ACCOUNTING TREATMENT FOR MUDARABAH REGARDING UNRESTRICTED INVESTMENT DEPOSITS IN MALAYSIAN ISLAMIC BANKS

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This study aims to understand the different between the practice of Malaysian Islamic banks and the standards recommended by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) in accounting treatment for mudarabah contract regarding unrestricted investment deposits. Previous reports and analysis show that, Islamic banks in Malaysia have classified unrestricted investment deposits as liabilities which is not in line with standards established by AAOIFI. The justifications and explanations behind this practice would be examined to clarify the position of investment deposit in Islamic banking system. Qualitative approach will be used for data collection and data analysis.

Field of Research: Islamic accounting, Islamic banking

1. Introduction

The interesting phenomena in recent decades is the emergence of Islamic financial institutions in the financial world. Islamic banking, sukuk market, takaful and many Islamic financial terms are widely used now in the industry. Most industry observers feel this trend will continue based on the good growth prospect of this industry. In Malaysia, for example, the Islamic banking assets have expanded by 23% to RM234.9 billion compared with a year ago. The Islamic banking industry now accounts for 16.7% of total assets in the industry. Similar trends can be observed in the growth of deposits that have reached RM180.4 billion, an increase of 27.7%, as stated by Dr Zeti Akhtar Aziz, Governor of Central Bank of Malaysia at launching of HSBC Amanah Malaysia Berhad on 25 November 2008 in Kuala Lumpur.

Clue to Islamic banking was traced to the permissibility of trading replaced prohibition of riba or fixed return on loans. This is stated in the Qur’an; (2:275) “those who devour usury will not stand except as stand one whom the Evil. One by his touch hath driven to madness. That is because they say: “trade is like usury,” but God hath permitted trade and forbidden usury”. This is the alternative to the practices of

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conventional banking system which applying the concept of interest as a return to capital. Based on the permissibility of trading, the concept of mudharabah had been used since the era of Prophet Muhammad (pbuh) until now with different versions.

In Islamic banking system, this concept has been applied in both side; liability side and financing side. In liability side, the investment depositors as the fund provider and the bank are involved in the contract of mudharabah. On the financing side, banks, who received fund from depositors act as a financier to the entrepreneurs who borrowed the money from the banks. This is called two tier mudharabah contracts.

This study will focuses on the liability side which related to investment deposit specifically in unrestricted investment deposit. This research aimed to analyze the practices by Islamic banks in Malaysia regarding accounting treatment for the unrestricted investment deposits. Issue of reporting investment accounts as liabilities on balance sheet is among the issues being highlighted by Rating Agency Malaysia (RAM) in their Research Report (October-December 2007) on critical comparison between Malaysian Islamic Banks and Middle Eastern Islamic Bank.

Survey and analysis by Ismail and Abdul Latif (2001) on financial reporting of Islamic banks shows that the main difference between standards produced by Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and selected Islamic banks in Malaysia including Islamic bank is in classification of deposits’ funds and the particular prominence that is given to restricted investment accounts and unrestricted investment accounts from other deposits like current and saving.

Most of the intellectual activity over the past few decades has been geared toward into developing Shariah-compliant alternatives for bank financing. The deposits side attracted little attention. A closer look at the matters reveals that the line of distinction between Islamic banks and their interest-based counterparts is thin. Tahir (2007)

The finding of this study will be a basis for further research in related areas in Islamic banking system such as the regulatory environment, harmonization of accounting standards and Shariah compliance.

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2. Literature Review

2.1 Concept of Mudarabah

Mudarabah is an Arabic terminology that has been used widely in Islamic finance. Islamic scholars have defined the concept of mudarabah to explain the characteristic of it.

According to Abu Saud (1976), Linguistically, both words Mudarabah and Qirad are used to signify the same idea: “to give somebody out of your capital a part to trade in, provided that the profit is shared between both of you, or that an apportioned shared of profit is allocated to him accordingly, the active partner are called darib, because he is the one who travels and trades. It is also possible that both capitalist and active partner are called Mudarib or Muqarib as both share the profits with each other”.

2
The two main Arabic names given to this type of partnerships are mudarabah (in the language of Iraq), and qirad in the language of Hijaz. The first name emphasizes that both the capitalist and the entrepreneur share in profits, while the second name emphasizes the fact that the capitalist gives part of his capital and part of his profit to the entrepreneur, Al-Zuhaily (2007). He describes, in a silent partnership contract, the owner of capital gives it to a worker to trade on their behalf, and profits are shared according to an agreed-upon formula. All financial losses are borne by the provider of capital (the silent partner, or the capitalist), while the entrepreneur can only lose his effort if no profits are made.

Doi (1984), explains, mudarabah is a contract in which certain property or stock (Ras al-Mal) is offered by the owner or proprietor (Rabb al-Mal) to the other party to form a joint partnership in which both parties will participate in profit. The other party is entitled to a profit I lieu of his labour since he is giving to manage the property (Mudarib). It is a contract of co-partnership.

2.2 Mudarabah in Islamic banking

The concept of mudarabah which based on the principles of profit-loss-sharing is an alternative of the interest-based system in banking industry. According to Tahir (2007), Islamic banking started in the 1970s without an initial working model. Clue to Islamic banking was traced to the permissibility of trading, mentioned along side the prohibition of riba in Al-Baqarah 2: 275. Thus, Profit-and-Loss Sharing (PLS) based banking was seen as the Islamic response to the dominant interest-based banking.

Investment accounts or investment deposits is among the product of Islamic banks which applied the concept of mudarabah. Sultan (2006) identifies, investment accounts, which utilizes the contract of Mudaraba is a contract where the customer or investment account holders assume the function of equity providers to the bank without voting rights. Maurer (2002), explains, unlike an interest-bearing savings account, a mudarabah account carries no guarantee of return.

Some of scholars have discussed the mobilization of deposits from investment accounts holders (Archer and Karim, 2007; Tahir, 2007). Archer and Karim (2007) found, the majority of Islamic banks commingle unrestricted IAH funds with their own funds, invest both under the bank's management in the same portfolio, and report these investments and their results in the bank’s balance sheet and income statement.

In the management of these deposits, banks follow an aggregative approach. All funds, regardless of the category of the deposits or depositors, are put together in one financing pool. Banks make all advances from this pool. There is a financial year for accounting purposes. At the end of the year, banks do their financial closures. Income and expense are taken into account, and profit and loss statements are prepared. Interest paid to the depositors during the course of the financial year is treated as expense for the banks, (Tahir, 2007).
However, the implementation of mudarabah in Islamic banking system, in real practice has raised comments from the scholars (Tahir, 2007; Chong and Liu, 2007).

Depositors are attracted on the promise that they will get return out of riba-free financing, but the contract forms, the funds management practices, the accounting conventions, the profit-and-loss calculations and the methods of distribution of profits are not different from those in vogue among interest-based banks. Tahir (2007)

Chong and Liu (2007) argue, in theory, mudarabah deposits are supposed to be equity-like because of their profit and loss sharing, the results show that mudarabah deposits are more debt-like than equity-like. In their study, they attempted to establish whether Islamic banking is really different from conventional banking. In practice, they found that Islamic banking is not very different from conventional banking from the perspective of the PLS paradigm. In accounting, the issue of investment deposits is related to how the accounting system has treated this kind of deposit.

The difference contract of investment deposit between Islamic banks and conventional banks as viewed by the scholars leads to the issue in accounting system.

2.3 Accounting treatment for mudarabah in unrestricted investment deposits

In Accounting and Auditing Standards for Islamic Financial Institutions published by AAOIFI (1998), Financial Accounting Standard No.6, it is clearly stated that "equity of unrestricted investment account holders shall be presented as an independent category in the statement of financial position of the Islamic bank between liabilities and owners’ equity. (paragraph 16)" This standard was effective for the financial periods beginning 1 Muharram 1419H or 1 January 1999.

Unrestricted investment deposits may be included within the statement of financial position on the ground that the Islamic banks mixes them with its own personal funds and with funds sourced out in the form of pure liability and then uses/invests them at its own discretion; but they must have a separate category under the title of “equity of unrestricted investment account holders” (Kahf, 2005).

Most of the scholars are agreed to this standard and have justified the reasons of the treatment (Karim, 2001; Akacem and Gilliam, 2002; Kahf, 2005; Sultan, 2006; Ayub, 2007; Ibrahim, 2007; Shubber and Alzafiri, 2008). Ayub (2007) argues that, policymakers and products developers of Islamic banking should stick to the standards issued by the AAOIFI that are based on the deep conceptual research by Shari’ah scholars under the aegis of the fiqh Academy of the OIC. This is the only way to avoid inconsistencies in interpretation of Shari’ah law by different scholars. In Islamic banks, equity must be interpreted to include the equity of shareholders and the equity of the owners of unrestricted
deposits because the latter carry their share of the risk of losses by virtue of the Mudharabah contract. (Kahf, 2005)

According to Sultan (2006), Investment account holders cannot be treated as a liability because by the nature of the Mudaraba contract they stand to bear all losses, nor are they shareholders, because they stand to bear all losses, nor are they shareholders, because they would partake in the profit sharing of their investment prior to dividend distributions and do not have voting rights. Leaving out these customers’ exposure or reporting them as liabilities would seriously misrepresent the status of these account holders. Mohamed Sultan (2006)

Karim (2001) argues, unlike debt instruments, investment account are not a liability of the bank because they earn their returns by sharing in the profits generated from their funds and also bear their share in any losses incurred. Furthermore, Islamic banks do not guarantee the value of these investment accounts. The fact that the mudaraba contract is neither a debt nor an equity instrument means that it is not a hybrid instrument comprising debt and equity.

Shubber and Alzafiri (2008) assert, Deposit accounts are neither a liability nor equity capital. They are a “hybrid” source of capital, and must be recognized as such. Depositors are partners with the bank, but possess no ownership right. Unrestricted investment accounts are not liabilities but a special class of equity (Ibrahim, 2007). It is important to note that investment accounts are different from savings accounts, since the face value of the former is not guaranteed (Akacem and Gilliam, 2002)

Disagree to the practice of reporting investment deposits as liability, Hamoud (1985) questioned, if it is determined that a bank deposit is a loan, it means that the increase paid by the bank over the sum deposited constitutes usury. What then does a bank pay to its depositors? The Governor, State Bank of Pakistan, Dr. Shamshad Akhtar has asserted that, the money held under investment account holders on profit and loss sharing basis and deployed in riskier businesses is not guaranteed and is not strictly a liability.

The arguments whether the investment deposit is a liability or not arises when there are different amongst the countries in accounting treatment. As reported by Rating Agency Malaysia (RAM) in their Research Report (October-December 2007) on critical comparison between Malaysian Islamic Banks and Middle Eastern Islamic Bank, reporting investment accounts as liabilities on the balance sheet is one of the issue.

Hussain, Gunasekaran, and Maskooki (2002) gave the reasons why some countries are differ in accounting policies and practices. These differences are partly due to their diverse social values and regulatory environments. However, some practices they follow do not match with their socio-cultural and religious norms. Although attempts have been made to make a few changes in some countries, they did not fulfill the Islamic banks’ accounting standards.

According to El-Gamal (2005) within the context of the banking firm, the interests of depositors are not included within the scope of corporate governance, since depositors are considered creditors and first claimants on the banks assets. He added, since the majority of Islamic bank managers built their
careers originally in conventional banking, they naturally bring this frame of mind to their Islamic financial institutions.

Even though these explanations are relevant to explain the issue of non-compliance to the standards established by AAOIFI for the unrestricted investment deposits in Islamic banking, there might be some extended justification and explanation to be examined. Some countries might experienced different characteristics in applying new changes in their culture.

3. Methodology and Research Design

This study will be adopted qualitative research method to get the justifications and explanations behind the practice of accounting system for unrestricted investment deposits. The strengths and its attributes in qualitative method seen to be more appropriate in deciding the method to be applied in this study. The qualitative researcher therefore seeks to discover the meanings that participants attach to their behaviour, how they interpret situations and what their perspectives are on particular issues, (Miles & Huberman, 1994).

Semi structured interviews will be conducted in this research. According to Kvale (2007) in qualitative interviews, social scientists investigate varieties of human experience. They attempt to understand the world from the subjects’ points of view and unfold the meaning of their lived world. The interviews give voice to common people, allowing them to freely present their life situations in their own words, and open for a close personal interaction between the researchers and their subjects.

The overwhelming strength of the face-to-face interview is the ‘richness’ of the communication that is possible. Questionnaire data in particular can appears (and usually are) thin, abstract and superficial. The richness comes at a price, of course. It isn’t just the time you give to interview itself, it is the time involved in transcription and analysis – a factor of about ten at least is involve here (Gillham, 2000).

Until now there are 17 Islamic banks as listed in the website of Bank Negara Malaysia. Only three Islamic banks would be chosen in the study, which represent the category of the banks. Sampling in qualitative research involves two actions that sometimes pull in different directions. First, you need to set boundaries: to define aspects of your case(s) that you can study within the limits of your time and means, that connect directly to your research questions, and that probably will include example of what you want to study. Thus, this research will be studied on three Islamic banks as follows:

i. Full-fledge Islamic banks
ii. Islamic banks which associated with conventional banks
iii. Foreign Islamic banks

The informants involved in this study will be:
1. Operational Officer who knows detail about bank’s operations.
2. Chief Financial Officer or accountant who responsible to the bank’s Account Department who knows the policy and all procedures in preparing financial statements.
4. Bank Negara Malaysia (BNM), as an institution that provides regulations and guidelines for banking industry in Malaysia.

5. Conclusion

The difference between countries about some issues is normal and might be accepted, but it has to be reviewed if the difference involved the basic principles of the knowledge, thought or belief. However, the process of reviewing and changing need research to be done in order to get explanations of that phenomenon.

The argument on the issue of unrestricted investment deposit in Islamic banking in accounting system has been discussed over the years. By examining the explanations of non-compliance to AAOIFI standards and achieving better solution for it, the accounting system in Islamic banking will improved.

References


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