IOSR Journal of Business and Management (IOSR-JBM)
e-ISSN: 2278-487X, p-ISSN: 2319-7668. Volume 18, Issue 7 .Ver. III (July 2016), PP 67-72
www.iosrjournals.org

Mudharabah and Musharakah from the accounting perspective by referring to AAOIFI, IFRS and MFRS.

[1]Md Rakib Mia, [2] Md. Abu Hasnat, [3]Wahida Mahjabeen
Department of Finance, International Islamic University Malaysia

Abstract: *The objective of this paper is to examine Mudharabah and Musharakah from the accounting perspective by refereeing to AAOIFI, IFRS and MFRS. As well as reviewing all annual reports of Islamic banks in Malaysia in terms of the use of Mudharabah and Musharakah also from accounting perspective. In order to achieve this objective, interview has been conducted, related papers has been reviewed, and annual reports of all Islamic in Malaysia has been reviewed as well.In this research found that, the use of Mudharabah and Musharaka are not popular among the Islamic banks in Malaysia due to the high risk and thus, the percentage is much less compare to other investments. Because of protection tools, Mudarabah-based account is similar to conventional deposits which they classified as liabilities, though Shariah prohibits assurance of return of principal to the investor, however, obligation arises from regulatory in order to maintain stable markets. The present study suggests that extra efforts are required in order to implement the use of Mudharabah and Musharakah.*
Keyword: *Mudharabah, Musharakah, AAOIFI, IFRS, MFRS*

I. Introduction

1.1 The tremendous growth of Islamic finance industry over the past decades has changed the direction of business used to be into a new better highway which attracted the attention of many business drivers around the globe. Specially, after the financial crisis, many conventional minded businesses converted into Islamic finance. The strengthening of the Islamic finance is due to its features, characteristics, and uniqueness that differentiate from others. At the beginning, Islamic banking and finance was established on the concept of profit and loss sharing between the parties that must be free from riba, gharar, maysir and gambling. Based on this, Islamic banks have developed a numbers of instruments that comply with shari'ah such as Mudarabah, Musharakah, Ijarah, Salam, Istisna and so on. In this project, we will examine Mudarabah and Musharakah in terms of recognition, measurement, and disclosure issues by referring AAOFI, IFRS, and MFRS and how all the Islamic banks in Malaysia reported them annually.

1.2 Mudharabah is a concept of partnership between Islamic bank and entrepreneur in terms of capital and work. Bank provides the capital needed and the entrepreneur provides the expertise needed. The profits are shared between them based on a pre-agreed ratio, in the event of any losses, bank will bear all, and entrepreneur losses time and efforts. However, Mudarib must bear any losses in case of negligence or Misconducting of the project.

1.3 Musharakah is partnership contract between two or more persons in a partnership structure where profit and loss are shared between the parties. Capital contribution can be equal or different-it doesn't matter-. Any profits are shared based on the pre-agreed ratio which must be agreed up-front and incase of any losses are shared based on the capital ratio not in the profit sharing ratio. All partners can be participated the musharakah management whereby everyone is responsible and acting as an agent of himself and by others.

II. Literature review

2.1 The idea of Mudarbah existed in the pre-Islamic area as a mode of financing because of, on that time trade was the main business activities for the people of Makkah -assoc. Prof. Dr. Ahmad Zafarullah in ISRA-. In the pre-Islamic area, there were no financial intermediaries or banking system and with that people adopted two methods of financing which are Mudarabah-partnership- and lending based upon interest EL-Ashker (1987). The medieval of Islamic period, the concept of profit and loss sharing were used to raise money to finance production (Chapra and Khan 2000). Interest based loans were disappeared during this period and the use of Mudarabah became more popular among the traders.

2.2 Moreover, according to Salman Ahmed Shaikh, (2011) Mudarabah is one the most preferable modes of Islamic finance for both past and present jurists and Islamic scholars. By the observation of Ibn Taymiyyah which is stated in "(Fatawa, Vol.20. p.356) one who looks closely on the basic principles of Mudarabah would easily find that Mudarabah is nearer to justice than hire. However, a survey conducted by Khan and Ahmad, (2001) about the perceptions of risks of different types of shariah principles in IFIs in 28 countries was stated that, Mudarabah and Musharakah were among the riskiest instruments compared to many types of Islamic products. Another study conducted by Ahmad (2011) on Malaysian Islamic banks found that only three banks reported exposure to Mudarabah and Musharakah and that is due to the higher risks, both become less popular among other Malaysian banks.

2.3 According to AAOIFI-FAS3- Mudarabah financing capital should be recognized when it is paid to the mudarib (transfer of cash of kind from the Rabul al-mal to the mudarib). It is stated that, in case of Mudarabah to be paid as an installment, by then, each installment should be recognized by the time of its payment. If the payment of capital is conditional for a future event or delayed to a future time, capital is recognized only when it is paid to the mudarib. AAOIFI's FAS No. 6 is stated that unrestricted investment account holders, Mudarabah should be recognized when received and measured by the amount received at the time of contracting, at the end of the period, equity will be measured at book value. Unrestricted Mudarabah, Profits should be allocated them (Islamic bank and account holder) according to the capital contribution in the jointly finance investment. Based on AAOIFI 1998 financial accounting standard number 6, stated that, equity of unrestricted investment account holders shall presented as independent category in the statement of financial position of the Islamic bank between liabilities and owners' equity.

2.4 Under MFRS) 132, financial instruments presentation shows the differences among the asset, liability and equity instruments. First equity, in general equity represents residual interests in the assets of an entity after subtracting all of its obligations. In addition, financial instrument to be classified under equity, there is other criteria must be met that equity instruments cannot be the same with contractual obligations which to deliver cash (paragraph 16). From the above prospective, if we look at the Mudarabah-based bank account which based on profit sharing lost, shariah prohibits assurance on the profit to the investor as he is the owner of the capital, because investor must be exposed to the risk of losses that could arise from the partnership activities unless the losses are caused by misconducting or negligence form the Mudarib (Islamic bank), in this case the bank must bear the losses. Although, Mudaraba investment carries high risk, Malaysian banks are offering mudarabah-based account but with better strategies those investors do not loss their life saving if the investments make losses.

2.5 However, in context of MFRS 132, Mudarabah investment cannot be classified as equity because the accounts represent a contractual obligation to deliver cash. Second liability, in general, liability represents contractual obligations to deliver cash or another financial asset to another entity. Moreover, the contribution amount in banking deposits is available for account holder to call it back at any time therefore, if the investor has a right to withdrawal his capital at any time, then that becomes obligation to the bank. Furthermore, the structure of mudarabah-based account is similar to conventional deposits which they classified as liabilities. Although, Shariah prohibits assurance of return of principal to the investor obligation arises from regulatory in order to maintain stable markets (paragraph 11). Thus, mudarabah-based account would be classified as liability because they are settled in cash and not equity shares of the investor.

It is also very interesting to mention that, AAOIFI under the FAS3 section, the measurement of capital, Mudarabah capital provided in cash by the Islamic bank shall be measured by the amount paid or the amount placed under the disposition of the mudarabah. If the capital provided by the Rabul al-mal, let's say the Islamic bank is kind of trading assets or non-monetary assets for the venture shall be measured at the fair value of the assets, if the value of the assets results in a difference between the fair value and book value, such difference shall be recognized as profit or loss to the Islamic bank itself.

2.6 At the very beginning, Islamic banking and finance was established for one principle which is profit and loss sharing (PLS) and the prohibition of interest Saeed (2004) Dusuki, Abozaid, (2007). Islamic microfinance institutions (IMFIs) should consider Mudarabah and Mushakarah as their main products since Islamic banking with their nature as a profit-oriented institution face difficulties in applying Mudarabah and Musharakah in their activities Prof. Dr. Norma at the department of economics IIUM.

2.7 In AAOIFI-FAS4- stated that the accounting rules for recognition and measurement for Musharaka capital is similar to those of mudaraba except for losses. The following are some of the rules. It says that Musharakah is recognized when the capital contribution of the banks (bank's share) is handed over to the partner or made available to the partnership by the name of Musharakah financing in the balance sheet. However, IFRS (MFRS) call interest of the joint venture instead of Musarakah. IFRS (MFRS) measure the joint venture investment as an asset because that is where they realize their economic benefits for the investment such as interest, dividends, lease charge and capital gain. Usually, under AAOIFI, any contracting expenses are not recognized as part of the capital unless agreed by both parties. It is mentioned that, in the constant Musharaka capital should be measured at the end of the financial period at historical cost (the amount which was paid or at which the asset was valued at the time of contracting). However, if the musharaka is a diminishing (musharaka mutanaqqisa), then the he Islamic bank's share in the diminishing Musharaka should be measured at the end of a financial period at historical cost after deducting the historical cost of any share transferred to the partner (such transfer being by means of a sale at fair value). Any difference between historical cost and fair value of the portion of share sold shold be recognized as profit or loss in the Islamic bank's income statement. On the other hand, IFRS (MFRS) measure joint venture based on short term investment and long term investment. Firstly they measure the short term investment as a fair value or the lowest price of cost value or market value. Moreover, IFRS measures the long term investment based on the amount of their cost. In addition, if the current value more than the market value due to the declining of the market value, after that, market value is reducing of the respective investment item. According to the MFRS 139 financial statement, Recognition and measurement, as both cash settled and equity –like asset measured as a financial instrument.

2.8 AAOIFI-FAS4 requires disclosure in the notes to the financial statements if the Islamic bank has made during that period a provision for a loss of its capital in Musharaka financing transactions. In practise, however, the banks provides for this in the balance sheet itself and this is more in line with international standards on asset impairment. In the IFRS 12 mentioned disclosures such that financial statement users can evaluate the nature of risk associated with investment.

III. Issues in practice of Musharakah and Mudarabah financing:

3.1 Financial Risks:

3.1.1 Financial risk is one of the several issues in conducting Mudarabah and Musharakah contracts which are exposures that have an effect in a direct loss to the liabilities or the assets of an Islamic bank. For instance, in Mudarabah investment, the Islamic bank (Rabbul-mal) involves in Mudarabah agreement with the entrepreneur (agent) by providing capital needed and the Mudarib provides as well experience needed, however the nature of Mudarabah disregards the bank to have a right to involve in the operation of the business management. As a result, agency problems may arise because the Islamic bank will not have appropriate tools to monitor the Mudarib (agent) activities in order to evaluate the administration of financing risk challenges. Therefore, the financial risks will present especially when the entrepreneur (Mudarib) provides a limit transparency in the financial disclosure to the Islamic bank and as well as when there is a high information asymmetry in the market.

3.2 Rate of Return Risk:

3.2.1 The uncertainty in the revenues received at the end of the investment by the Islamic banks on their assets it refers as rate of return risk. This uncertainty can cause changing in the expectation rate of return on the investment account holders that they have on their liability side. Because, the rate of return in the investment on Musharakah and Mudarabah by Islamic banks are not known accurately till the end of the investment, thus, Islamic bank has to wait until the output of his investment to identify the level of revenue will be earned. Therefore, during this period the rate of return risk will present if the expected prevailing rate of return change in the market, then the investors may expect similar rate form the bank.

3.3 Credit Risk:

3.3.1 In conventional bank the credit risk is loss of the revenue rising when there is counterparty’s postponement by the customer in payment on time or in full as contractual agreed. However, as we know Islamic bank based on profit and loss sharing modes of financing such as Musharakah and Mudarabah, then the credit risk occurs when the mudarib do not pay the profit share of the Islamic bank when it is payable. In this case the Islamic banks may have issues, especially when there is no sufficient information of the actual profit of the investment.

3.4 Equity Investment Risk:

3.4.1 Investing in Musharakah and Mudarabah will expose Islamic banks to higher risk as Mudarabah and Musharakah based on profit and loss sharing investment. Thus Islamic banks need to consider the financing risk in equity based on assets and the potential of losing the capital if the business makes any losses because both Mudarabah and Musharakah are subjected to loss capital even if there is a proper monitoring. In short, Islamic banks should take care when they chose the projects in order to reduce any potential losses that can arise from the investment.

IV. Annual reports of all Islamic banks in Malaysia (2014)

4.1 The expansion of Islamic banking sector over the past decades has shown a tremendous growth in many parts of the world. It is very interesting and beautiful adventure to review the annual reports of all Islamic banks in Malaysia. The establishment of Tabung Haji in 1963 is the history mentioned root of Islamic banking sector in Malaysia-though the aim of the institution was to invest the local Muslim savings and to facilitate the matters related their pilgrim. However, the first real modern Islamic banking system was established in 1983. Since then, the development of Islamic banking has come to the attention of many citizens in Malaysia. To be proud of, in this 15th December 2014, we have 16 Malaysian Islamic banks fully functioning and smartly computing with their conventional counterparts by offering a lot of Islamic instrument that fully or near comply with shariah. Below table here, we provided the names of the 16 Islamic banks and the use of two selected instruments which are Mudharabah and Musharakah.

Bank's name	Mudharabah	Musharakah
1. Affin Islamic Bank Berhad	✓	✓
2. RHB Islamic Bank Berhad	✓	✓
3. OCBC Al-Amin Bank Berhad	✓	✓
4. Maybank Islamic Berhad	✓	✓
5. Kuwait Finance House (Malaysia) Berhad	✓	✓
6. Bank Muamalat Malaysia Berhad	✓	✓
7. Standard Chartered Saadiq Berhad	✓	✓
8. Hong Leong Islamic Bank Berhad	✓	×
9. Bank Islam Malaysia Berhad	✓	×
11. Al Rajhi Banking & Investment Corporation (Malaysia) Berhad	✓	×
12. Alliance Islamic Bank Berhad	✓	×
13. Asian Finance Bank Berhad	✓	×
14. CIMB Islamic Bank Berhad	✓	×
15. Public Islamic Bank Berhad	✓	×
16. AmIslamic Bank Berhad	×	×

4.2 Based on the table, taken from the annual reports of all the 16 Islamic banks in Malaysia, we can see that, only seven (7) banks are offering both Musharakah and Mudharabah, AmIslamic Bank Berhad is offering neither Mudharabah nor Musharakah and the remaining 8 are offering only Mudharabah. According to many academician and practitioners been interviewed from out and inside IIUM, stated that, the limited use of Mudharabah and Musharakah among the Islamic banks in Malaysia in due to the high risk carried by the instruments. It is quite wasting of time and effort and most importantly, it's kind of redundant to mention how all the 16 Islamic banks use the instruments in terms of recognition, measurement, and disclosure. However, we would like to show some as an example.

4.3 Maybank Islamic Berhad annual report 2014 is stated that in the mudharabah side: the bank's loans/financing to financial institutions is financing granted to Maybank Islamic Berhad ("MIB"), a subsidiary of the Bank, under Restricted Profit-Sharing Investment Account ("RPSIA") amounting to RM9, 521.9 million (31 December 2013: RM8, 336.3 million). The RPSIA is a contract based on the Mudharabah principle between two parties to finance a financing where the Bank acts as the investor who solely provides capital to MIB whereas the business venture is managed solely by MIB as the entrepreneur. The profit of the business venture is shared between both parties based on pre-agreed ratios. Losses, if any, are borne by the Bank. Included in the deposits and placements from licensed banks is the Restricted Profit Sharing Investment Account ("RPSIA") placed by the Group's conventional operations amounting to RM9, 521.9 million (31 December 2013: RM8, 336.3 million). These deposits are used to fund certain specific financing. The RPSIA is a contract based on the Mudharabah principle between two parties to finance a financing where the investor solely provides capital and the business venture is managed solely by the entrepreneur. The profit of the business venture is shared between both parties based on pre-agreed ratios. Losses shall be borne by the Group's conventional operations as the depositor.

4.4 On the other hand, the Musharakah side of Maybank Islamic Berhad annual report mentioned that, On 30 May 2014, Etiqa Takaful Berhad, a subsidiary of the Bank, issued Tier 2 Capital Subordinated Sukuk Musharakah of RM300.0 million in nominal value ("Subordinated Sukuk Musharakah"). The Subordinated Sukuk Musharakah carries a tenure of ten (10) years on a 10 non-callable 5 basis, with a profit rate of 4.52% per annum, payable semi-annually in arrears, and is due on 30 May 2024. The subsidiary may, subject to the prior consent of BNM, redeem the Subordinated Sukuk Musharakah in whole or in part on any semi-annual distribution date on or after the fifth (5th) anniversary from the issue date.

4.5 In the KHF annual report (2014) stated that contracts of Mudharabah and Musharakah are recognized when cash is disbursed to customers. They are initially stated at fair value including any direct transaction cost and are subsequently measured at amortized cost using the effective yield rate method. Gains and losses are recognized in profit or loss when the financing, advances and other receivables are derecognized or impaired, and through the amortization process. Financial liabilities where the net book value of the restructured financing is higher than the fair value of the debt or equity instruments, the loss shall be recognized in the profit and loss in the current reporting period. Profit Expense Recognized when any profit expense on deposits and financing of the Group and the Bank under mudharabah deposits are recognized on an accrual basis. Financing income of both Musyarakah and Mudharabah are recognized based on estimated internal rate of return which is revised periodically over the duration of the financing. Lastly, we tried to find out the percentage of Mudharabah and Musharakah in the total of investment in each bank. What we did was that, we found the total of Mudharabah and Musharakah and divided by the total investment under the notes of Financing and advance. Some of the Islamic banks were disclosed and some of them we didn't to avoid mistakes because it was not state clearly or maybe we did not know enough how to read it. However, one of the experts in this area that we interviewed -Dr. Zaharuddin- said that the maximum percentage of Musharabah and Musharakah in the total investment if you check all the Islamic banks in Malaysia 20% or less. And prove of that, some of the Islamic banks that we successfully calculated were all less than even 10%. For instance, Maybank Islamic Berhad is 2.27%, OCBC Al-Amin Bank Berhad 3.02%, KHF 5.52%, Affin Islamic bank 3.45%. Based on this, we can prove that, the percentage of Mudharabah and Musharakah in all Islamic banks in Malaysia is very less compare to other investments as it's less than 20% of the total investment.

V. Analysis of Interview Data

5.1 As mentioned earlier, we conducted an interview in and out of the university for both academicians and practitioners as well. This was a tape-recoding and note taking. Five special people have been interviewed which included three International Islamic University Malaysia professors, one auditor, and a product manager in HSBC bank. It is impossible to type the whole questions and answers due to the limited wordings of our assignment but we will try to summarize as much as possible.

5.2 Product manager of HSBC, by the name of Mireland and his partner ashraf (from accounting and shariah part) stated that, by answering some of our questions- as long there is no enough market players, Mudharaba and Musharaka are less popular among the Islamic banks in Malaysia-. In addition, they said that, Mudarabah-based account is similar to conventional deposits which they classified as liabilities and that is because of protection tool but with better strategies to those investors so that they do not loss their life saving if the investments make losses.

5.3 Prof. Dr Noraini head of department of accounting International Islamic University Malaysia, we used MFRS instead of AAOIFI it's because of regulatory requirement, BNM wants this and the Main reason is easy to compare. If Islamic bank use AAOIFI standard and conventional banks use MFRS as a result bank Negara may face problems to measure the performances of all the banks because they are not using the same standard and with that, the measurement, recognitions, and disclosure also will be different. In her opinion, the prof insisted on, Malaysian should use MFRS and there is no problem in terms of presentation but the disclosure side should be improved and Islamic banks are expected to disclose as much as they can.

5.4 Dr. Zaharuddin Assistant professor of International Islamic University Malaysia: As we know Islamic banks can't guarantee the capital, thus it is a matter of how you want balance between the shari'ah compliant and also the tradability in order to achieve mqasid al shari'ah. However, we have to know the bigger picture of the Islamic bank because Islamic bank have to move gradually with knowledge enhancement of the bankers, the lawyers, stakeholders, the clients and regulators, so we have to think practically is not simple to ask why this and why that, Islamic bank will die tomorrow because they will not have depositors.

5.5 En Ahmad Nasri (auditor of KPMG) said that, all those standards represent just a language, so which language everybody can understand is the most suitable and so I guess IFRS (MFRS) is best language that everybody can understand.

5.6 Asso.prof.dr. dzuljastr- the head of finance department in International Islamic University Malaysia-, insisted during the interview Musharakaha Mutanaqisah is 100% shariah compliant and he suggested that Islamic microfinance institutions should refrain themselves from imitating Islamic banks by only focusing on debt financing products as a way of obtaining easy, risk-free, and steady flow of income.

VI. Methodology

6.1 Mainly, the data of the study was collected through interviews, from annual reports of all Islamic banks in Malaysia, and reviewing the previous studies related to area. Top level academicians from International Islamic University Malaysia authorities and practitioners from the industry had been interviewed to enhance the quality of the study.

VII. Findings and Recommendation

7.1 The findings reveal, though we have many Islamic banks here in Malaysia, the use of Mudharaba and Musharaka are very much less compare to other investment. This due to the high risk of the instrument and the reluctant of Islamic to have more on this investment side as there are no enough market players. Because of protection tools, Mudarabah-based account is similar to conventional deposits which they classified as liabilities, though Shariah prohibits assurance of return of principal to the investor, however, obligation arises from regulatory in order to maintain stable markets.

7.2 In terms of disclosure, there are already guidelines for Mudharaba and Musharaka. However, there is no specific percentage mentioned in the guidelines, so Islamic banks are expected to disclose as much as they can. The overall use of Mudharaba and Musharaka should be in line with the guideline of AAOIFI. Islamic banks are encouraged to use of Mudharaba and Musharaka regardless of their high risks because, there must be something good in it as they are derived from quran and sunnah. AAOIFI should cooperate and collaborate as much as they can engage.

VIII. Conclusion

8.1 Overall, the use of Mudharabah and Musharakah is not that well known among Malaysians due to the missing practice of it. Since both instruments are highly risk, Malaysian Islamic banks mostly avoided using it. The percentage of Mudharabah and Musharaka is much less comparing to other instruments such Murahabah. Though the percentage is very less, however, again there is a positive sign to it, because both instruments are gradually increasing.

References

[1]. Abushareah.M.A.R, Naim, A.M,(2015).The practice of Musharakah Mutanaqiash in Islamic Financial Institutions. International Journal of education and social science .vol.2.no.3

[2]. Muhannad A. Atmeh Abdul Hadi Ramadan,(2012),"A critique on accounting for the Mudarabah contract",Journal of Islamic accounting and Business research ,Vol.3 Iss1 PP 7-19

[3]. Shaikh.S.A(2011),"A critical Analysis of Mudarabah and a New approach to equity financing in Islamic finance", Journal of Islamic banking & finance ,ISSN 1814-18042

[4]. Norma Md saad and Dzuljastri Abdul Razzak (2013), "Towards and application of Musharakah Mutanaqish principle in Islamic Microfinance"

[5]. Annual reports of all the 16 banks in Malaysia in 2014

[6]. Muhammad Shodiq (2012)"Mudaraba & Musharakah Problems & the Solutions".

[7]. Khan, Tariqullah and Ahmed, Habib. 2007. Risk Management in Islamic Banking.

[8]. http://www.bnm.gov.my/?ch=li&cat=islamic&type=IB&lang=en