract for goods to be delivered later – forward)*	*Seller of commodity/goods which will be delivered later*	*Purchaser of commodity/goods which will be delivered later*	*Proceeds from sale of goods received – if there will be delivering in the interim*	*Usually the largest cash flows occur at maturity when delivery occurs. Cash flow is from sale proceeds*
Istisna	*Purchaser of asset under construction*	*Financier for asset under construction*	*Payments from Mudharib if any*	*Profit from sale of completed asset*
Murabaha	*Purchaser of asset*	*Financier of asset*	*Periodic payments received from Mudharib representing price of asset plus mark up*	*Unlikely. Final payment could simply be the last periodic payment of contract*

Source: Obiyathulla I. Bacha(2015). Islamic Capital Market Slide, INCEIF. Slide No. 21

Appendix 6

Summary of Risk Characteristics of *Sukuk* Structures

Types of *Sukuk*	Description of *Sukuk* Structure	Credit Risk	Rate of Return (Interest-Rate Risk)	FX Risk	Price Risk	Other Risks
Zero-Coupon Sukuk	*Istisna'*, *Murabahah* debt certificates—**nontradable**	Unique basis of credit risks exists (see Khan & Ahmed, 2001)	Very high due to fixed rate, remains for the entire maturity of the issuance	If all other conditions are similar, FX risk will be the same for all cases of *Sukuk*. However, those *Sukuk* that are liquid or relatively short term in nature will be less exposed. The composition of assets in the pool will also contribute to the FX risk in different ways. Hence, this can be a very useful tool to overcome the FX risk by diversifying the pool in different currencies.	Price risk relates to the prices of the underlying commodities and assets in relation to the market prices. *Ijarah Sukuk* are most exposed to this, as the values of the underlying assets may depreciate faster as compared to market prices. Maintenance of the assets will play an important part in this process. Liquidity of the *Sukuk* will also play an important part in the risk. *Salam* is also exposed to serious price risks. However, through parallel contracts, these risks can be overcome	**Liquidity risk** is serious as far as the nontradable *Sukuk* are concerned. **Business risk** of the issuer is an important risk underlying *Sukuk* as compared to traditional fixed incomes. ***Shari'ah* compliance** risk is another one unique in case of *Sukuk*. **Infrastructure rigidities**, i.e., nonexistence of efficient institutional support, increases the risk of Sukuk as compared to traditional fixed incomes, see Sundararajan and Luca (2002)
Fixed-Rate Ijarah Sukuk	Securitized *Ijarah*, certificate holder owns part of asset or usufructs and earns fixed rent—**tradable**	Default on rent payment, fixed rate make credit risk more serious	Very high due to fixed rate, remains for the entire maturity of the issuance			
Floating-Rate Ijarah Sukuk	Securitized *Ijarah*, certificate holder owns part of asset or usufructs and earns floating rent indexed to market benchmark such as LIBOR—**tradable**	Default on rent payment, floating rate make default risk less serious—see previous case	Exists only within the time of the floating period normally six months			
Fixed-Rate Hybrid/ Pooled Sukuk	Securitized pool of assets; debts must not be more than 49%, floating rate possibility exists—**tradable**	Credit risk of debt part of pool, default on rents, fixed rate make credit risk serious	Very high due to fixed rate, remains for the entire maturity of the issuance			
Musharakah Term Finance Sukuk (MTFS)	Medium-term redeemable *musharakah* certificate based on diminishing *musharakah*—**tradable as well as redeemable**	*Musharakah* has high default risk (see Khan & Ahmed, 2001); however, MTFS could be based on the strength of the entire balance sheet	Similar to the case of the floating rate. This is, however, unique in the sense that the rate is not indexed with a benchmark like LIBOR; hence, least exposed to this risk			
Salam Sukuk	Securitized *salam*, **fixed-rate and nontradable**	*Salam* has unique credit risk (see Khan & Ahmed, 2001)	Very high due to fixed rate			

Appendix 7

Sukuk – Players

- ✓ *Originator/Mudharib (could be govt-sovereign or corporate)*
- ✓ *Regulator (SC in Malaysia)*
- ✓ *Credit Enhancer (Govt for GLCs, third party for others)*
- ✓ *Trustee – (to manage and administer the SPV)*
- ✓ *Vendor/Manufacturer (of asset/machinery that is the object of financing)*
- ✓ *Rating Agency (to rate and monitor the Sukuk)*
- ✓ *Investment Bank – (structures, Sukuks, compliance, prospectus and bring to market)*
- ✓ *Shari'ah Advisors (at the investment bank level and at the regulators)*
- ✓ *Sukuk Investor*

- *Source:* Obiyathulla I. Bacha(2015). Islamic Capital Market Slide, INCEIF. Slide No. 31

Appendix 8

Balance Sheet Sunway

Currency in Millions of Malaysian Ringgits	As of:	Dec 31 2013 Restated MYR	Dec 31 2014 MYR
Assets			
Cash And Equivalents		961.4	1,647.5
Short-Term Investments		557.4	353.9
TOTAL CASH AND SHORT TERM INVESTMENTS		**1,518.8**	**2,001.4**
Accounts Receivable		1,114.1	1,184.7
Other Receivables		396.6	478.4
TOTAL RECEIVABLES		**1,510.7**	**1,663.1**
Inventory		1,790.8	2,098.3
Prepaid Expenses		--	47.8
Other Current Assets		28.0	171.7
TOTAL CURRENT ASSETS		**4,848.3**	**5,982.3**
Gross Property Plant And Equipment		1,731.3	1,927.0
Accumulated Depreciation		-902.8	-948.7
NET PROPERTY PLANT AND EQUIPMENT		**828.5**	**978.3**
Goodwill		319.4	319.4
Long-Term Investments		2,306.7	2,524.1
Accounts Receivable, Long Term		2.3	6.7
Deferred Tax Assets, Long Term		37.7	42.7
Other Intangibles		8.2	8.1
Other Long-Term Assets		2,750.3	2,995.5
TOTAL ASSETS		**11,101.6**	**12,857.1**

LIABILITIES & EQUITY		
Accounts Payable	1,150.2	1,202.9
Accrued Expenses	--	333.9
Short-Term Borrowings	731.1	885.5
Current Portion Of Long-Term Debt/Capital Lease	1,269.6	1,247.4
Current Portion Of Capital Lease Obligations	10.6	2.7
Current Income Taxes Payable	21.4	24.9
Other Current Liabilities, Total	966.6	393.2
Unearned Revenue, Current	--	188.1
TOTAL CURRENT LIABILITIES	**4,138.9**	**4,275.8**
Long-Term Debt	927.0	1,795.9
Capital Leases	4.2	1.8
Minority Interest	316.9	387.5
Unearned Revenue, Non-Current	17.7	15.7
Deferred Tax Liability Non-Current	74.0	82.9
Other Non-Current Liabilities	294.6	361.2
TOTAL LIABILITIES	**5,456.4**	**6,533.3**
Common Stock	1,723.5	1,730.6
Additional Paid In Capital	2,628.4	2,642.2
Retained Earnings	1,886.5	2,451.0
Treasury Stock	--	-29.3
Comprehensive Income And Other	-910.2	-858.1
TOTAL COMMON EQUITY	**5,328.3**	**5,936.4**
TOTAL EQUITY	**5,645.2**	**6,323.8**
TOTAL LIABILITIES AND EQUITY	**11,101.6**	**12,857.1**

Appendix 9

Income Statement

Currency in Millions of Malaysian Ringgits	As of:	Dec 31 2013 Restated MYR	Dec 31 2014 MYR
Revenues		4,721.4	4,558.1
TOTAL REVENUES		**4,721.4**	**4,558.1**
Cost Of Goods Sold		3,220.6	3,108.0
GROSS PROFIT		**1,500.8**	**1,450.1**
Selling General & Admin Expenses, Total		719.2	764.4
Other Operating Expenses		166.0	165.7
OTHER OPERATING EXPENSES, TOTAL		**885.2**	**930.1**
OPERATING INCOME		**615.6**	**520.0**
Interest Expense		-124.6	-67.1
Interest And Investment Income		32.4	38.8
NET INTEREST EXPENSE		**-92.3**	**-28.3**
Income (Loss) On Equity Investments		190.6	233.4
Currency Exchange Gains (Loss)		13.2	14.0
Other Non-Operating Income (Expenses)		-8.1	-2.1
EBT, EXCLUDING UNUSUAL ITEMS		**719.0**	**737.0**
Gain (Loss) On Sale Of Investments		769.6	--
Gain (Loss) On Sale Of Assets		47.8	16.7
Other Unusual Items, Total		363.9	206.6
Legal Settlements		--	4.3
Other Unusual Items		2.0	1.4
EBT, INCLUDING UNUSUAL ITEMS		**1,900.4**	**960.2**
Income Tax Expense		137.0	148.6
Minority Interest In Earnings		-273.0	-77.6
Earnings From Continuing Operations		1,763.3	811.6
NET INCOME		**1,490.4**	**734.0**
NET INCOME TO COMMON INCLUDING EXTRA ITEMS		**1,490.4**	**734.0**
NET INCOME TO COMMON EXCLUDING EXTRA ITEMS		**1,490.4**	**734.0**

Appendix 10

Cash Flow Statement

Currency in Millions of Malaysian Ringgits	**As of:**	**Dec 31 2013** Restated MYR	**Dec 31 2014** MYR
NET INCOME		**1,490.4**	**734.0**
Depreciation & Amortization		133.4	114.5
DEPRECIATION & AMORTIZATION, TOTAL		**133.4**	**114.5**
Amortization Of Deferred Charges		6.4	3.3
(Gain) Loss From Sale Of Asset		-47.8	-15.4
(Gain) Loss On Sale Of Investment		-768.5	12.3
Asset Writer own & Restructuring Costs		-356.6	-197.8
Other Operating Activities		477.6	333.1
(Income) Loss On Equity Investments		-190.6	-233.3
Provision & Write-Off Of Bad Debts		54.2	12.0
Change In account Receivable		-2.1	-85.1
Change In Inventories		-56.7	-86.5
Change In account Payable		-2.9	190.0
Change In Other Working Capital		316.8	-101.5
CASH FROM OPERATIONS		**1,093.4**	**708.0**
Capital Expenditure		-154.6	-206.1
Sale Of Property, Plant, And Equipment		18.4	29.1
Cash Acquisitions		-71.4	--
Divestitures		-38.7	8.6
Sale (Purchase) Of Real Estate Properties		-513.2	-518.4
Sale (Purchase) Of Intangible Assets		-3.1	-3.2
Investments In Marketable & Equity Securities		-722.3	-196.2

CASH FROM INVESTING	**-1,377.4**	**-886.0**
Short-Term Debt Issued	608.7	560.5
Long-Term Debt Issued	2,014.9	2,740.8
TOTAL DEBT ISSUED	**2,623.5**	**3,301.3**
Short Term Debt Repaid	-980.3	-470.9
Long Term Debt Repaid	-1,858.7	-1,957.0
TOTAL DEBT REPAID	**-2,838.9**	**-2,427.9**
Issuance Of Common Stock	732.9	18.6
Repurchase Of Common Stock	--	-29.3
Common Dividends Paid	-163.7	-172.3
TOTAL DIVIDEND PAID	**-163.7**	**-172.3**
Other Financing Activities	-311.4	-89.0
CASH FROM FINANCING	**42.4**	**601.4**
Foreign Exchange Rate Adjustments	11.0	-2.2
NET CHANGE IN CASH	**-230.6**	**421.2**

Appendix 11 Tranches

Sunway Treasury Sukuk (ICP 1)	MYR 240,000,000
Sunway Treasury Sukuk (ICP 2)	MYR 100,000,000
Sunway Treasury Sukuk (IMTN 2)	MYR 30,000,000
Sunway Treasury Sukuk (IMTN 3)	MYR 10,000,000
Sunway Treasury Sukuk (ICP 3)	MYR 100,000,000
Sunway Treasury Sukuk (ICP 4)	MYR 160,000,000
Sunway Treasury Sukuk (IMTN 4)	MYR 10,000,000
Sunway Treasury Sukuk (ICP 5)	MYR 240,000,000
Sunway Treasury Sukuk (ICP 6)	MYR 100,000,000
Sunway Treasury Sukuk (ICP 7)	MYR 100,000,000
Sunway Treasury Sukuk (ICP 8)	MYR 100,000,000
Sunway Treasury Sukuk (ICP 9)	MYR 200,000,000
Sunway Treasury Sukuk (ICP 10)	MYR 240,000,000
Sunway Treasury Sukuk (ICP 11)	MYR 100,000,000
Sunway Treasury Sukuk (ICP 12)	MYR 100,000,000
Sunway Treasury Sukuk (ICP 13)	MYR 100,000,000
Sunway Treasury Sukuk (ICP 14)	MYR 155,000,000
Sunway Treasury Sukuk (ICP 15)	MYR 240,000,000
Sunway Treasury Sukuk (ICP 16)	MYR 100,000,000
Sunway Treasury Sukuk (ICP 17)	MYR 200,000,000
Sunway Treasury Sukuk (ICP 18)	MYR 100,000,000
Sunway Treasury Sukuk (ICP 19)	MYR 150,000,000
Sunway Treasury Sukuk (ICP 20)	MYR 150,000,000
Sunway Treasury Sukuk (ICP 21)	MYR 100,000,000
Sunway Treasury Sukuk (ICP 22)	MYR 100,000,000