AN EXPLORATORY STUDY OF ACCOUNTING PRACTICES FOR MURABAHAH AND BAI'BITHAMAN AJIL BY ISLAMIC BANKS IN MALAYSIA

BY

NORI YANI ABU TALIB

A dissertation submitted in fulfilment of the requirement for the degree of Master of Science in Accounting

Kulliyyah of Economics and Management Sciences
International Islamic University Malaysia

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ABSTRACT

The study aims firstly to examine whether the accounting recognition, measurement and disclosure on *Murabahah* and *BBA* under FRS 118, BNM GP8*i*, MASB TR*i*-3 and MASB TR*i*-4 are compatible with AAOIFI FAS 2 and FAS 20. Secondly, the study examines the perceptions of accountants and financial accounting executives on existing accounting standard and guidelines on *Murabahah* and *BBA* of Islamic banks in Malaysia. Thirdly, perceptions of accountants and financial accounting executives on AAOIFI accounting standards for *Murabahah* and *Bai' Muajjal* (deferred payment sales) are examined accordingly. Finally, the study analyses the relationship between training of Islamic banking finance, total working experience and education background with the level of acceptability of AAOIFI FAS 2 and FAS 20 among the Islamic banks' accountants and financial accounting executives of Islamic banks in Malaysia. The study found that there are major differences in terms of revenue recognition, asset and profit measurement and disclosure between those standards and guidelines. The result of the questionnaire survey indicated high degree of acceptability towards MASB FRS 118 and MASB TR*i*-3 and TR*i*-4 and thus, indicated the support towards convergence with IFRS. Whereas, the moderate acceptability of AAOIFI FAS 2 and FAS 20 signifies the implementation of the Islamic accounting practices to the Islamic banking industry in Malaysia will be a paramount challenge. Perhaps, the accountants and financial accounting executives of the Islamic banks are not aware of the accounting issues related to *Murabahah* and *BBA* due to their moderate acceptability of the statements related to accounting issues in *Murabahah* and *BBA*. The result of Pearson Correlation Coefficient test has indicated that there are no significant relationship between attendance in training of IBF, total working experience and education background with the level of acceptability of AAOIFI FAS 2 and FAS 20. However, the result of the correlation are not conclusive due to certain limitations exist in the study. The study implies that the ability to compare the financial performance of different Islamic financial institutions becomes seriously impaired because the difference in accounting practices exists among global Islamic financial institutions. There are paramount challenges on the harmonisation of financial reporting of the Islamic finance as a result of inconsistency of the financial reporting of Islamic financial institutions worldwide. The challenges will involve many parties, the scholars, practitioners and regulator to discuss, research and engage toward developing a just and fair accounting that will benefit not only the business but more importantly to humanity.

ملخص البحث

يهدف هذا البحث أولاَ : إلى دراسة ما إذا كانت القوانين المحاسبية المتعلقة بالقياس والإفصاح في المرابحة والبيع بثمن أجل تحت GP8*i* ,FRS 118. و القانون MASB TR*i*- 3 وMASB TR*i*-4. متوافقة مع AAOIFI رقم FAS 2 ورقم FAS 20. ثانياَ : هذا البحث يهدف إلي دراسة التصورات الخاصة بالمحاسبين و المدراء التنفيذيين حول المعايير المحاسبية الحالية والمبادئ الإرشادية الخاصة بالمرابحة والبيع بثمن أجل لدي المؤسسات المالية الاسلامية في ماليزيا. ثالثاَ : أن التصورات الخاصة بالمحاسبين والمدراء التنفيذيين حول AAOIFI الخاص بالمرابحة والبيع المؤجل قد تم دراستها بالشكل الكافي. واخيراَ : يهدف البحث إلي تحليل العلاقة ما بين دراسة التمويل المصرفي الاسلامي, وأجمالي الخبرات العملية والخلفية التعليمية مع مستوى قبول AAOIFI رقم 2 ورقم 20 في المصارف الإسلامية بدولة ماليزيا. خلصت هذه الدراسة إلي أن هنالك إختلافات معنوية كبيرة فيما يخص الإعتراف بالعوائد والإيرادات , كيفية قياس الأصول والأرباح والإفصاح المالي ما بين هذه المعايير والمبادئ الإرشادية. نتيجة الاستبيان الذي تم إجراؤه تشير إلي درجة قبول عالية نحو معيار MASB-FRS 118 ومعيار MASB TR*i*–3 وكذلك معيار MASB TR*i*-4 وبالتالي , هذا يوضح مدي التقارب نحو IFRS. في حين أن ضعف قابلية معايير هيئة المحاسبة والمراجعة رقم AAOIFI FAS 2 ورقم FAS 20 يوضح حجم التحدي الذي سيواجه صناعة الصيرفة الإسلامية في دولة ماليزيا عندما تسعي لتطبيق هذه المعايير. ربما لا يدرك المحاسبين والمدراء التنفيذيين للمصارف الإسلامية القضايا المحاسبية المرتبطة بصيغ المرابحة والبيع بثمن أجل نسبة لمحدودية تقبلهم للبيانات المتعلقة بالقضايا المحاسبية للمرابحة والبيع بثمن أجل .وقد اوضحت نتيجة إختبار معامل الارتباط (بيرسون) أنه لا توجد علاقة ذات دلالة معنوية ما بين حضور دورات تدريبية في المصارف الإسلامية , وإجمالي الخبرات العملية والخلفية التعليمية مع مستوى قبول AAOIFI FAS 2 و FAS 20. ومع ذلك، نتيجة للارتباط ليست نهائية نظرا للقيود معينة موجودة في الدراسة .يعني الدراسة أن القدرة على مقارنة الأداء المالي للمؤسسات المالية الإسلامية المختلفة يصبح ضعف خطير بسبب الاختلاف في الممارسات المحاسبية فيما بين المؤسسات المالية الإسلامية العالمية .هناك تحديات كبرى على تنسيق إعداد التقارير المالية للتمويل الإسلامي نتيجة للتضارب في التقارير المالية للمؤسسات المالية الإسلامية في جميع أنحاء العالم .إن التحديات تنطوي على العديد من الأطراف، والعلماء والممارسين ومنظم لمناقشة والبحث والمشاركة نحو تطوير المحاسبة عادلة ومنصفة من شأنها أن تعود بالنفع ليس فقط على رجال الأعمال ولكن الأهم للبشرية جمعاء.

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Science in Accounting.

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Abdul Rahim Abdul Rahman
Supervisor

I certify that I have read this study and that in my opinion it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a research paper for the degree of Master of Science in Accounting.

....
Noraini Mohd Ariffin
Examiner

This dissertation was submitted to the Department of Accounting and is accepted as a fulfilment of the requirement for the degree of Master of Science in Accounting.

....
Suhaiza Ismail
Head, Department of Accounting

This dissertation was submitted to the Kulliyah of Economics and Management Sciences and is accepted as fulfilment of the requirement for the degree of Master of Science in Accounting.

....
Khaliq Ahmad
Dean, Kulliyyah of Economics
And Management Sciences

DECLARATION

I hereby declare that this dissertation is the result of my own investigation, except where otherwise stated. I also declare that it has not been previously or concurrently submitted as a whole for any other degrees at IIUM or other institutions.

Nori Yani Binti Abu Talib

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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institution
ACCA	Association of Chartered Certified Accountants
AOSSG	Asean-Oceanian Standard-setters Group
BBA	*Bai' Bithaman Ajil* (Deferred Payment Sales)
BFR	Base Financing Rate
BLR	Base Lending Rate
BNM	Bank Negara Malaysia
CEV	Cash Equivalent Value
FRS	Financial Reporting Standard
GP8	Garis Panduan 8
IASB	International Accounting Standard Board
IFRS	International Financial Reporting Standard
IRTI	Islamic Research and Training Institute
IFSB	Islamic Financial Services Board
IIFM	International Islamic Financial Market
IBF	Islamic Banking and Finance
IFI	Islamic Financial Institutions
ISRA	International *Shariah* Research Academy
JBIC	Japan Bank for International Corporation
KLIBOR	Kuala Lumpur Interbank Offer Rate
LMC	Liquidity Management Centre
LIBOR	London Interbank Offer Rate
MASB	Malaysian Accounting Standards Board
OPR	Overnight Policy Rate
TR	Technical Release
SAC	*Shariah* Advisory Council
SOP*i*	Statement of Principle *i*

CHAPTER ONE

INTRODUCTION

1.1 BACKGROUND OF THE STUDY

Islamic finance today has achieved the impressive result and is able to compete with the conventional financial system. However, Islamic finance is still in its infancy stage and the sustainability of Islamic finance as a financial intermediation must continually strengthen. For example, further development of Islamic financial markets, financial infrastructure, research and development need to be emphasized in order to support innovation. Besides, *Shariah* and legal infrastructure as well as regulatory and supervisory framework need to be enhanced (ISRA, 2011). Islamic banks are those banks that follow Islamic rules or *Shariah* in their business dealing. The transactions of the Islamic banks have particular unique characteristics that may have accounting implications different from those of transactions in conventional banks. Thus, Islamic banks might need a different set of accounting standards due to the different characteristics of its Islamic financial transactions. Meanwhile, Islamic bank has sought to develop *Shariah* compliant financial products to meet the financing needs of Muslims. Fixed return modes of financing rank highest in use by most Islamic banks and the majority of the financing arranged by Islamic bank is based upon *Murabahah* (Sairally, 2002). However, the extensive use of *Murabahah* has given rise to heavy criticisms of the Isamic banking industry.

Murabahah is defined as cost plus mark-up sales. The mark-up represents the profit portion received by the Islamic bank. Originally, *Murabahah* was a particular type of sale and not a mode of financing. According to *Shariah*, the ideal modes of financing are *Mudharabah* or *Musharakah*. However in the side of the current economic circumstances, there are certain practical complications in applying *Mudharabah* and *Musharakah* as instruments in every type of financing. Consequently, contemporary *Shariah* experts have allowed, subject to certain condition the use of *Murabahah* on a deferred payment basis as a mode of financing. Indeed, *Murabahah* as a mode of financing has been allowed by the scholars with conditions which can clearly make a distinction between the interest- bearing loan and the transaction of *Murabahah*. If these conditions are ignored, the transaction becomes invalid according to *Shariah* (Albaraka Bank, 2009).

Murabahah involves a sale- and- purchase agreement under which the seller buys raw materials, good or equipment required by the customer for resale to the same customer at a mark-up price agreed upon by both parties. *Murabahah* seems to function similar to *Bai' Bithaman Ajil (BBA)* to some extent. However, *Murabahah* is applied for medium or short term financing as compared to *BBA*, which is applied for long term financing such as to finance houses. The practice of *BBA* in Malaysia is dedicated for consumer financing, home financing, education financing, car financing and so forth (Amin, 2008).

Murabahah financing is very important to the Islamic banks as it dominates their financing activities. Some scholars argue that this financing is similar in some aspects to loan provided by the conventional bank. Thus, this raises the issue of the relevance of conventional standards such as IAS 18 Revenue Recognition to account for this transaction. The issue of revenue recognition from *Murabahah* is very important for the Islamic banks. The mark-up charged to the purchaser over the original cost of items to the bank cannot be considered as interest. The traditional accounting standards for instalment sales, which require the separation of a mark-up into profit margin and interest charges, are not suitable from the Islamic perspective (Napier, 2007). Besides, the use of interest rate as a benchmark for determination of the mark-up like LIBOR has been criticised on the ground that the use of interest as a benchmark makes the transaction resemble an interest based financing and hence, it renders it *haram* (prohibited).

Amin (2008) highlighted four main reasons why do we need accounting standards for Islamic financial institutions. Firstly, the number of Islamic financial institutions around the globe has shown a rapid growth. This is due to wider understanding and public acceptance and the support of the government to promote Islamic financial institutions. This can be proven by the introduction by the government of a structural framework of Islamic banking as well as a set of facilitative measures to nurture a healthy development of the industry for Islamic banking system. Second, there is a lack of *Shariah* consistency since Islamic banks and other Islamic financial institutions, as well as conventional banks providing Islamic banking services have relied heavily on the prevailing guidelines issued by the Bank Negara Malaysia (BNM) and *Shariah* advisors appointed by the respective banks. Third, there is a lack of comparability and consistency since the absence of a proper set of accounting standards for the recognition, measurement, and disclosure of Islamic based transactions complicate or hinder attempt to compare financial performance among banks or between periods for individual banks. Fourth, the existing standards, for instance, MASB standards, which have been developed in harmony with the IASs, have not been able to address accounting issues within Islamic banking operation adequately (FRS*i*-1). The fundamental differences in underlying principles, along with the distinctive nature of Islamic financial practices, have rendered many facets of conventional accounting standards irrelevant to Islamic banking.

As a result, AAOIFI has established specific Islamic accounting standards with regard to *Murabahah* and *Murabahah* to Purchase Orderer and deferred payment sales which are FAS 2 *Murabahah* and *Murabahah* to Purchase Orderer and FAS 20 *Bai Muajjal* (Deferred Payment Sales). However, Islamic banks in Malaysia are currently adopting FRS 118 *Revenue Recognition* (a localised version of IFRS) but at the same time applying relevant technical releases issued by MASB which are MASB Technical Release-*i* 3 on Presentation of Financial statement of IFI and MASB Technical Release-*i* 4 on *Shariah* Compliant Sales Contract. This is due to the national's law and regulatory requirements that the Islamic banks in Malaysia are subjected to follow.

1.2 RESEARCH PROBLEM

Islamic banks face unique accounting issues both from a technical perspective and philosophical perspective. Some of the accounting issues are the profit recognition and allocation (Karim, 1998; Talib, 2000; Napier 2007) and the inappropriateness of International Accounting Standards (Hamid et al, 1993; Karim, 1999; Amin, 2008). Thus, questions had arisen as to whether existing accounting standards could adequately address Islamic transactions or whether the transactions were so unique that some other form of accounting framework would be required (AOSSG, 2010). As the Islamic banks in Malaysia are currently adopting the localised version of International Financial Reporting Standards (IFRS) which is FRS 118 (IAS 18) for the revenue recognition of *Murabahah* and *BBA* financing, this becomes the main issue as the standard deals with the separation of financing charges from the profit margin. The standard requires the difference between fair value and nominal amount of consideration in sales of goods is recognised as interest revenue which is not suitable in the Islamic perspective. The mark-up charged to the customers cannot be considered as interest due to the prohibition of interest itself. The mark-up should not be separated into trading profit and separate charges for credit, as this would lead to the treatment of credit facility as a conventional loan (Archer and Karim, 2001). Thus, the existing accounting standards adopted by the Islamic banks in Malaysia also were also perceived to be inappropriate and irrelevant to address the Islamic financial transactions of the Islamic financial institutions. Perhaps, specific accounting framework which can address the unique characteristics of the Islamic financial institutions might need to be considered.

Mohamed Ibrahim (2007) discusses that Islamic banking might need a different set of accounting principles because of its different product characteristics and participation level. Thus, Karim (1996) argued the need to implement accounting standards promulgated by AAOIFI because these standards specifically cater for the unique characteristics of the contract that govern the operation of Islamic banks.

Majority of financial transactions of Islamic banks are based on the mark-up or cost plus sales contract and it dominates the financing activities of the Islamic banks. *Murabahah* and *BBA* have been extensively practised by Islamic banks because these products cater the need of the customers who are seeking *Shariah*-compliant banking and financing. *Murabahah* or cost plus mark-up sale is the first of asset based financing contract employed by Islamic banks and become the most widely used financing instrument as it somehow resembles a loan contract (Mohamed Ibrahim, 2012). The issue of revenue recognition from *Murabahah* is very important to the Islamic banks since in late 1980s, *Murabahah* represented over 70% of the asset portfolio (Mulhem, 1989) and reached 90% in some of them (Hassanien, 1996). Napier (2007) discusses the arguments that this financing activity as practiced by Islamic banks is similar in some aspects to loan provided by conventional banks (Siddiqi, 1983; Al-Abadi, 1988; Al-Azzizi, 2000; see also Hamoud, 1988) raises the relevance of conventional accounting standards such as IAS 18 *Revenue Recognition* to account for this transaction. In case of Malaysia, FRS 118 *Revenue Recognition*, a local accounting standard based on IFRS is currently applied in the Islamic banks in Malaysia is similar to IAS 18. However, Karim (2001) concludes that adopting IFRS would not make Islamic banks' financial statements comparable, due to the slack resulting from the inadequate fit of IFRS to Islamic banks transactions.

Islamic banks around the world still apply different accounting treatments and few have started to use AAOIFI standards. This may be due to the flexibility provided by the current accounting system and the differences in the interpretation in applying *Shariah* principles to the Islamic banking activities that lead to different accounting implications. Many of the Islamic banks apply the accounting treatments suggested by their *Shariah* Supervisory board as they apply different interpretations of Islamic principles (Napier, 2007). However, the author further explained that the problem of different interpretations of *Shariah* by those advising on the relevant accounting treatments for Islamic banks that emerged from the literature is that considering zakat as the main objective of accounting which implies the use of current value. In the meantime, the concept of *Tandeed* apparently imposes the use of historical cost which is supported by the major schools of thought. It would be hard for the Islamic scholars to justify the use of current values to the extent that these are based on calculation of present value incorporating the time value of money. Hence, this would appear to recognise the legitimacy of interest and would run counter to the provision of *Shariah*.

This will be a great challenge to reconcile these two conflicting positions and in order to develop a coherent Islamic accounting or a uniform view of the accounting concepts from an Islamic perspective.

Besides, Naser and Pendlebury (1997) viewed that the variation in financial reporting of Islamic banks is due to the variation in the application of the *Shariah* principle to the banking activities as interpreted by different schools of thought and Muslim scholars. Hence, variation in applying *Shariah* principles is expected to have different accounting implication. AAOIFI proposed different accounting treatments for *Murabahah* and *BBA* which are AAOIFI FAS 2 *Murabahah* and *Murabahah* to Purchase Orderer and AAOIFI FAS 20 Deferred Payment Sales. The AAOIFI has the responsibility of setting accounting standards which have the objective of harmonising the financial reporting practices of the Islamic banks and financial institutions (Naser and Pendlebury, 1997).

There are also issues related to the concept of substance over form in *Murabahah* and *BBA* recognition and measurement (Talib, 2000). The contrasting views with regard to this concept have indicated the unresolved issues related to *Murabahah* and *BBA* that require further clarification and attention. Some argue that the recognition and measurement of Islamic financial transactions should give prominence to its legal form to differentiate it from a perceived conventional equivalent (AOSSG, 2010). On the other hand, the opponents believe that the concept of substance over form is acceptable and benefit user more, in order to present the economic substance of an Islamic financial transactions. The concept of substance over form may be applied in financial reporting from Islamic perspective as its application does not conflict with general *Shariah* methodology.

The measurement issues with regard to *Murabahah* and *BBA* also important to be highlighted. Some argue that the application of non-*Shariah* compliant reference point does not invalidate a *Shariah* compliant transaction as it is simply a reference point (Askari et. al, 2009). However, the current use of effective interest rate method as a benchmark in determining the profit rate of the *Murabahah* and *BBA* is certainly direct conflict. Although it is accepted on an ad hoc basis under the law of necessity and in the absence of Islamic benchmark, several researchers have correctly brought up the need to develop benchmark based on the rate of return to reflect Islamic modes of financing. A lot of criticisms against Islamic banking and finance for depending on the conventional benchmark have led to a call for initiating an independent benchmark pricing for Islamic banks to many contemporary Muslim scholars. In fact, pursuant to this issue, the International *Shariah* Research Academy for Islamic Finance (ISRA) has assigned a team of researchers to undertake a project that aims to develop an Islamic pricing benchmark model for Islamic banking industry specifically for Malaysia (Omar et. al, 2010).

Thus, the unresolved issues related to *Murabahah* and *BBA* in the Islamic banks have indicated the increasing controversies over financial accounting problems in the Islamic banks. The problems currently facing in the Islamic financial institutions need to be highlighted and improved in order to ensure the transparency in asset and liabilities recognition and measurement.

1.3 OBJECTIVES OF THE STUDY

The first objective of the study is to examine whether the accounting recognition, measurement and disclosure on *Murabahah* and *BBA* of Islamic banks in Malaysia based on FRS 118 (Revenue Recognition), BNM GP8*i* (Specimen Report and

Presentation for Islamic Financial Institutions), MASB TR*i*-3(Presentation of Financial Statement of Islamic Bank) and MASB TR*i*-4 (*Shariah* Compliant Sales Contract) are compatible with AAOIFI FAS 2 (*Murabahah* and *Murabahah* to Purchase Orderer) and AAOIFI FAS 20 (Deferred Payment Sale). This study will enable the researcher to understand and identify the unresolved issues in *Murabahah* and *BBA*. Thus, the examination of accounting recognition, measurement and disclosure on *Murabahah* and *BBA* of Islamic Banks in Malaysia under specific standards and guidelines available will be conducted. The standards and guidelines currently adopted by the Islamic banks in Malaysia are set by MASB which are FRS 118 Revenue Recognition and MASB Technical Release *i*-3 Presentation of Financial Statements of IFIs and MASB Technical Release *i*-4 *Shariah* Compliant Sales Contract as well as BNM GP8*i*, guidelines issued by BNM. Besides, this study also takes into consideration on examination of accounting treatments on *Murabahah* and deferred payment sales set by AAOIFI which are AAOIFI FAS 2 *Murabahah* and *Murabahah* to Purchase Orderer and FAS 20 on Deferred Payment Sales (*Bai'Muajjal*). The main objective of the first study is to critically compare the accounting standards and guidelines available and provide clarifications and highlights the unresolved issues in accounting practices for *Murabahah* and *BBA*. By doing the comparative analysis of the first study, the gap that exists between both standards of MASB and AAOIFI can be clearly identified and discussed in order to provide better understanding of the similarities and differences. Consequently, the accounting standards examined can be concluded whether they are harmonised or departed from each other.

The second objective of this study is to examine the perceptions of accountants and financial accounting executives of Islamic banks in Malaysia on the existing accounting standard and guidelines of *Murabahah* and *BBA*. The accountants and financial accounting executives are those directly engaged in the financial accounting and reporting of the Islamic banks specifically on *Murabahah* and *BBA*. The accountants refer to the professional qualified people who are trained in bookkeeping and in preparation, auditing and analysis of the accounts and have professional certificate as accountants. Whereas the financial accounting executives are the Islamic banks executives who are primarily responsible for an account of the Islamic banks which may include the managers, directors, senior managers and may or may not have professional certificate as certified accountants.

The third objective of this study is to examine the perceptions of accountants and financial accounting executives of Islamic banks in Malaysia on AAOIFI's accounting standards of *Murabahah* and *Bai' Muajjal* (Deferred Payment Sales). This study may contribute in term of understanding the issues on the *Murabahah* and *BBA* which need to be improved by intensely examining the views of accountants and financial accounting executives in the Islamic banks in Malaysia on accounting standards available on *Murabahah* and *BBA* currently applied in the Islamic banks in Malaysia and also Islamic accounting standards set by AAOIFI related to *Murabahah* and *BBA*.

The fourth objective of the study is to analyse the relationship between the level of acceptability of AAOIFI FAS 2 and FAS 20 with the attendance at training programmes of Islamic Banking and Finance (IBF), the total working experience of the accountants and their education background. These factors of training on IBF, total working experience and education background have been selected according to the previous researcher, Che Pa (2006) who studied on the relationship between those factors with the level of acceptability of the AAOIFI FAS 17 for Islamic bond. This study may contribute to the knowledge of the factors that may influence the level of acceptability of AAOIFI standards (AAOIFI FAS 2 and FAS 20). Thus, the significance of the factors examined can be known.

1.4 MOTIVATIONS OF THE STUDY

A review of literature has revealed that there are only a few studies being undertaken on *Murabahah* and *Bai' Bithaman Ajil (BBA)*. Most of the prior studies are descriptive, mainly discussing *Shariah* and legal issues (Sairally, 2002 & Talib, 2000). Thus, the study aimed to empirically explore the accounting practices for *Murabahah* and *BBA* as well as the Malaysian accountants and financial accounting executives' perceptions on accounting practices for *Murabahah* and *BBA*. Up to date, there is only a study focuses on *Murabahah* and *BBA* which are undertaken by Talib (2000) introduces its arguments on theoretical basis and discusses some of the issues raised by Islamic banking and financing particularly *Murabahah* and the method of deferred payment sales (*Bai' Bithaman Ajil*). The researcher also raises the accounting issues and provides a hypothetical example to further illustrate the contention. Thus, further empirical research needs to be done in order to overcome this limitation.

The above limitation creates a need to undertake a study to explore the current perspectives of key people who are directly deal with financial accounting and reporting of the *Murabahah* and *BBA* financing. The aim is to address the issues of accounting for *Murabahah* and *BBA* financing especially in terms of recognition, measurement and disclosure issues. Rationally, a well regulated Islamic financial system requires a sound accounting and reporting standard to reflect the differences from the conventional side. Hence, it is important to examine the perceptions of the accountants and financial accounting executives as the need to properly recognise the