

INTERNATIONAL JOURNAL OF
ISLAMIC ECONOMICS AND
FINANCE STUDIES



*Uluslararası İslam Ekonomisi ve Finansı
Araştırmaları Dergisi*

November 2016,
Vol: 2, Issue: 3

*Kasım 2016,
Cilt: 2, Sayı: 3*

e-ISSN: 2149-8407

p-ISSN: 2149-8407



journal homepage: <http://ijisef.org/>

Accounting Issues in Sukuk Issuance

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ARTICLE INFO

ABSTRACT

Keywords: *Sukuk,
Accounting Issue, IFRS*

JEL Classification: *M41,
G00, G29*

This research aims to establish an accounting guideline for Sukuk issuance in non-financial companies and it has a special significance in solving various accounting problems during the Sukuk issuing process. Online survey has been conducted to obtain the accountants', academic and professional perceptions about the research questions, it covers several accounting issues, and it had received 25 on-line responses. In conclusion, we point, among other things, that the IFRS are accepted to account for Sukuk transactions, as using Special Purpose Vehicle is necessary to issue Sukuk, it should be consolidated by the Originator as well; it showed that Sukuk certificate could represent ownership of assets, represent liability or claim on the SPV and Right of usufruct of Assets. But the biggest part of respondents replied that Sukuk certificate should appear under liability.

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I. Introduction

Recently in Italy, an Increasing interest from government and corporates has been noticed to use Sukuk to fund their project, and this desire was due to the globally increase in using Sukuk. Thomson Reuters report expects Global outstanding Sukuk issuance to grow to \$907 billion by 2020. Islamic Finance Gateway. (2014)

In recent years, the international Sukuk market has grown considerably, with Sukuk issuances surging not only by volume and value, but also in the geographical scope of the issuing markets, the value of international Sukuk issued in 2014 reached US\$114 billion, of which 85% was issued by sovereign and quasi-sovereign entities, Several factors are driving sovereigns to participate in the Sukuk market, including: the desire to establish a benchmark and to encourage the development of a corporate Sukuk market in the relevant country or territory, as well as the need to develop a legal and regulatory framework that recognizes and facilitates the issuance of Sukuk — especially in jurisdictions where Islamic principles are not enshrined in national law. But the expectation that sovereign and quasi-sovereign issuances would pave the way for corporates to issue Sukuk has not so far materialized, (IRVINE, 2015) because most of the corporates still have ambiguity in accounting practise for issuing Sukuk, and lack of knowledge about the legal and regulatory framework.

The term Islamic finance encompasses any type of financial activity that is undertaken in accordance with Islamic law (Shariah). Sukuk is a generic term used to encompass a broad range of financial instruments designed to conform to the principles of Islamic law (Shariah). Although many Sukuk structures are designed to replicate the economic function of conventional bonds, their legal structures are different. Classifying Islamic financial instruments, including Sukuk, under existing regulatory frameworks has posed challenges in the UK and other jurisdictions.(HM Treasury, 2009) The interests on Islamic accounting has been growing for the past two decades, however, the development of Islamic accounting is still at the infancy stage. (Rahman and Rahim, 2003)

Due to the growth in the Islamic finance particularly Sukuk, the need for specific accounting standards, which account for the issuance transactions and Islamic contracts, is an essential issue.

This study will explore only the accounting treatment for Sukuk issuance transactions, because the researchers take into consideration the existence of different jurisdiction schools in Islam, which could cause the variation in Fatwa and implications of Islamic finance instruments.

The research questions cover several accounting issues, including the accounting standards used during the issuance, using the SPV in Sukuk structure, consolidation of the SPV, recognition of the assets from the originators book and accounting classification of Sukuk certificate in the financial statement.

The paper starts with an introduction. Afterwards, section two elaborates literature review, an overview of Sukuk structures and accounting issue as well. Section three demonstrates the methodology used and explanation of the survey. Section four provides the research findings. Section five concludes the paper.

II. Literature Review

Sukuk is a plural (what does this mean?) of Sakk; Sukuk is an Islamic financial certificate that complies with Shariah principle and laws. Investment Sukuk as defined by AAI OFI are the certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity. However, this is true after the receipt of the value of the Sukuk, the closing of the subscription and employment of funds received for the purpose of which the Sukuk were issued. (AAIOFI 2008).

This definition includes two important points; the first one is that Sukuk holders must have real ownership of the asset of the specific project. The second one is that the project and the Sukuk issuance procedure must be consistent with Shariah principle.

Most of Sukuk issuance usually begin with same process, starting from establishing the SPV (issuer), after that the originator transfers specific assets, or the usufruct right of the assets to the SPV, then the Investors subscribe for Sukuk and pay the proceeds to SPV, therefor the SPV issue Sukuk certificates to Sukuk holder. The difference between the structures depends on the contract between the SPV and the originator (lease, wakalah,...); after that we back to the common steps which are to distribute the profit to the Sukuk holder by the SPV and redeem the Sukuk at maturity. We can divide the Sukuk into two phases, the first one is the general phase which is common in most of Sukuk structures; the second one is a specific phase which depends on the contracts used between the SPV and other parties. (Biancone and Shakhatreh, 2015)

From the preceding discussion, many questions have arisen about the accounting issue and transactions in the Sukuk, which are the main obstacles to the originators; therefore this study aims to answer the ambiguous questions and investigate the accounting treatment for issuing Sukuk.

The previous studies explored the Sukuk structures and most of them have focused on the accounting regulation and standards of Islamic financial institution, but limited number of studies are about non-financial companies which need to use the Islamic finance.

A study by (Mirza and Baydoun, 1999) stated that there exists a need for developing accounting and reporting standards that are relevant to Muslim firm, because of the accounting and reporting practices of firms in Islamic societies are likely to reflect the Islamic business contracts and business practices. Moreover, the study showed that the Accounting standards for firms in Islamic societies need to be broad and flexible.

According to (Lewis, 2001) In an Islamic society, the development of accounting theory should be based on the provisions of Islamic law along with other necessary principles and postulates which are not in conflict with Islamic law. Two approaches suggest themselves:

a. Establish objectives based on the spirit of Islam and its teaching and then consider these established objectives in relation to contemporary accounting thought.

b. Start with objectives established in contemporary accounting thought, test them against Islamic shari'a, accept those that are consistent with shari'a and reject those that are not.

So far, Islamic accounting standards are limited to Islamic finance institutions and the leader organization is the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), which is an Islamic international autonomous non-for-profit corporate body that prepares accounting, auditing, governance, ethics and Shariah standards for Islamic financial institutions. AAOIFI has issued 48 Shariah standards, 26 financial accounting standards, five auditing standards, seven governance standards, and two ethics standards. According to (Lewis, 2001), AAOIFI has followed the second approach when formulating accounting standards. It is taking into consideration the international standards and practices which comply with Islamic Shariah rules. AAOIFI financial accounting standards (FAS) give guidance on, amongst others, presentation of financial statements for Islamic financial institutions (IFIs), accounting treatment for specific Islamic finance products and mechanisms.

A working group was established by The Asian-Oceanian Standard-Setters Group (AOSSG) to investigate the financial reporting issues which are related to Islamic finance; the objective of this Group is to facilitate AOSSG members providing input and feedback to the IASB on the adequacy and appropriateness of proposed and existing International Financial Reporting Standards (IFRSs) to Islamic financial transactions and events.

(AOSSG) is a grouping of the accounting standard-setters in the Asian-Oceanian region. The group has been formed to discuss issues, share experiences on the adoption of International Financial Reporting Standards (IFRS) and to contribute to the development of a high-quality set of global accounting standards.

(Rahman and Rahim, 2003) examined contemporary accounting regulatory issues on investments in Islamic bonds or Sukuk. Their study also highlights and discusses the requirements made by AAOIFI's Financial Accounting Standard No.17 (FAS 17) on accounting for investments in Islamic bonds or Sukuk. The standard setting out the principles for the recognition, measurement, presentation and disclosure of investment Sukuk by Islamic financial institutions. It concluded that the development of a new discipline, called Islamic accounting, establishes an urgent need for the accounting academics and practitioners to undertake studies that attempt to understand how accounting is influenced by and adapted to the way the economic system is organized and the philosophy underpinning its system.

(Sukor et al., 2008) aims to examine the contemporary accounting regulatory issues on investment in Sukuk in Malaysia; it explained AAOIFI new standard, FAS 17 which covers Islamic Investments including Sukuk, and according to the standard, Islamic bonds should be classified into three categories according to investment intentions, rather than two categories in accordance to the period of holding as is the practice in the traditional accounting.

a) Accounting standards

The first accounting issue is the accounting standards used by the Originator during the Sukuk issuance. We assume that the International Accounting standards are accepted and fit with Islamic finance, except the standards incompatible with Shariah principle, because Islam is not against any accounting standards unless they conflict with Shariah, at which the most important principle is prohibition of (Riba) interest, although most business activities must be permitted by Islamic law, and forbidding Gharar (ambiguity) And Maysir (uncertainty).(Biancone and Radwan, 2015)

More than 100 countries currently subscribe to the International Financial Reporting Standards (IFRS), while most other jurisdictions permit the use of IFRS in at least some circumstances, or some countries use their national standards which are based on IFRS,

(Asian-Oceanian Standard-Setters Group, 2011) survey found that the term 'Islamic accounting standards' does not refer to a homogenous set of standards. Instead, the term appears to refer to various sets of religiously-influenced standards that can have markedly different requirements for similar

transactions. While some requirements may be comparable with IFRS, others are not. Foremost among Islamic accounting standards are those issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), but some jurisdictions have locally-developed Islamic standards which may or may not be based on AAOIFI standards. The survey has a question about the financial reporting standards generally apply to entities engaged in finance and from the 23 standard-setters that answered this question, 47% (11 jurisdictions) replied that IFRS would generally apply to entities engaged in finance, and another 35% (eight jurisdictions) replied that national standards based on IFRS would apply. Most participants (78%) do not have special reporting standards for Islamic finance.

Furthermore, using international standards to account for Sukuk transactions would enhance the comparability and comprehensiveness of financial report, and would allow to wide range of companies to engage with Islamic finance instruments, without concern about the difference between accounting standards.

By reviewing number of Sukuk issuance, we found that most of Sukuk issuers (SPV) do not publish their financial report, but the financial result should appear in the consolidated financial statement of the Originator (parents companies). We found financial statement of one of the Sukuk issuer (subsidiary) which is HM Treasury UK Sovereign Sukuk (UKSS). Both of the Originator and issuer have published their financial report, and according to (UKSS) financial report 2015, the company prepared their financial report in accordance with IFRS.

b) Consolidate the SPV

The originator of Sukuk usually establishes SPV to issue Sukuk, whether it is a sovereign or corporate Sukuk, This SPV is totally owned by the Originator, the manager and staff recruitments have been doing by the originator. The SPV has been established for specific purpose and activities, and accordingly the Originator has a control of the subsidiary. According to (Collings, 2012) A parent company only has a subsidiary when the parent controls that subsidiary. If the parent doesn't have control, it doesn't have a subsidiary. Then it accounts for its investment in a company as an associate under IAS 28 Investments in Associates or as a simple investment as a financial asset under IAS 39 Financial Instruments. IFRS 10 says that a company has control of another company (the investee) if (and only if) it has power over the investee, which means that the investor has:

- ✓ Rights that enable it to direct the subsidiary's activities
- ✓ Exposure, or rights, to variable returns from its involvement with the investee

- ✓ Power over the investee to such an extent that it affects the amount of return the investor receives from the investee. (Collings, 2012)

By returning to our example about (UKSS), this subsidiary is owned by HM Treasury; it draws its staff resource from HM treasury and government legal department, and operates in general under the governance and control arrangements in place for the treasury, it has been consolidating from the Originator as well.

c) Transfer of assets

Generally, the originator transfers an asset to a special purpose Vehicle (SPV). This transfer could be a transfer of ownership of the assets, Or Right of usufruct of Assets, and sometimes the transfer is arranged with an arrangement for the assets to eventually be transferred back to the originator. With regard to classification of Sukuk into asset back or asset based, under asset-backed Sukuk the Sukuk holder has a resource to underlying assets and these assets must be separated from the originator books. While asset based Sukuk, the Originator keeps the assets in his book, thus Sukuk holder has beneficial ownership in the underlying assets.

Recognition of the assets from the originator books is a very important and controversial issue, and related to other issues like the type of assets and the classification of the certificate.

Under AAOIFI Shariah standard no.17 S 4.2, the investment Sukuk represents a common share in the ownership of the assets made available for investment, whether these are non-monetary assets, usufruct, services or mixture of all.

Under UK finance act (2007/48A(1)/(b)) the Sukuk arrangements identify assets, or a class of assets, which the (Sukuk Issuer) will acquire for the purpose of generating income or gains directly or indirectly.

In our example (UKSS) the Sukuk assets was a 99-years Head lease on the trust assets. The Issuer (UKSS) discloses this head lease under the financial statement note. Department of Communities and Local Government DCLG as Landlord will lease to the Trustee (UKSS) certain land and buildings (the "Premises") for a term of 99 years, together with the benefit of the Rights, in consideration for the lease of the Premises; the Trustee (UKSS) shall pay a Premium, which will be an amount equal to the proceeds of the issue of the Certificates. Acquiring the head lease does not make any change in the original assets. The issuer considers it as financial assets, which fall within the category of loan and receivable and all the financial liabilities fall within the category of financial liabilities at amortised cost as defined in IAS 39.

English law stated that the issuer uses the subscription proceeds to acquire assets, which are specified in the arrangement, and are held for the benefit of the “Sukuk-holder”. Income generated from the assets is distributed to the Sukuk holders and, on maturity of the Sukuk, the assets are sold under pre-existing arrangements and the proceeds returned to the Sukuk-holder. (Corporate Tax Act 2009 section 507 paragraph 1399)

d) Sukuk certificate

Exploring the Sukuk certificate definitions will lead to detect a contradiction between the definitions and real practices, AAOIFI defined the Investment Sukuk as the certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity. (AAOIFI, 2010)

In our example (UKSS), by looking to the balance sheet of the issuer, we will find Investment account under noncurrent assets which is equal to issuance value; it is classified as financial assets, and it comprises 99-year Head lease as a lessee, and respects to the 5 years sublease of the trust assets back to DCLG by the company as a lessor. On the other hand, Sukuk certificate account appears under long term liability, company classified it as financial liabilities. The certificate pays periodic distributions to investors at a rate of 2.036% per annum.

From our example, we conclude that Sukuk certificate is classified as liability, and this issuance is governed by the English law, which is the most used by the issuers. English law stated that “The arrangements are wholly or partly treated in accordance with international accounting standards as a financial liability of the bond-issuer (Sukuk issuer)”. Finance act (2007/48A(1)/(i)). This means that Sukuk is liable; moreover under (ICTA, S 417) a bond-holder is a loan creditor in respect of the bond-issuer.

An Islamic asset includes all valuable property resulting from previous events belonging to the owner. Such an asset should not be usurped and if it is obtained in a lawful (halal) way, it will have economic benefits for its owners. Lawful acquisition is a critical aspect of ‘asset’ in this context; rights to interest income are never recognised. Liability is defined in Islam either as a faithful obligation, or any debt to other persons or business entities. Again, in respect to both, the paying of interest is prohibited. Finally, equity in residual benefits is obtained directly from the financial evaluation and contrasting assets and liabilities. (Lewis, 2001)

In this research we suggest four possible accounting classifications for Sukuk certificate in the Balance sheet: the first possibility is under liability, which is most used in previous issuance; in this case if it is normal liability, we

think that the Originator can issue the Sukuk directly without the SPV. The second option is under Owners equity, which we disagree with, because the entitled to a number of rights, including receiving a regular flow of information on developments of the company's business and exerting voting rights, but in case of Sukuk the holders are entitled to the profit but have no voting rights because they do not own any portion of equity capital. The third one is an intermediary between liability and owner equity; we agree with this classification because according to Sukuk definitions the Sukuk is not liability and also Sukuk holders are not owners. The fourth and last option is Contra asset account, we suggest this option because we think that the assets appear in the SPV balance sheet but in fact the real owner of this asset are the Sukuk holders.

III. Research design and method

Qualitative research method has been used, Secondary data was collected by exploring literature, accounting standards and previous Sukuk issuance. The research analyses the information which is already available to make a critical evaluation of the material. We are mainly depending on international accounting standard (IFRS), International public sector accounting standards (IPSAS), AAOIFI, financial report, and English law.

Primary data was collected by using questionnaire. Online survey has been used to obtain the accountant, academic and professional perceptions about the research questions, which include the main accounting issue in Sukuk, it includes 15 questions with a possibility to specify each answer, and it was published by research gate and LinkedIn throughout the Islamic finance groups and also by sending directly to the contents, it has been sent also by email to 75 professors and academics who are specialist in Islamic finance, it has been sent by email to 16 audit and accountant companies in golf, UK, Malaysia and Indonesia.

The following are the main research questions used in our study:

- ✓ Is it possible to apply IFRS in issuing Sukuk?
- ✓ Is the using of special purpose vehicle (SPV) necessary to issue SUKUK?
- ✓ Does the originator have the control over the SPV?
- ✓ Should the Sukuk Originator consolidate the SPV?
- ✓ Should the originator derecognize the assets from its book?
- ✓ In case of transfer the beneficial interests in the assets, should the originator keep the assets on its financial statements, and recognise a liability related to the transfer?

- ✓ Could the repurchase option from the Sukuk originator effect on the derecognition of the assets.
- ✓ Are the Waa'd (promise) of repurchase the assets at the end of the sukuk's term considered as a liability?
- ✓ Could Sukuk certificate represent a claim or liability? And if yes where it should appear in the financial statement?
- ✓ Could Sukuk certificate represent an Ownership of the assets? And if yes where it should appear in the financial statement?
- ✓ Could Sukuk certificate represent a Right of usufruct of Assets and its future cash flows? And if yes where it should appear in the financial statement?

IV. Research finding

The survey was run between 5th June and 15th July 2015, unfortunately the survey had received 25 on-line responses, and 64. % of the respondents were from academics and only 12% from accountants.

The results showed that 68% of respondents were agreeing with the possibility of using IFRS in issuing Sukuk, which means that most of the respondents agreed that International Accounting standards are accepted and applied in sukuk issuance process.

And regarding the consolidation of the SPV, the result showed that 60 % of respondents consider the SPV is necessary in issuing Sukuk, and 32% thought that it depends on the type of Sukuk, but only 4% thought that the originator could be the issuer without SPV.

In addition, 72% of respondents stated that the Originator has the control over the SPV, and 52% of respondents replied that the Originator should consolidate the SPV.

And about the transfer of assets to the SPV the result indicated that 52% of respondents replied that the assets should be derecognised from the originators book, and 44% replied that it depends on the type of assets, and only 4 % were stated that the originator should keep the asset in their books, which mean that the assets have to be derecognised from the originators book; one of respondents said that one asset cannot have double owners at 100 percent, and we are with the second group who replied that it depends on type of assets. We asked those groups which assets should derecognize, and the respondents choose tangible assets 7 times and right to use tangible assets 6 times, cash flow from tangible assets 4 times, and twice for intangible assets and once for financial assets.

But in case of transfer the beneficial interests in the assets, the result showed that 64% of the respondents agreed that the originator should keep

the assets on its financial statements, and recognise a liability related to the transfer, one of the respondents commented: the beneficial interest in assets is classified as assets based sukuk, and the originator should keep the assets in his books, and disclose the transfer under financial statement note, and recognise a liability related to the transfer. 64% of the respondents revealed that the promise of repurchase (Waa'd) from the Sukuk originator effects on derecognition of the assets; in our opinion it depends if the Waa'd is considered as a liability or not which is answered by the next question.

76% of respondents agreed that the Waa'd (promise) of repurchase the assets at the end of the Sukuk's term is considered as a liability, one of the respondents added a comment: it is liability because failure to fulfil the Waa'd will cause financial loss, another respondent said that it depends on the contract if it is mandatory or not, and we agree with this comment. And finally with regard to Sukuk classification, the result showed that 64% of respondents agreed that Sukuk certificate represents the ownership of underlying assets, 35% of them replied that Sukuk certificate in this case should appear under liability, and 20% under owner's equity, and 30% under intermediary account between owners' equity and liability 10% stated that it should be treated like contra assets account, 5% choose other.

While 60% of respondents agreed that Sukuk certificate represents liability or claim on the SPV, 44.4% of them replied that Sukuk certificate should appear under liability, and 16.7% under owner's equity, and 27.8% under intermediary account between owners' equity and liability 11.1% stated that it should be treated like contra assets account.

76% of respondents agreed that Sukuk certificate represents Right of usufruct of Assets and its future cash flows, 40% of them replied that Sukuk certificate should appear under liability, and 25% under owner's equity, and 20% under intermediary account between owners' equity and liability 10% stated that it should be treated like contra assets account, 5 % choose other.

V. Conclusion

The rapid growth of Sukuk industry and desire of many companies to use Sukuk have been the motivation behind the study of accounting issue in Sukuk issuance. Ambiguous accounting issue has been faced during exploring the Sukuk issuance steps in non-financial companies; a survey was used to clarify these issues. The result showed that IFRS are accepted to account for Sukuk transactions. Most of respondents stated that creating SPV is necessary to issuance Sukuk, and the originator has the control over the SPV, and it should be consolidated by the originator and that in line with the IFRS.

The study indicated that in case of transferring the assets to the SPV, it should be derecognised from the originator books, but in case of transfer the

usufruct right the result showed that the originator keeps the assets in his books and recognizes liability. It also showed that repurchase Waa'd is considered as a liability and could effect on derecognition of assets. It concludes that Sukuk certificate could represent ownership of assets, liability or claim on the SPV and represent Right of usufruct of Assets, at which the biggest part of respondents replied that Sukuk certificate should appear under liability, this was against our expectations, because we assume that the relationship between Sukuk holder and issuer is buyer-seller relationship, not lender borrower relationship, and we think that if the Sukuk is liabilities, the Originator can issue Sukuk without SPV and keep the assets in his books. Our expectation was with the second group who choose the intermediary account between liability and owner equity.

VI. Limitations and future research

This study is limited regarding to accounting issues in non-financial companies, in order to help them to diversify their finance sources and to overcome the accounting obstacles in Sukuk issuance, in the presence of the organization concern only about Islamic banks and Islamic institutions. The second limitation was about the type of Sukuk; this research explores the Sukuk in general. It doesn't investigate the accounting treatment to any particular type of Sukuk. In the future, further research should be carried out to explore the accounting treatment and the reporting practices of each type of Sukuk. The last limitation was the number of respondents; the survey was run between 5th June and 15th July 2015, unfortunately the survey had received 25 on-line responses, we sent it by emails, LinkedIn and Research gate, we expected to receive more responses, especially from accountants and auditors.

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