



Accounting Treatment for Unrestricted Investment Deposits and its Implication to Islamic Financial Institution

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Abstract: The objective of this paper is to analyze the accounting treatment for *mudharabah* especially for account unrestricted investment (*mudharabah mutlaqoh*) in practical side which has been applying in the current Islamic banking system. This paper also concerns on the implication of different accounting treatment to the Islamic financial institution. This study finds that there two different accounting treatment for Unrestricted *Mudharabah* currently practised by Islamic banking, namely as liability and as different account between equity and liability. The two different of accounting treatment for *mudharabah* investment account (UIAHS) will have some implication to Islamic banking, namely: Profit distribution, Capital Adequacy Ratio (CAR), Risk management and Capital structure. Based on IFSB Capital Adequacy Standard, in accounting treatment AAOFI standard, since the *mudharabah* Investment account has portion between liability and equity, thus the “alpha maybe equal to 0.5”. However, in case of Malaysia which is more based on IFRS which is treated this account as a liability, “alpha is close to one (1)”. The different CAR also will have implication on the risk management that should be conducted by Islamic bank. Capital structure policy is another aspect that will be influenced by the different of accounting treatment of UIAHS. Hence, the accounting treatment of UIAHS on whether it will be treated as equity or liability will has direct effect on capital structure policy and some other aspect such as default risk, bankruptcy cost etc.

Keywords: Mudharabah, Unrestricted Investment Deposits, Liability, Equity.

Introduction

Islamic finance is one of the fastest growing segments of global financial industry. In some countries, it has become systemically important and, in many others, it is too big to be ignored. Several factors have contributed to the strong growth of Islamic finance, including: (i) strong demand in many Islamic countries for shariah-compliant products; (ii) progress in strengthening the legal and regulatory framework for Islamic finance; (iii) growing demand from conventional investors, including for diversification purposes; and (iv) the capacity of the industry to develop a number of financial instruments that meet most of the needs of corporate

and individual investors (IFSB, 2010; Hasan and Dridi, 2010). In case of Islamic banking, industry forecast that Islamic banking assets globally, will reach \$1.1 trillion in 2012 (2010: \$826bn) (Ernst and Young, 2011).

The main clue to Islamic banking was traced to the permissibility of trading and some Islamic contracts which replaced the 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"*". The verse is stated the prohibition of usury (*riba*). Hence, one of the important concepts applied by Islamic banking is *mudharabah*. According to Al-Zuhaily (2007); Abdullah M., Shahimi. S & Arshad N.C (2008); and Ismail A.G & Arshad N.C (2009), *mudharabah* is defined as a form of partnership between one who contributes capital (*rabb al-mal*) and the other who contributes efforts in the form of managerial skills (*mudharib*).

In Islamic banking system, the concept of *mudharabah* has been applied in both liability side and financing side. In the financing side, banks, who received fund from depositors act as a financier to the entrepreneurs who borrows the money from the banks. On the liability side, the investment depositors as the fund provider (*robbul maal*) and the bank are involved in the contract of *mudharabah* as a manager (*mudharib*). As fund providers, are engaged in the *mudharabah* contract with the bank and hence the returns which allocated to *mudharabah* Unrestricted Investment Account Holders (UIAHS) depend on the profit achieved through the investment of these funds by the bank which applies a profit-loss sharing (PLS) base (Atmeh and Ramadan, 2012).

In accounting practice, 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.

Malaysian Islamic bank recognizes *mudharabah* investment deposit as a liability, which is more based on IFRS standard. However, AAOIFI, *mudharabah* investment account will be stated separately from liability and equity. The different accounting treatment of *mudharabah* investment account which conducted by Islamic bank will raise some issues namely; shariah issue, financial decision perspective issue especially related to the CAR policy of Islamic banks, capital structure and risk management.

The objective of this paper is focused on the liability. First, explain the nature of *mudharabah* contract. Second, this paper then will give some overview about the current application of *mudharabah* investment account in Islamic banking. Third, this research describes accounting treatment of Unrestricted Mudharabah Investment Account. And finally, this study then will discuss about some issue related to the different accounting treatment between Malaysia Islamic Bank and AAOIFI standard, namely which accounting treatment which is more appropriate with shariah rule of *mudharabah* investment contract, and what is the implication of two different accounting treatments on the some financial decision such as capital structure and CAR policy.

Literature Review

The Nature of Mudharabah Contract

Literally, the word *mudharabah* is derived from the phrase "*al-darb fi al-ard*" which means to make a journey (al-Zamakhsari, Al-faiq fi ghoribul hadis, 3/187). This literal meaning is related to this type of partnership because normally it requires, particularly in the past,

traveling to do business (ISRA, 2012). *Qirod* is the other term of *mudharabah* which linguistically, both words are used to signify the same idea: “to give somebody out of your capital apart 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 (Abu Saud, 1976).

Mudharabah is a partnership in profit whereby one party (*rabbul mal*) provides capital and the other party (*mudharib*) provides labour (AAOIFI, 2010; ISRA, 2011). Doi (1984), explains, *mudharabah* is a contract in which certain property or stock (*Ra 'su 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 lieu of his labour since he is giving to manage the property (*mudharib*).

The system of *mudharabah* in history was initially suggested by Hashim ibn Abd al-Manaf ibn Qusayy during the fifth Century A.D. in order to control the destructive potential of ‘ritual suicide’. Ritual suicide was committed by Meccans if they experienced business disasters (Ibrahim, 1982, 343-5). The Muslims continued the pre-Islamic practice of *mudharabah* for financing their trade ventures (Anwar, 2010).

In the shariah perspective, *mudharabah* is a valid and legal contract based on some evidence from the *Quran*, *Sunnah* and *Ijma'*. In the Holy Quran, there are several verses that indicate the legitimacy of *mudharabah* such as (Al-Quran, 73: 20) “*and others who travel in the land seeking of the bounty of Alloh*”. According to Al-Kasani (Bada'i Al-sana'i, 6/79) although the above verses do not directly address the legitimacy of *mudharabah*, they have been interpreted to include those who travel for the purpose of trading and seeking permissible income (ISRA, 2012). There are also some *sunnah*, *ijma'* and *qiyas* that stated the legitimacy of *mudharabah* in *muamalah* contract.

There are three pillars in *mudharabah* contract, namely: *sighoh* (offer and acceptance), *rabbul maal* and *mudharib* (the contracting parties), *mahallul aqd* (the subject matter). In addition, for each three pillars, there are also some conditions that must be fulfilled to ensure the validity of contract, call *shahih* contract. In *sighoh*, the condition of *sighoh* is similar with the other contract, for example in *sighoh*, offer (*ijab*) is done by uttering the term *mudharabah*, or any other term that effect. In the *fiqh*, the term of *sighoh* can be done verbally, in writing or through any means of communication that is acceptable by both contracting parties. The condition for contracting parties; both *mudharib* and *rabbul mal* must be qualified persons under the law (*ahliyyatul ada al kamilah*).

For the *mahallul aqd* (subject matter) has some condition (AAOIFI);

- a) In principle, the capital of *mudharabah* must be provided in form of cash. However, it may be presented in the form of tangible asset which the valuation done by the expert.
- b) The capital should be clearly known to the contracting parties and defined in term of quality and quantity in manner to eliminate any possibility of uncertainty.
- c) It is not permitted to use debt owed by the *mudharib* or another party to the capital provider as capital in a *mudharabah* contract.
- d) For *mudharabah* contract to be valid and for the *mudharib* to be considered as having control over the capital, the capital must be, wholly or partially, put at the disposal of the *mudharib*.

In addition, in term of profit, there are also some important conditions in *mudharabah* contract. It is a requirement that the mechanism of profit distribution must be clearly known in a manner to eliminate uncertainty. The distribution also must be on the basis of an agreed percentage of the profit and not on the basis of a lump sum or percentage of capital. The party also should agree on the ratio of profit distribution when the contact is concluded (ISRA, 2012).

According to AAOFI (Standard no 13, Clause 8/2), apart from the agreed portion of the profit as determined in the above manner, the *mudharib* cannot claim any periodical salary or

fee or remuneration for the work done by him. However, it is permissible for the two parties to construct a separate agreement independent of *mudharabah* contract, assigning one party to perform, for a fee, a business activity that is not by custom part of the *mudharabah* operations.

Another aspect in the *mudharabah* contract is about the guarantee of capital in contract. According to the arguments of past Islamic jurisprudence, the jurists were unanimous in their opinion that when losses occur in a *mudharabah* contract, the loss is to be borne by the *rabb maal* and not the *mudharib* as the latter's status is only *amin* (trustee). However, if it could be proven that the loss was clearly due to the *mudharib* negligence or intentional, then the *mudharib* is to make good the capital to the investor.¹ Past Islamic jurists were unanimously of the opinion that in a situation where a loss occurs on a *mudharabah*, a capital guarantee by the *mudharib* is not permissible. However, they have a different opinion on the status of the contract. The Hanafi and Hanbali Mazhab were of the opinion that the contract is valid and the conditional guarantee should be nullified. The Maliki and Syafi'i Mazhab, however, were of the opinion that the *mudharabah* contract is immediately nullified if there is such a guarantee.

Contemporary Islamic jurists have made studies on the acceptable level of capital in *mudharabah* contracts that can be guaranteed according to the perspective of Islamic jurisprudence. The main issue of concern in relation to capital guarantee is whether the guarantee given will cause the *mudharabah* contract to be nullified since it violates the *muqtadha`aqd* (the main objective of a contract). They have submitted several solutions on *mudharabah* capital guarantee, including: third-party guarantee based on *tabarru`* (voluntarily given); third-party guarantee based on *qardh* (debts); *mudharib yudharib* (the entrepreneur channels the investor's capital to investing in a third party); and guarantee through special funds (MIFC, 2011).

The OIC Fiqh Academy discussed on the matter of insurance of *sanadat muqaradhah* and summarised that *mudharib* guarantee on capital and *mudharabah* profits are not permissible. However, the guarantee may be issued by a third party who has no connection whatsoever with the *mudharib* if it is done by way of *tabarru`* and is not included as a condition in the actual *mudharabah* contract sealed and signed by both parties.² The Shariah Council for Accounting and Auditing Organization for Islamic Institutions (AAOIFI)³ allowed for third-party guarantees other than by *mudharib* or investment agent or business partner towards the liability of investment losses⁴. However, this is on the provision the guarantee given is not tied to the original *mudharabah* contract.⁵ The basis of their decision is *tabarru`* which is allowed by Shariah.⁶ Husain Hamid Hassan summarised the basis of the permissibility of third-party guarantees based on the views of the Maliki Mazhab which allow *wa`d mulzim* (promises that

¹ Al-Kasani, *Badai'i` al-Sana'i`*, vol. 6, p. 87. Al-Nawawi *Al-Majmu` Syarh al-Muhazzab*, Maktabah al-Irsyad, Jeddah, vol. 15, pp. 194–195, 198. Ibnu Rusyd, *Bidayah al-Mujtahid*, vol. 2, pp. 303, 305. Ibnu Qudamah, *Al-Mughni*, vol. 5, pp. 147–148, 192. Ibnu Najjar, *Muntaha al-Iradat*, vol. 1, pp. 460, 466. Ibnu Juzay, *Al-Qawanin al-Fiqhiyyah*, p. 186. In MIFC Shariah Resolution.

² 4th meeting on 6–11 February 1988

³ 6th Meeting on 19–23 May 2001

⁴ See AAOIFI standard about *Mudharabah* transaction (2,3,3)

⁵ AAOIFI, *Al-Ma`ayir al-Syar`iyyah*, Bahrain, 2001, p. 80.

⁶ AAOIFI, *Al-Ma`ayir al-Syar`iyyah*, Bahrain, 2001, p. 89.

must be kept). It is further strengthened by *maqasid shariah* (shariah's objective) which allows for such action.⁷

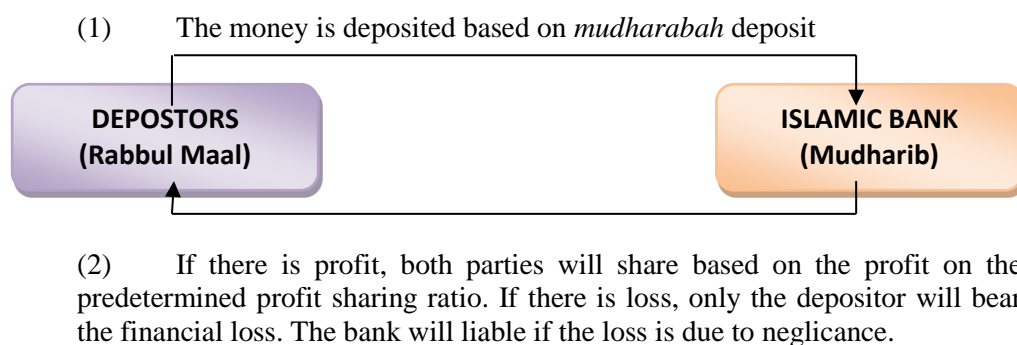
Mudharabah Investment Account in Islamic Banking in Malaysia.

A *mudharabah* deposit is a form of investment account which under this principles the depositor who acts as a *rabbul maal* deposits his money into the bank which acts as a *mudharib* that subsequently use the money for investment purposes. The distribution of profit between the bank and the depositors is in accordance to a mutually pre agreed profit sharing ratio. This must be disclosed and agreed upfront by both parties at the time of the opening of the account (ISRA, 2012). *Mudharabah* can be divided into two model, namely *mudharabah muthlaqah* (unrestricted *mudharabah*) and *mudharabah muqoyyadah* (restricted *mudharabah*).

In the current application in Malaysia Islamic bank, there are two type of application product deposit. First, *Mudharabah* General Investment Account (MGIA), which is based on *mudharabah muthlaqah* concept, which is Islamic bank, has the right to invest the money in the project without any special restriction from the depositors. Second, *Mudharabah* Special Investment Account (MSIA), which based on the concept of *mudharabah muqoyyadah*. In this deposits product, the *rabbul mal* (depositors) will be advised on where the fund will be invested, what the minimum amount they can invest in the projected return and what the loyalty risk that comes with it.

The figure below describes the application of *mudharabah* investment account in Islamic bank. In this figure, the depositors are as a *rabbul maal* (investor) who will invest their fund in Islamic bank. Hence, in this model, Islamic bank acts as *mudharib*. The money is deposited based on the *mudharabah* contract. The profit will be distributed based on the profit sharing ratio. If there is profit generated by *mudharib* (Islamic bank), both parties will share based on the profit on the predetermined profit sharing ratio. If there is loss, only the depositor will bear the financial loss. The bank will liable if the loss is due to negligence of *mudharib*. Unlike an interest-bearing savings account, a *mudharabah* account carries no guarantee of return (Maurer, 2002).

Figure 1. Mudharabah Deposit



Some of scholars have discussed the mobilization of deposits from investment accounts holders. Archer and Karim (2007) found, the majority of Islamic banks commingle *mudharabah* investment account 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 perspective of these deposits, banks follow an aggregative approach. All funds, regardless of the category of the deposits or depositors, are put

⁷ OIC, Majallah Majma` al-Fiqh al-Islami, Jeddah, 1988, no. 4, vol. 3, p. 1875.

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). Hence, the profit will be distributed by Islamic bank to their depositors.

Accounting Treatment of Unrestricted *Mudharabah* Account.

Islamic accounting associated with Islamic banking and finance need to be innovative to ensure that all activity can be better in the future (Napier, 2009). In case of the *mudharabah* investment account which is considered as a new model financial product in banking industry there are still debatable accounting treatment on how to recognize, measure, and report this activity. Off course the basic guideline is the shariah principle it's self-related to *mudharabah* contract.

In *mudharabah* contract, Islamic bank actually acts as both the *rabbul maal* and the *mudharib*. This is known as the two tier *mudharabah* which in this arrangement, it involves two separate contracts of *mudharabah*; between the bank and the suppliers of capital (depositors) on the other hand, between the bank and the user of capital (entrepreneurs). Thus, there are actually two contracts signed by the three parties; Islamic bank, depositors and entrepreneurs (Rahman, 2010).

There are at least two types of investment account in Islamic banking namely unrestricted *mudharabah* and restricted *mudharabah*. According to AAOIFI, restricted *mudharabah*, investor restricts the manner as to where, how and for what purpose the fund to be invested. In addition, no comingling of fund is required from other sources of fund to ensure the proper management and accountability funds. Hence, in accounting treatment, restricted *mudharabah* will be treated in a separate disclose (off balance sheet). In the form of restricted investment is required. However, in unrestricted *mudharabah*, comingling of fund from other sources is permitted and separate in the financial statement is required (Rahman, 2010).

In unrestricted *mudharabah* investment account, there are two different accounting policies. First, Financial Accounting Standard No.6 published by AAOIFI (1998) In Accounting and Auditing Standards for Islamic Financial Institutions 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)".

Equity of unrestricted account holder should be recognized when received by the Islamic bank. In case of Islamic bank make a condition that the fund will not be invested before a certain date, than the fund received shall be recorded in the current account until their date of investment is due (FAS, 6. Par.3). Equity of unrestricted investment account shall be measured by the amount received by the Islamic bank at the time contracting (FAS, 6, par. 4). At the end of a financial period, equity of unrestricted investment account holder shall be measured at their book value (balance recorded in the books of the Islamic bank), (FAS, 6, par.5). Profit of an investment jointly financed by the Islamic bank and unrestricted investment account holders shall be allocated between them according to the contribution of each of the two parties in the jointly financed investment (FAS, 6, Par.6)

For *mudharabah* contract accounting AAOIFI is that neither considers UIAHS as a liability nor as owners' equity. The AAOIFI Statement of Financial Accounting (FAS) No. 2: Concepts of Financial Accounting for Islamic Banking and Financial Institutions adds a new category in the statement of financial position (Atmen and Ramadan, 2012). This new category is entitled, Equity of Unrestricted Investment Account Holders (UIAHS) and their Equivalent. In addition, this category is presented in between liabilities and owners' equity in the statement of financial position. It includes the UIAHS and their related reserves.

The main argument behind this accounting treatment is that UIAHS are fund which received by Islamic bank and the main purpose is for investment based on profit and loss sharing or participation basis under *mudharabah* arrangement, thus, the Islamic bank is not obliged to return the fund in case of loss. Accordingly, the equity of UIAHS cannot be considered as a liability. Likewise, the equity of UIAHS cannot be considered as the owners' equity since the holders of these accounts do not enjoy powers and ownership rights, such as the voting rights held by owners (Atmen and Ramadan).

According to Kahf (2005), 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" This argument is supported by Akacem and Gilliam, (2002); Kahf, (2005); Sultan, (2006); Ayub, (2007); Ibrahim, (2007); Shubber and Alzafiri, (2008).

According to Sultan (2006), Karim (2001) *mudharabah* investment account holders cannot be treated as a liability because by the nature of the *mudharabah* contract which is based on the concept of profit and loss sharing. 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. 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).

Second, practically, in Malaysia, most Islamic banks are treating *mudharabah* investors in the same way as they treat conventional depositors. The relationship is purely leading and thus, the investors are treated as creditors. Islamic banks in Malaysia have classified unrestricted investment deposits as liabilities which are not in line with standards established by AAOIFI (Rahman and Zainuddin, 2009).

This is supported by some studies which is classified Unrestricted Investment Account Holders as liabilities. Archer and Karim (2009), based on the International Accounting Standards (IAS) 32, classify UIAHS from the *mudharabah* contract as a puttable instrument in the Islamic banks' capital structure. The definition of a puttable instrument is that when the depositors have right of withdrawal from such accounts by investors at any (Atmen and Ramadan, 2012). IAS 32 defines a financial instrument as a puttable instrument when it gives the holder the right to put the instrument back to the issuer for cash or any other financial asset.

However, IAS 32 states that such an instrument should be considered a financial liability in the issuer's books even when the amount of cash or other financial assets is determined on the basis of an index or another item that has the potential to increase or decrease, or when the puttable instrument gives the holder the right to a residual interest in the assets of an issuer. The concept of UIAHS in the *mudharabah* contract is similar to the concept of unit holders in open-ended mutual funds in that the holders have the right to redeem their interests at any time for cash, and the amount of cash is determined according to the performance of the bank or the mutual fund. IAS 32 also affirms that such a classification is a financial liability, independent of considerations such as when the right is exercisable, how the amount payable upon exercise of the right is determined, and whether the puttable instrument has a fixed maturity (Atmen and Ramadan, 2012).

According to Aren et al (2010) compared to conventional accounting, the case of UIAHS in Islamic bank is considered as a contingent liability. A contingent liability is said to exist in the following situations: there is a potential future payment to an outside party due to an existing

condition; there is uncertainty about the amount of a future payment; and the outcome will be resolved by some future events.

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 differs 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 noncompliance 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 experience different characteristics in applying new changes in their culture.

Some Implication of Accounting Treatment for Unrestricted Investment Account to the Islamic Bank.

Accounting treatment basically not only accounting per se, but it is also will has implication to the financial decision and the whole economy. In the case of unrestricted *mudharabah* investment account, the different accounting treatment will also will have impact on some aspect in the Islamic bank.

First, in term of profit distribution, the relationship between *mudharabah* income and overall return on bank assets is first explored based on available accounting standards. Drawing on this relationship, a methodology for measuring the risks facing UIAHS and the risk sharing between bank shareholders and UIAHS is suggested (Archer, Karim and Sundrarajan, 2010).

According to Financial Accounting Standards (FAS) (No. 6) of the AAOIFI, when a bank commingles its own funds (K – capital) with *mudharabah* funds (DI – unrestricted investment deposits), profits are first allocated between the *mudharib's* own (i.e. shareholders') funds and the funds of UIAHS, and then the share of the Islamic bank for its work as *mudharib* is deducted from the share of profits allocated to the UIAH.

In addition, FAS No. 6 states that profits of an investment jointly financed by the Islamic bank and unrestricted UIAHS should be allocated between them according to the contribution of each of the two parties in the jointly financed investment. Allocation of profit based on percentages previously agreed upon by the two parties is also juristically acceptable (for example in *mudharabah* and *musharakah* contracts), but the AAOIFI standard calls for allocation proportionate to the contributions.

In distribution profit there mainly some important aspect. First, there are two methods to distribute profit to all depositors whether based on AAOIFI or IFRS which is applied by most Islamic bank in Malaysia, namely Separate Investment Account Methods (SIAM) and Pooling Methods. The different between two are only in how to share the expenses. In pooling methods Islamic bank will distribute profit net income, while SIAM will distribute based on the gross profit. Second, many Islamic banks are conducting "smoothing return" by using Profit Equalization Ratio (PER) account. This method is very important for Islamic bank to make

Islamic bank competitive to other bank in order to ensure the investor will put their money in Islamic bank (Rahman, 2010).

In term of profit distribution, 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. Hence, based on our short analysis, the main issue basically not only about how accounting can be different between AAOIFI and the real practice of Islamic bank in Malaysia (IFRS), but also how accounting treatment can solve the problem above which is applied by Islamic bank in current system.

The model applied by current Islamic bank raised some comment from the scholars. In addition, Tahir (2007) Chong and Liu (2007) argue, in theory, *mudharabah* deposits are supposed to be equity-like because of their profit and loss-sharing, the results show that *mudharabah* 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.

Unrestricted investment account cannot be treated as a liability, since the nature of *mudharabah* contract. *mudharabah* is partnership contract which is both of *mudharib* and *rabbul maal* commit each other to conduct a business. If this business generate profit then will be distributed based on some proportion determined earlier, and if loss incur not due to the *mudharib*, the loss will be faced by the *rabbul maal* (depositor). Hence, *mudharabah* Investment account should be separated from liability since the nature of contract *mudharabah* is very difference. In this perspective, this study argues that accounting treatment of AAOIFI is properly with the nature of *mudharabah* contracts. Moreover, 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.

In the management perspective of these investment account deposits, banks follow an aggregative approach. It means that 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 (Tahir, 2007). This is the crucial problems which actually can be solved by the good accounting system. How to ensure, that the money invested by *mudharib* (depositor) can be really invested by Islamic bank and the profit generated by this fund is not comingled with the profit from other sources. In addition, good accounting system will ensure that fund are not pooled into one, thus the profit/loss incur will be detected. This analysis can be proved by the table 1 above about the profit distribution of Islamic bank. In that model, there is no difference between *wadiah* product, *mudharabah* product etc. which is in shariah should be difference. All funds then will be putted into one pool, and the profit generated will be distributed to all depositors.

Second, the accounting treatment will have impact on Capital Adequacy Ratio (CAR) issue. In principle, Investment Account under the *mudharabah* contract, all losses on investments financed by these funds (due to credit and market risks) are to be borne by Investment account holder (IAH), while the profits on these investments are shared between the IAH and the Islamic Banking as manager of the investments (*mudharib*) in the proportions specified in the contract. However, any loss due to “misconduct and negligence” (operational risk) should be borne by the Islamic Bank, under the shariah principles applying to *mudharabah* contracts.

In reality, however, the managements of Islamic Bank may engage in a range of practices that smooth or cushion the cash returns paid to IAH, thus protecting the cash returns on IAH funds against variations in the income from assets financed by those funds. A major aim of

these practices is to pay market-related returns to IAH for competitive reasons and to mitigate “withdrawal risk,” namely the risk that IAH will withdraw their funds in search of better returns (Archer, Karim and Sundrarajan, 2010).

As explained before, in AAOIFI, *Mudharabah* Investment Account is treated separately from liability. However, in current practice in Malaysia, the *Mudharabah* Investment Account is treated as purely liability. The accounting treatment both AAOIFI and IFRS will have significance impact on the measurement of Risk in Islamic bank, especially on term of Capital Adequacy Ratio (CAR).

The recently issued IFSB Capital Adequacy Standard recommends that supervisors should assess the extent of risks borne by PSIA based on management decisions on the payout to IAH, and should reflect these assessments in the computation of capital adequacy. This is referred to as “supervisory discretion formula.” More specifically, the IFSB supervisory discretion formula for the capital adequacy ratio (CAR) specifies that a fraction “alpha” of the assets funded by PSIA may be included in the denominator of the CAR, where the permissible value for “alpha” is subject to supervisory discretion. The supervisory assessment of how an Islamic bank manages the risk-return profile of PSIA would determine “alpha,” with “alpha near zero” reflecting a pure investment-like product and “alpha close to one” capturing a pure deposit-like product (Archer, Karim, Sundrarajan, 2010). It means that if based on AAOIFI standard, since the *Mudharabah* Investment Account has portion between liability and equity, thus the “alpha maybe equal to around 0.5”. However, since in Malaysia which is more based on IFRS treated this account as a liability, “alpha is close to one (1)”.

The two difference “alpha” will has impact on CAR. Study conducted by Archer, Karim and Sundrarajan (2010) find that a change in the value of alpha from 0 to 1 can have the effect of reducing the CAR by nearly 50 percent. Off course, this is very important number for Islamic bank, since CAR is the dominant indicator to measure the capability of Islamic bank to face risk. In addition, CAR is also used by regulator (Central Bank) to detect some problem which is potentially arises in banking. Hence, it is questionable if the Islamic bank has two different accounting standards which will has impact on CAR.

Third issue is the impact of accounting treatment on the risk management. As we know that there are some risks associated with Islamic bank, namely Credit risk, Equity investment risk, Market risk, Liquidity risk, Rate of return risk, Operational risk (IFSB, 2005). As stated by IFSB (2005), equity investment risk is specific risk which will be faced by PLS contract; *mudharabah* and *musharakah*. By putting the *mudharabah* investment account as liability will has impact on the misleading of risk measurement, and also how to mitigate this risk.

Fourth, in the finance decision perspective, the issue of accounting treatment will has impact on the issue of capital structure. Some study in Islamic finance has been conducted in the relationship between *mudharabah* investment account and the issue of capital structure. Archer and Karim (2009), said that based on the International Accounting Standards (IAS) 32, classify UIAHS from the *mudharabah* contract as a puttable instrument in the Islamic banks’ capital structure. Capital structure is a combination of debt and equity of companies. This structure includes long-term debt, preferred stock and common stock (Dastgir, 2003). The most important issue in determining capital structure is deciding about an appropriate and desirable portion of liabilities and equity. These decisions must be make in order to increase firm value. Based on theoretical basic of financial management, capital structure determination is achieving an appropriate and desirable combination of equity and debts in a way that could maximize the firm value and in contrast, reduced the cost of financing (Kohher, 2007).

The focus of capital structure study is how to combine liability and equity to create the highest value of company. It means that, the capital structure will focus on the liability side. In the context of Islamic banking, if there are two different accounting treatment, one categorized a *mudharabah* as liability, while the other will consider *mudharabah* as not a liability but separated as a “equity unrestricted investment account”, there is will be different impact on the

capital structure measurement. If based on AAOFI standard, the number of liability used in capital structure is lower than IFRS standard. Hence, the two different accounting treatments will create a bias in financial analysis.

Moreover, the capital structure policy also will have some implication in the financial analysis. For example, in default risk measurement, bankruptcy cost etc. When, some company face problems, some analyst will conduct financial analysis to detect the potential problem which possible arise in Islamic bank, include in what level of default risk, default probability and also in term of bankruptcy prediction. This is due to the important part of liability that must be determined in financial analysis.

Conclusions

The Profit and Loss Sharing (PLS) system is no doubt a just system since it fairly distributes the risk between lender and borrower that will replace the conventional system which is interest base (Sugema et al., 2010). *Mudharabah* contract in Islamic banks is the main vehicle to accomplish this mission, that is, PLS. However, in practice, this type of contract imposes several accounting challenges including, among others, the presentation of UIAHS in the statement of financial position, provisions, and reserves related to UIAHS, and profit allocation between investment account holders (UIAHS) and the banks' stockholders (Atmen and Ramadan, 2012).

There is a debate among scholars related to whether UIAHS should be classified as a liability or a special class of equity. Some scholars argue that *mudharabah* investment should be treated as equity, while the other opines that *mudharabah* investment account as liability. The paper argues that the business model of the Islamic bank is to invest deposits and share the profit with the holders and that the bank is not obliged to repay these amounts in case of loss; hence, equity classification for UIAHS is more appropriate.

The paper also argue that the two different accounting treatment for *mudharabah* investment account (UIAHS) will have some implication to the element of Islamic banking, namely profit distribution, Capital Adequacy Ratio (CAR), Risk management and Capital Structure. These elements will have impact on the Islamic bank performance and also the whole economy. Profit distribution should be rearranged to be more appropriate with the nature of *mudharabah* contract. The good accounting system will ensure that *mudharabah* investment account is fully shariah compliance.

CAR is the other element that will influence the accounting treatment. Based on IFSB Capital Adequacy Standard, in accounting treatment AAOFI standard, since the *Mudharabah* Investment account has portion between liability and equity, thus the "alpha maybe equal to around 0.5". However, since in Malaysia which is more based on IFRS treated this account as a liability, "alpha is close to one (1)". The different CAR also will have implication on the risk management that should be conducted by Islamic bank.

Capital structure policy is the one aspect that will be influence with the accounting treatment of UIAHS. This is caused by the basic theory of capital structure focused on how company can increase their value with combine liability and equity. Hence, the accounting treatment of UIAHS on whether it will be treated as equity or liability will has direct effect on capital structure policy and some other aspect such as default risk, bankruptcy cost etc.

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