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INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA
بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

**AN EXPLORATORY STUDY ON THE
UNDERSTANDING AND ACCOUNTING FOR
ISLAMIC BONDS: PERSPECTIVES OF
MALAYSIAN BANK MANAGERS**

BY

ANI SALWANI BINTI CHE PA

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FULFILMENT OF THE REQUIREMENT
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ABSTRACT

Malaysia has made commendable progress in developing the Islamic bonds market. Despite this development, Malaysian Islamic bonds have been criticized as they allow the trading of receivables based on true trade transactions as opposed to the lending of money. In contrast, in other Middle Eastern countries, Islamic bonds are the trading of real asset which subject to profit as well as loss. However, the extent to which Malaysian bank managers understand Islamic bonds has yet to be explored. The development of Islamic bonds also gives rise to a number of accounting and reporting issues in the current accounting practice. The introduction of Financial Accounting Standard No.17 on investment (AAOIFI FAS 17, 2003) is a proactive effort in providing a codified Islamic accounting standard. However, the extent to which AAOIFI FAS 17 is relevant and acceptable in Malaysia hasn't been examined. As Islamic bonds are new in the market, only a few research studies have been undertaken on the topic. In view of this limitation, this study aims to explore the level of understanding on the principles of Islamic finance and Islamic bonds among Malaysian bank managers. Further, the study also explores the nature of current Malaysian accounting practices on Islamic bonds and the level of acceptability of AAOIFI FAS 17. Using a self-designed questionnaire, a sample of 84 bank managers working in local commercial, Islamic and merchant banks registered in Malaysia was selected. Out of 84 questionnaires distributed, 38 were returned. The results of the analyses indicate that majority of bank managers who are directly involved in investment in Islamic bonds have only moderate level of understanding of the principles of Islamic finance as well as Islamic bonds. These results provide evidence that Malaysian bank managers have inadequate understanding on Islamic products that they are offering and managing. The study also found that AAOIFI FAS 17 is reasonably well accepted by Malaysian bank managers. In addition, using Pearson correlation analysis the study observed that bank managers' understanding of the principles of Islamic finance and Islamic bonds, age, education background, working experience and trainings attended are positively related to their perceived acceptability of AAOIFI FAS 17. However, understanding on bonds is the only factor that significantly influences bank managers' level of acceptability of AAOIFI FAS 17.

ملخص البحث

قد أبدت ماليزيا تقدما جديرا بالثناء في تطوير سوق السندات الإسلامية. ولكن على الرغم من هذا التطور، فقد واجهت السندات الإسلامية الماليزية انتقادا لكونها تسمح بتجارة سندات القبض المبنية على المعاملات التجارية الحقيقية المعارضة للقرض المالي. بالمقابل في بعض دول الشرق الأوسط، نجد أن السندات الإسلامية هي التجارة في الأصول الثابتة والتي تخضع للربح والخسارة. مع ذلك، فإن مدى الفهم الصحيح من أصحاب المهن الماليزيين للسندات الإسلامية يحتاج إلى زيادة من التحري. إن تطور السندات الإسلامية أيضا يبحث إلى عدد من الأمور الحسابية والبيانية في الممارسة الحسابية الجارية. إن تقديم معيار الحسابات المالية رقم ١٧ في الاستثمار AAOIFI FAS 17 هو جهد فعال في توفير معيار حسابي إسلامي مصنف. ومع ذلك، فإن مدى قبول وصله الـ AAOIFI FAS 17 في ماليزيا يحتاج إلى فحص. بما أن السندات الإسلامية جديدة في السوق، هناك دراسات بحثية قليلة أجريت في هذا الموضوع. ونظرا للتقصير، فإن هذه الدراسة تهدف إلى اكتشاف مستوى الفهم لعناصر الموارد المالية الإسلامية والسندات الإسلامية في ما بين مديري البنوك ماليزية. فضلا عن ذلك، هذه الدراسة تتحري طبيعية الممارسات الحسابية الماليزية الحالية في السندات الإسلامية ومستوى قبول الـ AAOIFI FAS 17. وباستعمال استبيان صمم من قبل الباحثة، تم اختيار عينة تضم ٨٤ من مديري البنوك الذين يعملون في بنوك تجارية عامة وإسلامية وتجارية محلية في ماليزيا. من بين مجموع الاستبيانات التي وزعت، ٣٨ فقط تم إسترجاعهم. نتائج تحليل تشير بأن أغلبية مديري البنوك الذين لديهم تعامل مباشر في الاستثمار في السندات الإسلامية، لديهم فقط مستوى فهم متوسط عن عناصر الموارد المالية الإسلامية والسندات الإسلامية. هذه النتائج تزور الأدلة بأن مديري البنوك الماليزية ليست لديهم فهم كاف لما يديرونه. أيضا، وجدت هذه الدراسة بأن AAOIFI FAS 17 مقبول لدى مديري البنوك الماليزية. زيادة على ذلك وباستعمال علاقة Pearson التحليلية، لاحظت الدراسة بأن هناك علاقة إيجابية بين فهم مديري البنوك لعناصر الموارد المالية وللسندات الإسلامية، عمر المديرين، مستواهم التعليمي، خبرتهم العملية والمؤتمرات او الدورات التي شاركوا فيها مع القبول الإدراكي لـ AAOIFI FAS 17. مع ذلك، هذا التحليل وجد بأن فهم السندات هو العامل الوحيد الذي يؤثر على قبول مديري البنوك لـ AAOIFI FAS 17.

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 dissertation for the degree of Master of Science in Finance.



Abdul Rahim Abdul Rahman
Supervisor

This dissertation was submitted to the Department of Business Administration and is acceptable as partial fulfillment of the requirements for the degree of Master of Science in Finance.



Rafikul Islam
Head, Department of Business Administration

This dissertation was submitted to the Kulliyah of Economics and Management Sciences and is acceptable as partial fulfillment of the requirements for the degree of Master of Science in Finance.



Mansor Ibrahim
Dean, Kulliyah of Economics and
Management Sciences

DECLARATION

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

ANI SALWANI BINTI CHE PA

Signature:  _____

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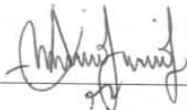
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In the Name of Allah, Most Gracious, Most Merciful

Praise be to Allah SWT the Most Gracious and the Most Merciful, who gave me the strength and blessings to complete this thesis. Peace and blessings be upon Prophet Muhammad SAW (peace be upon him) the prophet and the ideal role model for human beings.

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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
AAOIFI FAS 17	Accounting and Auditing Organization for Islamic Financial Institutions, Financial Accounting Standard No.17 on Investment
AASB	Australian Accounting Standard Board
ABBA/ BBA	<i>Al-bay^c Bithamin Ajil</i>
ACCA	Association of Chartered Certified Accountants
BAFIA	Banking and Financial Institutions Act
BIMB	Bank Islam Malaysia Berhad
BNM	Bank Negara Malaysia
CIMA	Chartered Institute of Management Accountants
DSU	Deficit Spending Unit
etc	(et cetera): and so forth
FRS 132	Financial Reporting Standard No.132 on Financial instruments: Presentation and Disclosure
FRS 139	Financial Reporting Standard No.139 on Financial instruments: Recognition and Measurement
GP8- <i>i</i>	Guidelines on the Specimen Financial Statements for Licensed Islamic Banks
IAS	International Accounting Standard
IASC	International Accounting Standard Committee
MARC	Malaysian Rating Corporation Berhad
MASB	Malaysian Accounting Standard Board
MASB ED 35	Malaysian Accounting Standard Board, Exposure Draft No. 35 on Financial instruments: Recognition and Measurement
MASB ED	Malaysian Accounting Standard Board, Exposure Draft No. 45 on Financial instruments: Presentation and Disclosure
MASB- <i>i</i>	Malaysian Accounting Standard Board for Islamic Accounting Standard
MuNIF	<i>Murābahah</i> Notes Issuance Facilities

LIST OF ABBREVIATIONS - Continued

MDS	<i>Mudhārabah</i> Debt Securities
OIC	Organization of Islamic Countries
SAC	<i>Sharīʿah</i> Advisory Council
SC	Securities Commission
SPV	Special Purpose Vehicle
SSU	Surplus Spending Unit

CHAPTER 1

INTRODUCTION

Two decades ago Islamic finance was considered a wishful thinking. However, serious research and development of Islamic financial products have shown that Islamic finance is not only feasible and viable but it is also efficient and productive way of financial intermediation. Today, Islamic bond is among the most successful Islamic financial product in the industry. The successful operation of Islamic bond market in Malaysia and other Muslims countries such as Bahrain and Qatar are sufficient to show that Islamic bonds can be an alternative for commercial financing.

Many Malaysia's *Shari'ah* scholars view Islamic bonds as debt certificate that can be traded freely in the primary as well as in the secondary market. The system allows the trading of receivables based on true trade transactions as opposed to the lending of money. This means that bondholders are entitled to a certain amount of return through the difference of amount they paid during the time they buy the bond and the amount they receive during the maturity when the debt certificates are redeemed upon the issuer.

Global bond market often refers Islamic bond as *Sukūk*. *Sukūk* are normally backed by assets sold to a company that is created by the borrower (issuer). The borrower then rents back the assets and the rent is paid to investors (bondholders) instead of interest. At maturity, the borrower buys back the assets at an agreed price and investors are paid their principal.

Malaysia has certainly made commendable progress in developing the Islamic bond market. During the first quarter of this year, it was reported that outstanding Islamic bonds in Malaysia have been more than doubled in the past four years as the

nation competes with Middle East financial centers like Bahrain for business that complies with Islamic law. Recently, Malaysia is the biggest and fastest-growing market globally for the bonds¹.

The objective of this study is to examine the perceptions and understanding on Islamic bonds among bank managers in Malaysia. The study also attempts to examine the perceptions of Malaysian bank managers on the accounting principles and practices on Islamic bonds as well as acceptability of AAOIFI FAS 17 on investment in securities in Malaysia. In order to achieve the first two objectives, the study analyzes the perception of key personnel who are directly deal with trading of bonds in local financial institutions in Malaysia. A sample of 38 bank managers who are also Islamic bonds traders and finance officers from treasury departments in seven commercial banks, three Islamic banks and four merchant banks was selected. A self-designed questionnaire was distributed among the samples for the purpose of the study.

It is expected that by evaluating the level of understanding of bank managers or traders of Islamic bonds and other Islamic products, the relevant and regulatory agencies can take appropriate steps to enhance bank managers' knowledge and proficiency. This is to ensure that Islamic products currently on offer do not appear to be merely *Shari'ah*-compliant versions of their conventional counterparts. By doing so, Malaysian money market would have a clearer and better target market especially when Islamic bonds are structured with the prospect of attracting some of the estimated US\$250 – US\$ 1 trillion in assets held by Islamic institutions domestically and globally.

¹ David Young (2005), Malaysia Leads Way in Islamic Debt Sales, *International Herald Tribune*. <<http://www.iht.com/articles/2005/04/25/bloomberg/sxasia.php>> (accessed August 7, 2005).

1.1 OBJECTIVES OF THE STUDY

The study aims to explore the understanding among bank managers on the concepts of Islamic bonds and the nature of accounting practices for Islamic bonds in Malaysia. This analysis is carried out from two perspectives, namely *Shari'ah* and accounting perspectives.

Three research objectives have been formulated for the study:

- i. to examine the level of understanding on the principles of Islamic finance and Islamic bonds among bank managers in Malaysia.
- ii. to examine the nature of current accounting practices on Islamic bonds in Malaysia and the level of acceptability of AAOIFI FAS 17 on investment among the Malaysian bank managers
- iii. to examine the relationship between the bank managers' understanding on Islamic finance and Islamic bonds and their perceived acceptability of AAOIFI FAS 17

The study aims to examine the perception of Islamic bonds traders and dealers as well as finance officers in treasury departments working in local commercial, Islamic and merchant banks. The individuals were selected mainly due to their experiences and involvements in the trading of Islamic bonds as well as conventional. Furthermore, banks are among the active players in bonds market. Thus, they are considered to be reliable and relevance in providing an overall picture of Islamic bonds as well as accounting practices on Islamic bonds in Malaysia.

1.2 BACKGROUND OF THE STUDY

Islamic finance is tremendously developing in Malaysia. The focus is on structuring deals that are *Shari'ah*² compliant with the prospect of attracting some of the estimated US\$250 billion in assets held by Islamic institutions globally³. It is known that Islamic financial institutions are not allowed to deposit the excess balances they have in short term debt instruments. As a result, most institutions end up having highly liquid balance sheets with raising liabilities.

Over the past few years, Islamic bonds have created new venues for the short-term placement not only to solve the above liquidity management problem but also to attract the Muslims wealth in the region. For example, the government of Malaysia issued a US\$600 million Islamic bond known as Global *Sukūk Al-Ijārah* in June 2002 to raise funds from global investors especially those from Middle- Eastern countries. At the same time, Islamic bonds have become standard for domestic sales, with Islamic bonds issues exceeding conventional bonds. It was also reported that in 2003, the domestic trading of Islamic private debt securities (IPDS) increased by 59.7 percent to RM 60.7 billion from RM 38 billion in 2002.

Malaysian money market trades Islamic bond as debt certificate that can be traded freely in the primary as well as in the secondary market. The system allows the trading of receivables based on true trade transactions as opposed to the lending of money. This means that through Malaysian version of Islamic bonds, bondholders are entitled to a certain amount of return through the difference of amount they paid during the time they buy the bond and the amount they receive during the maturity

² *Shari'ah* is the Islamic law of human conduct which is derived from the Koran (The Muslim Holy Book) and the deeds and sayings of Prophet Muhammad (Abdel Karim, 1995)

³ Islamic debt appeals (2004), *Asiamoney*, <<http://proquest.umi.com/pqweb?did=694507911>> (accessed August 7, 2005).

when the debt certificates are redeemed upon the issuer. In contrast, in other Middle Eastern countries, Islamic bonds are claimed as real assets which subject to profit as well as loss.

Most Islamic bonds issued in Malaysian companies have been heavily structured using the sale-based Islamic financing instruments. The most common sale contracts used in Malaysia are sale with deferred payment or *Bay' Bithamin Ajil* (BBA) contracts, mark-up sale or *Murābahah* contracts, and recently, some forms of manufacturing contracts or *Istisna'*. Some argued that the actual contracts underlie the above-mentioned contracts are mostly that of 'sale of cash' or *bay' al- 'inah* (Engku Ali, 2003), which are disallowed by majority of the classical and contemporary jurists (Rosly, 1999 and Engku Ali, 2003). This is the main reason for Rosly (1999) to claim that contract of *bay' al- 'inah* is a *hilah* (legal device) that is seen as something which is indifferent to *riba'* based financing.

Another additional Islamic law compliance issue in the structure of Malaysian Islamic bonds is the practice of *bay' al-dayn* (sale of debt) to securitize the indebtedness created in the process of *bay' al- 'inah* asset creation. Asset is used as the subject matter in the contract of sale of debt is the 'debt' itself, which is arguable to be a suitable asset for trading (Engku Ali, 2003).

By looking into the above differences, who are actually Malaysian Islamic bonds target market? What are the impacts of the differences? Harun (2004)⁴ believes that one of the limitations for a comprehensive growth strategy in Islamic banking and finance market in Malaysia is the lack of understanding among Islamic financiers in what they are involved in. Harun (2004) further argued that many bank

⁴ Shaipudin Shah Harun, Islamic debt appeals (2004), *Asiamoney*, <<http://proquest.umi.com/pqweb?did=694507911>> (accessed August 7, 2005).

managers in Islamic banking were not formally trained and it was assumed that the above reason contributes to the fact that Islamic products currently on offer appear to be merely *Shari'ah* version of conventional counterparts.

Islamic bonds are also termed as *Sukūk* in global market. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI)⁵ in its 17th *Shari'ah* Standard for Investment *Sukūk* defines investment in *Sukūk* as “certificates of equal value representing receipt of the value of the certificates and common title to shares and rights in tangible assets, usufructs and services, or equity of a given project or equity of a special investment activity” (AAOIFI, 2003:298). The issue is whether this definition is well understood by bank managers who manage investment in Islamic bonds and whether Malaysian Islamic bonds suit the definition.

The development of Islamic bonds as a non-interest based financial instruments at the same time give rise to a number of accounting and reporting issues in the current accounting practices (Hancock, 1999 and Abdul Rahman, 2004). As Islamic bonds are developed with a different based on Islamic principles and *Shari'ah* as the main basis, they may require different set of accounting and reporting standard to differentiate them from the conventional bonds. The introduction AAOIFI FAS 17 was a pro-active effort in providing a codified Islamic accounting standard. However, the main question is to what extent the AAOIFI FAS 17 can be accepted and relevant in providing adequate disclosure and treatments on Islamic bonds in Malaysia.

In addition, as Malaysian Islamic bonds are claimed to be similar to conventional bonds by certain scholars, the question is do bank managers need other

⁵ AAOIFI is an international autonomous non-profit making corporate body based in Bahrain. AAOIFI was established in 1991 to develop and disseminate relevant accounting and auditing thought as well as to prepare, interpret, review and amend accounting and auditing standards for Islamic financial institutions according to the Islamic *Shari'ah*. The standards are aimed to increase confidence of the financial statement's users by providing guidelines to produce useful information.

accounting standards besides the national accounting standard which are currently in force for better accounting treatment of Islamic bonds? To answer the above questions, the paper will undertake a survey to examine the extent of understanding among bank managers on Islamic bonds and to test the level of acceptability of AAOIFI FAS 17 among practitioners on the current accounting practice.

1.3 MOTIVATION OF THE STUDY

A review of literature has revealed that there are only a few studies being undertaken on Islamic bonds. Most of the prior studies are descriptive, mainly discussing *Sharī'ah* and legal issues (Bakar, 1997; Ngadimon, 1998; Abdul Aziz, 1998; Rosly and Sanusi, 1999; Moustapha, 2001; Muhammad Amine, 2001; Engku Ali 2003 and 2004; Adam and Thomas, 2004). Thus, the study aims to empirically explore the Malaysian understanding on Islamic bonds.

Up to date, there is only one study undertaken by Abdul Rahman (2004) that examined accounting issues on investment in Islamic bonds. The study provides descriptive analysis on AAOIFI FAS 17 on investment in securities analyzing issues of classification, recognition, measurement, presentation and disclosure of Islamic bonds. Rationally, a well regulated Islamic financial system requires a sound accounting and reporting standard to reflect the differences from the conventional side. However, the lack of knowledge and understanding on Islamic bond could be contributing factor towards the lack of studies in other related areas such as accounting, finance etc. Perhaps the most fundamental reason could be due to the infancy stage of Islamic banking and finance.

The above limitation creates a need to undertake a study to explore the current perspective of key people who are directly deal with trading of bonds about this type

of investment. The aim is to address the lack of awareness and understanding on Islamic bonds as well as accounting issues on Islamic bonds among practitioners especially bank managers as one of the major players of this money market instrument in Malaysia.

Since Islamic bonds can be considered as new modes of Islamic financing, good understanding of Islamic financial contracts as guided by the *Qur'an* and *Sunnah* of the prophet can facilitate understanding of the principles of Islamic bonds. Thus, the study aims to examine the extent of understanding on Islamic financial contracts among bank managers (traders, dealers, and financial officers). The findings can be considered crucial in assisting bank managers to understand Islamic bonds. As good understanding can indicate relative adequacy in practicing Islamic financial products, perhaps it will also be useful in determining the acceptance of AAOIFI standards in practice.

Hence, the outcome of this study is hoped to provide some insights for several parties such as academicians, banking practitioners, accountants as well as regulators and the public at large in term of enhancing the effectiveness, efficiency as well as credibility of the Islamic financial industry.

1.4 ORGANIZATION OF THE CHAPTERS

The research will be presented in six chapters. The first chapter presents an introductory part of the research. The second chapter provides review of literature on Islamic bonds. The literature review will provide overview of the principles of Islamic bonds specifically from *Shari'ah* perspective. The chapter also highlights basic principles of Islamic finance, the nature and development of Islamic bonds in Malaysia. It can be achieved by reviewing some emerging issues on Islamic bonds.

Chapter three introduces the accounting issues for Islamic bonds. The chapter firstly discusses the relationship between accounting and Islam. Then, it analyzes and highlights the development of accounting standards on financial instruments and the nature of accounting standards for financial instruments in Malaysia. Finally, the chapter compares AAOIFI FAS 17 on investment in *Sukūk* with two other relevant accounting standards for financial instruments in Malaysia, namely; (1) Financial Reporting Standard 132₂₀₀₅ for financial instruments on presentation and disclosure and (2) Financial Reporting Standard 139₂₀₀₅ for financial instruments on recognition and measurement.

Chapter four discusses research methodology adopted by this study. First, it outlines research objectives and research questions developed. Then, it presents the research methodology adopted to examine the research objectives and questions. Finally the chapter explains the procedures involved in data collection and data analysis.

Chapter five analyzes the data collected and provides findings and statistical test formed. Finally, Chapter six discusses the findings for each of the research objectives and underlines few limitations faced in the study. It also highlights contributions made by the study and offers some suggestions for future research.

CHAPTER 2

ISLAMIC BONDS: AN INTRODUCTION

2.1 INTRODUCTION

The purpose of this chapter is generally to provide a brief understanding and introduction to Islamic bonds. In particular, the chapter attempts to review the underlying principles of Islamic financial contracts that very much influence the creation and importance of Islamic bonds in current financial market.

The chapter is organized into five parts. Firstly, the chapter analyses the literature concerning the basic principles of Islamic financial contracts. Secondly, the chapter examines the basic concept which underlies the Islamic bonds contract especially the concept of debt in Islam. Thirdly, the chapter briefly explores the development of Islamic bonds in Malaysia and examines the differences between Islamic bonds and conventional bonds and *Sukūk*. Finally, the chapter examines the emerging and unresolved issue related to the Islamic bonds structured in Malaysia.

2.2 BASIC PRINCIPLES OF ISLAMIC FINANCIAL SYSTEM

Generally, a financial system is a set of rules and regulation that govern and control the flow of fund from surplus spending units (SSU) in a society to deficit spending units (DSU). While, Islamic finance is a discipline in Islamic *mu'āmalāt* (economic transactions) used as a tool in managing a financial system, which derives its principles from the *Qur'an*, the traditions of Prophet Muhammad (peace be upon him), and secondary sources including the *ijma'*, *qiyas* and *maslahah* which are based on the former two main sources of Islamic teaching. Qureshi and Millet (1999) identified that there are three principles that differentiate between Islamic finance and