A critique on accounting for the *mudarabah* contract

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Abstract

Purpose – The purpose of this paper is to examine the accounting treatment for *mudarabah* contract and its implications on the reliability and fairness of the financial statements. In addition, the paper also aims to explore the effect of provisions and reserves on profit allocation among unrestricted investment account holders (UIAHS).

Design/methodology/approach – This study reviews the accounting treatment for *mudarabah* contract as stated in the *Accounting Standards for Islamic Financial Institutions* issued by the AAOIFI and compares it with other financial reporting frameworks, especially the IFRS.

Findings – The paper finds that presenting UIAHS in a separate category in the financial position statement (balance sheet), without reclassifying the assets in the financial position statement to reflect the assets attributable to UIAHS, suggests undue bias in the financial statements. This contradicts the concepts of full disclosure and true and fair view of the financial statements. The paper also reveals that reserves may result in profit misallocation among UIAHS. Additionally, there is an overlap between provisions and reserves, which may affect the reliability and fairness of the financial statements. It is also revealed that reserves presented under the UIAHS section could not be readily understandable since investors have no right to these reserves. The paper further finds that using a donation contract in business may result in diverting wealth from the less wealthy to the wealthier.

Originality/value – The paper criticizes the AAOIFI treatment for UIAHS and suggests an extension to this treatment by presenting assets attributable to UIAHS in order to enhance disclosure. Additionally, it questions the applicability of using donation (Tabarru) contract in transactions with profit-making substance.

Keywords Mudarabah, Islamic accounting, Investment risk reserve, Financial reporting, Investments, Financial risk, Accounting and Auditing Organization for Islamic Financial Institutions

Paper type Conceptual paper

1. Introduction

One of the most dominant financing contracts utilized by Islamic banks is the *mudarabah* contract, that is, a partnership in profit between the provider of labour and the provider(s) of capital. In this type of contract, profit is shared by the two parties, as agreed upon by both, but losses are borne only by the provider of funds (Kamla, 2009). This contract may appear as liability and/or asset in the financial statements of Islamic banks. On the liability side, all unrestricted investment accounts holders (UIAHS), as fund providers, are engaged in the *mudarabah* contract with the bank and hence, returns allocated to UIAHS depend on the profit achieved through the investment of these funds by the bank which applies a profit-loss sharing (PLS) base. On the asset side, banks may invest part of the funds received from UIAHS or funds available from other

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sources in *mudarabah* contracts. In this case, banks act as a financier to the parties who borrow these funds and receive a share of the profit by applying a PLS base.

This paper is concerned about the *mudarabah* contract on the liability side which is related to the investment received from depositors. A lack of a similar type of contract in conventional accounting imposes several challenges. In order to overcome such problems, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was established in 1991 in Bahrain to provide a reliable platform for the accounting treatment of *Shariah* compliant contracts. The AAOIFI approach is to adopt the accounting concepts developed and used by conventional accounting, as long as these concepts do not contradict with Islamic principles. Hence, the role of AAIOFI is to fill the gap by developing Islamic accounting standards for *Shariah* compliant contracts since such standards are not available in conventional accounting (AAOIFI, 2008, Statement of Financial Accounting No. 1, Para. 24). This inductive approach is criticized by several scholars in favour of the normative deductive approach (Gambling *et al.*, 1993; Sulaiman, 2003; Baydoun and Willett, 2000; Zaman and Movassaghi, 2002; Napier, 2007). The opponents of the inductive approach argue that Islamic values are unique and complete while conventional accounting is influenced by several concepts like shareholders wealth maximisation, economic income, and time value of money, which contradict with Islamic values.

Hence, the purpose of this paper is to critically evaluate the accounting treatment of *mudarabah* contract according to AAOIFI standards and its implications on the fairness and reliability of the financial statement. Several financial reporting issues are addressed in this regard. First, the UIAHS have both debt features (the depositor has the right to withdraw his/her deposit) and equity features (PLS), so what is the appropriate classification for UIAHS in the statement of financial position; liability or owners' equity? Second, AAOIFI suggests for the inclusion of two types of reserves attributable to UIAHS: risk reserve and profit equalization reserve. These reserves are appropriated out of the income of UIAHS in order to cater against future losses for the UIAHS and if there are no losses, then these amounts could be donated to charitable causes when the *mudarabah* contract is terminated (AAOIFI, 2008, Financial Accounting Standard (IFS) No. 11 Provisions and Reserves, Appendix b). These reserves may result in profit misallocation among UIAHS and may affect the reliability and fairness of the financial statements. Additionally, there is an overlap between provisions and reserves which may further affect the reliability of financial statements.

The paper proceeds as follows. Section 2 critically evaluates the equity of UIAHS and their equivalent category in the statement of financial position. Section 3 examines provisions and reserves related to UIAHS and their effects on transparency and earnings management, as well as the users' perceptions and interpretations of these elements in making decisions. Additionally, the applicability of using donation (*tabarru*) contract to create reserves is also explored. Section 4 investigates the way reserves and provisions are implemented in Jordan. Section 5 presents the conclusions and remarks.

2. Equity of UIAHS

One of the main distinctions of the *mudarabah* contract accounting is that AAOIFI neither considers UIAHS as a liability nor as owners' equity. The *AAOIFI Statement of Financial Accounting No. 2*: *Concepts of Financial Accounting for Islamic Banking and Financial Institutions* adds a new category in the statement of financial position.

This new category is entitled, *Equity of UIAHS and their Equivalent*. This category is presented in between liabilities and owners' equity in the statement of financial position. It includes the UIAHS and their related reserves.

It is argued that since the UIAHS are funds received for the purpose of investment on a profit sharing or participation basis under *mudarabah* arrangements, the Islamic bank is not obliged to return the funds it has received 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.

The literature recognized this type of contract as a hybrid source of capital since the *mudarabah* contract carries no guarantees of return as well as the face value. These studies conclude that this type of account is different from an interest-bearing savings account, and therefore must be recognized as a special class of equity (Shubber and Alzafiri, 2008; Ibrahim, 2007; Sultan, 2006).

On the other hand, other studies classified UIAHS as liabilities[1]. Archer and Karim (2009), based on the International Accounting Standards (IAS) 32, classify UIAHS from the *mudarabah* contract as a puttable instrument in the Islamic banks' capital structure. They stated that the right of withdrawal from such accounts by investors at any time meets the definition of a puttable instrument. 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 *mudarabah* 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.

Hence, from the preceding argument, the reason presented by AAIOFI not to classify UIAHS as a liability is not valid. Even though the Islamic bank is not obliged to return the full funds it has received, a liability is still outstanding as long as the funds have not been wiped out by losses. Compared to conventional accounting, this case 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 event/s (Arens *et al.*, 2010). If the uncertainty of the future payment is probable, then a liability should be recognized according to the best estimation. Nevertheless, in Islamic banks, the balance of the UIAHS is the maximum liability the bank could bear. In other words, if anything goes wrong and there are losses from the impairment of productive assets financed by investors, the liability would decrease. Hence, there is no need for estimation or contingent settlement provisions since the recognized amount is the most conservative one.

Moreover, the AAOIFI's definition of Equity of unrestricted UIAHS is inconsistent with the definition of the owners' equity and could be misleading. In the *AAIOFI*

Statement of Financial Accounting No. 2: Concepts of Financial Accounting for Islamic Banks and Financial Institutions, Para. 26, equity of unrestricted UIAHS is defined as the amount remaining from the fund originally received from UIAHS plus (minus) their share in profit (loss) and decreased by withdrawals from or transfers to other types of accounts. This definition ignores the right of the UIAHS to any changes in the value of productive assets financed by the UIAHS. Defining the equity of UIAHS by linking it with specific assets would produce a fairer disclosure since the reader of the financial statements would expect that the amount of this account could be changed according to these specific assets' valuation, that is, the reader would not assume UIAHS as a monetary item (fixed amount of money). This approach is used to define the owners' equity in the *Statement of Financial Accounting No. 2*, Para. 30. Owner's equity is defined as the remaining amount from the Islamic bank assets after deducting the bank's liabilities and equity of unrestricted UIAHS[2]. However, this definition is not truly accurate. It implicitly indicates that any change in assets value would be attributable to the owners while in reality, this change is proportionally attributable to both the owners and the UIAHS. In order to overcome this issue, classifying assets into two subcategories (assets attributable to shareholders and assets attributable to unrestricted UIAHS) in the statement of financial position would match the classification used on the other side of the statement of financial position where two classes of equity are presented (equity of UIAHS and owners' equity). The balance of the UIAHS depends on the value of the assets financed by UIAHS accounts, and hence, these assets must be presented with sufficient disclosure regarding their values and risks[3].

To sum up, the notion of UIAHS is similar to the notion of non-controlling (minority) interest since they both represent an ownership stake in a corporation's assets but their held positions have no influence on how the company is run. In a business combination, there is no need to match non-controlling interests with specified assets. This is because this information is presented in the stand alone financial statements for the subsidiary since there are two separate entities with two sets of financial statements, besides the consolidated financial statements for the group. Unlike the Islamic banks, UIAHS are not a separate legal entity and the only source of information for that party is the financial statement of the Islamic bank.

In practice, Islamic banks commingle the funds received from UIAHS with other funds provided by stockholders or current accounts but at the end of the period, the profit is allocated proportionally for each type of fund[4]. Similar calculations could be performed to determine the proportion of performing assets of each party.

3. Provisions and reserves

Reserves attributable to UIAHS also comprise a unique type of account since UIAHS can benefit from these reserves only to cover for any losses incurred by their investments. On the other hand, if there are no losses, these amounts could be donated to charitable causes when the *mudarabah* contract is terminated (AAOIFI, 2008, IFS No. 11 Provisions and Reserves, Appendix b)[5]. Moreover, Islamic jurists legalized these reserves by relying on a donation (*tabarru*) contract, which may have several implications on the usefulness of financial statements and more importantly, profit misallocation among UIAHS. Such types of reserves may undermine the main notion of *mudarabah* PLS) and convert the substance of UIAHS to be similar to deposit accounts in conventional banks.

In a *mudarabah* contract, neither deposit amounts nor returns on deposits are guaranteed. Therefore, and in order to override this issue, AAOIFI stated in the IFS No. 11 that the Islamic bank may use two types of reserves: profit equalization reserve (PER) and investment risk reserve (IRR).

PER is the amount appropriated by the Islamic bank out of the *mudarabah* income before allocating the *mudarib* share in order to maintain a certain level of return on investment for the UIAHS. The balance of the profit equalization reserve to the required level shall be treated as an appropriation of income before allocating the *mudarib* share, and the share of UIAHS in the profit equalization reserve shall be presented under the equity of UIAHS (AAOIFI Statement of Financial Accounting No. 2, Para. 29). On the other hand, IRR is the amount appropriated by the Islamic bank out of the income of UIAHS after allocating the *mudarib* share in order to cater against future losses for the UIAHS. The amount needed to bring the balance of the IRR to the required level shall be treated as an appropriation of income after allocating the *mudarib* share, and the IRR shall be presented under the equity of unrestricted UIAHS in the statement of financial position.

Although such types of reserves may undermine the main notion of *mudarabah* (PLS), Islamic jurists permit the deduction of part of the profit attributable to certain individuals (i.e. UIAHS) and make it available for the benefit of other UIAHS. Concerning the amounts which were deducted to create reserves, it is preferred that they be donated to charitable causes when the contract is terminated, if the purpose for which they were deducted no longer exists (Appendix b, IFS 11). IFS 11 allows the use of the profit equalization reserve, which is appropriated out of the *mudarabah* profit, to maintain a certain level of return on investment for UIAHS.

However, using profit equalization reserve could result in profit misallocation between UIAHS, that is, the profit earned in a specific year could be distributed to other UIAHSs in a different year that do not belong in the same pool of UIAHS. This issue is critical for the Islamic banks for several reasons. First, earnings management or income smoothing is mentioned in conventional accounting and auditing standards as mechanism that may result in fraud and misstatement. Hence, the management has a responsibility to publish financial statements that reflect the economic position of the firm in a very transparent way rather than in the way that the management desires. Although the main goal for this reserve is to enable the bank to distribute a certain level of profit to UIAHS regardless of the profit achieved, managers and shareholders of an Islamic bank can draw benefits from a "loose" accounting standard that provide managers with latitude in timing the reporting of income. Furthermore, UIAHS investors in Islamic banks have no influence in determining the balance of the profit equalization reserve as they do not have any representative on the board of directors of the bank or in the senior management level. This flaw in the corporate governance environment in the Islamic banks allows the management to transfer profit attributable to UIAHS between periods and accordingly, the effective yield on investment appears in a manner that serves the management's goals rather than protecting the UIAHS' interests. Archer *et al.* (2010) argues that the management of the Islamic bank may engage in a range of practices that smooth or cushion the cash returns paid to UIAHS, thus keeping a stable trend of income from assets financed by those funds. This is done either to pay market-related returns to UIAHS or to reduce the risk of investment accounts drawing.

This treatment also raises an ethical concern on whether the AAOIFI's accounting standards are based on Islamic ethics in serving public interest or are they based on serving the interests of the shareholders of the bank? It is fairer to appropriate risk reserve and profit equalization reserve out of the shareholders' profit than out of the UIAHS' profit. This is because the ultimate objective of these reserves is to attract deposits and to ensure sustainability of the bank, which should be the concern of Islamic bank shareholders.

3.1 What is the rationale for using the risk reserve to cope with future losses?

IRR (as defined by IFS 11) constitutes a unique case in Islamic accounting which cannot be matched with reserves in conventional accounting. Reserves in conventional accounting constitute a part of the stockholders' equity and are appropriated from retained earnings for different reasons, such as managerial polices or legal requirement, and the determination of periodic profit is not affected by the appropriation of retained earnings. On the other hand, to provide for any expected losses or decreases in assets' values, contingent liabilities should be recognized or impairment tests should be applied to the different assets presented in the financial position statement. If the contingent liability is probable and the amount can be estimated reliably, a liability is recognized and the amount is charged to the income statement. Additionally, any impairment losses should be charged to the income statement and the provision should be deducted from the related assets in the statement of financial position[6].

Risk reserves in Islamic banks play a different role. It can be perceived as a cooperative (*takaful*) insurance. The UIAHS donate a specific percentage of their profit for each year to the IRR and the balance of this reserve is used to cover for any losses that may occur in the coming years. In other words, the fund is available for the benefit of other UIAHS. Although IRRs are appropriated from the UIAHS' profit, neither the UIAHS nor the shareholders have the right to these amounts. These amounts must be donated to charitable causes when the contract is terminated, if the purpose for which they were deducted no longer exists. Presenting this reserve as a component of the investment account holders' section could be misleading, as UIAHS do not have the right to these amounts.

Furthermore, the profit on investing reserve assets should be attributed to the party who received the donation. In practice, this share of profit is allocated to the banks' shareholders. The mechanism of IRR may contradict with the PLS concept, in the *mudarabah* contract and differentiates between Islamic and conventional banks. By considering the various deposit holders throughout the years meant that some account holders have to forego part of the profit that they are entitled to other account holders in the future, if and when an investment incurs losses. This is justified by AAIOFI by stating that profit may be shared by consent, whereas losses should only be borne by the providers of capital in proportion to their shares of capital. The possibility of losses to account holders in banks with high IRRs becomes remote as the reserve will serve as a buffer for any future losses.

On the other hand, IRR may affect the competitive positions of Islamic banks in the market. As a significant amount of the investment account holders' profit is deducted yearly, the distributed profit is reduced. If the level of distributions becomes lower than the interest paid on deposits by the conventional bank, the competitive position of the Islamic bank would be affected as the depositors get a lower return on their deposits with higher risk. To overcome this issue, Islamic banks' shareholders may donate[7] part of their profit to the UIAHS. For example, the Islamic International Arab Bank in Jordan disclosed in its annual report of 2008 that the shareholders of the bank donated 5 percent of their profit to the investment account holders but no further explanation was presented in the notes to the accounts. It is not clear to the readers of the financial statements whether it is a policy of the bank to keep the profit on deposits at a certain limit or to match with other banks. Apparently, in the 2009 annual report, no such donation was declared by the bank[8].

3.2 How will the readers of the financial statements possibly interpret the reserves presented as part of the UIAHS equity section?

The comparison between the UIAHS equity section and the stockholders' equity section is not appropriate. Reserves under the stockholders' equity section affect the book value of the stocks and these reserves can also be distributed to the stockholders through dividends (laws and regulations considered). Thus, the trading prices of shares reflect, at least theoretically, the reserves and the amount of the retained earnings in the stockholder equity section. Similarly, reserves are also considered when performing valuation and financial analysis for the firm. However, the risk investment reserve under the UIAHS equity section cannot be distributed to the investors and as such, it does not affect the book value of the investment accounts since this amount will be donated to a third party in case of liquidation. Such techniques may support the financial position of the Islamic banks and qualify the bank to mitigate displaced commercial risk (Archer *et al.*, 2010) but are these techniques in line with the PLS concept and the *Shariah* principles? Is the investor in UIAHS receiving his/her fair amount?

It is clear that the investor loses his/her share of the amount deducted for reserves when withdrawal occurs. The investor also cannot benefit from the reserves' balances. These reserves could be useful for future investors who would need to counteract possible losses. Hence, such reserves have a value but this value is still unrecognized by the decision makers and the users of the financial statements of the Islamic banks. It is also complicated to determine the fair value of the UIAHS section (deposits plus related reserves) for several reasons. The assets financed by UIAHS are undeterminable as the bank commingles the stockholders resources with UIAHS when performing finance and investment activities[9]. Additionally, the fair values of such assets are not determinable. Unlike open-ended funds, the assets financed by UIAHS are not evaluated on a daily basis as these assets include long term financing contracts such as *murabaha*, *musharakah* and *ijarah*[10]. Furthermore, the UIAHS are not traded in a market and any investor that draws his/her investment gets the face value of the investment regardless of any returns achieved.

A solution to solve this dilemma is offered by Archer and Karim (2009). They suggest that Islamic banks may use a separate legal entity for fund management activities, and this entity could be a subsidiary of the retail bank. The retail bank would handle current accounts, chequebook, letters of credit, and other banking activities while the fund management company may take UIAHS from the public and take any surplus funds from the retail bank. In this case, the balance sheet of the retail bank will not present any amount related to UIAHS and the assets financed by them. This suggestion could also eliminate the problem of corporate governance and supervision identified above.

*3.3 Is it appropriate to use donation (*tabarru*)[11] contracts in doing business with commercial substance[12]?*

UIAHS donate part of their profit either to other UIAHS in different periods that suffer a defined loss, or to a third party in case of liquidation. The case of liquidation in Islamic bank is very remote as the UIAHS bear the investment losses and not the shareholders because of the multiple reserves and provisions performed by the bank. Therefore, the going concern assumption usually exists when the UIAHS deposit their investments. The major use of the IRR is to cater against future losses for UIAHS and the question here is whether the UIAHS are qualified to receive donations? More importantly, does this donation fit with the Islamic purposes of donation which is supposed to be for the poor and the needy? For instance, UIAH A deposits money in a year and achieve profit but part of this profit was deducted as IRR leaving him with a wealth of say 1 C.U[13]. UIAH B, who deposits his money in a later period and incurs losses, is entitled to receive "donation" from the IRR despite having a wealth of 10 C.U. The donation concept here does not take into consideration neither the financial positions of the donors nor of the recipients of the donations. Instead, it is related to the year's performance. Donations in this case could flow in the opposite direction from the less wealthy to the wealthier. Although the consent of the UIAHS to reduce their share of profit is secured through the deposit contract and other forms used by the Islamic bank, UIAHS are keen to get every amount related to their investments since the major purpose to deposit money in a commercial bank is to get profit rather than donate charity to unknown parties with an unknown financial status.

4. Application of provisions and reserves in Jordan

There are three Islamic banks in Jordan: the Jordan Islamic Bank which was established in 1978 as a public shareholding limited company with a current capital of JD (100) million; the Islamic International Arab Bank which commenced its banking operations in 1998; and the Jordan Dubai Islamic Bank which started to operate at the beginning of 2010.

According to the Jordan Banking Law No. 28 for the year 2000, article 55: an Islamic bank shall maintain an account in an investment risk fund to cover any losses in the mutual investment accounts exceeding the total investment earnings in a given year. Such a fund shall be sustained by deducting not less than 10 percent of the net investment earnings realized by various operations carried out during the year.

In addition, according to article 56 of the previous law, when the Central Bank decides to liquidate an Islamic bank, the balance of the investment risks fund shall be transferred to the *Zakah* fund after covering and amortizing all losses or expenses for which the fund was established. The investors in the Islamic bank have no right to the deducted amounts.

Although the Islamic banks in Jordan use reserves (IRR[14]) and provisions (bad debts provisions or *murabaha*, *musharakah* and other receivables), the accounting treatment for such reserves and provisions differs significantly from what is mentioned in AAOIF standards. First, due to IFS 11, the required level of IRR will be determined initially and after that the amount needed to reach the desired balance is appropriated from income. In Jordan, 10 percent of the *mudarabah* profit is charged to the income statement (as expense, not as appropriation of income), regardless of the prudent required reserve balance[15]. Second, IRR is used by Islamic banks in Jordan to cover for any losses related to transactions financed by UIAHS and initiated in previous years, for example, by selling stocks purchased in prior periods or by amortizing the subsidiaries' losses. It is also used to provide for bad debts related to nonperforming loans[16]. According to IFS 11, IRR is created in order to cater against future losses for UIAHS, but it is not clear whether these losses can be assigned to specific items or whether these reserves must only be applied if there is a loss for the entire period from all activities related to UIAHS.

For Jordanian Islamic banks, there is a mix between reserves and provisions. Since the risk reserve could be perceived as a cover for losses related to previous periods, in this case, any losses resulting from impairment of assets (receivables, investment assets, and financing assets) are qualified to be deducted from the risk reserve[17]. In other words, risk reserve overlap with provisions. By utilizing the annual report of 2009 of the Jordan Islamic Bank, several issues may be noticed:

In the income statement, no bad debt expenses are recognized. The amount of the required balance for provision of doubtful accounts is transferred from the investment risk reserve balance. The ending balance of the Investment Risk Reserve is presented in the statement of financial position in different locations as follows:

- A part is allocated as a provision for doubtful receivables (receivables from *murabahah*, *musharakah*, and other receivable), and this amount is deducted from the related assets in the statement of financial position[18].
- The residual balance is presented under the UIAHS Equity in the statement of financial position.
- The IRR is used to substitute for the allowance for doubtful accounts.

Hence, profit does not accurately reflect the management performance in granting financial facilities to credit worthy clients. The residual balance of the IRR (shown in the UIAHS Equity section) could be considered as a hidden reserve for bad debts and management can utilize this amount by adopting a lenient lending policy without incurring any losses for loans default.

For example, the balance of the IRR for the Islamic Bank of Jordan as of 31 December 2009 was J.D 41,015,908. The amount that is allocated as provision for doubtful accounts is J.D 20,252,574, and the residual balance of J.D 20,733,334 is shown in the UIAHS Equity section as an IRR. The bank has the ability to absorb additional impairment losses from new clients in 2010 of up to J.D 20,252,574, plus 10 percent of the profit on mutual investment accounts in 2010, without recognizing any losses in the income statement. It is expected that the Islamic banks may achieve higher return than the conventional banks since the Islamic banks can be involved in more risky transactions, and accordingly have higher returns.

5. Conclusion and remarks

The PLS system is no doubt a just system since it fairly distributes the risk between lender and borrower. The interest-based system, on the other hand, is unjust for borrowers experiencing adverse shocks and is unfair for lenders in the case of favourable shocks (Sugema *et al.*, 2010). *Mudarabah* 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.

There is a debate among scholars as to whether UIAHS should be classified as a liability or a special class of equity. 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. On the other hand, and to comply with equity definition as a residual interest, the paper suggests that assets in the statement of financial position should be classified into two subcategories: assets attributable to shareholders and assets attributable to unrestricted UIAHS. This would improve the disclosure of the financial statements and help the users of the accounts in making decisions.

Other accounts related to UIAHS are reserves (profit equalization reserve and IRR). These accounts are designed to stabilize rewards attributed to UIAHS. In substance, reserves undermine the concept of PLS and can be used to achieve income smoothing (Taktak *et al.*, 2010). As the IRR is appropriated out of the profit of UIAHS to cater against future losses for UIAHS, the profit distributed to UIAHS is reduced. Conversely, the shareholders may donate part of their profit to UIAHS to keep the distributed profit reasonable. This mechanism may affect the transparency and reliability of the financial statements. Additionally, each investor may not get his/her fair share of profit. The paper also argues that using reserves based on a donation (*tabarru*) contract is inappropriate and may result in diverting wealth from the less wealthy to the wealthier, contradicting Islamic principles. Furthermore, some banks mix reserves and provisions. This is because reserves are not created to meet losses from an identified past event deemed to cause losses; hence, any impairment of assets could be absorbed by reserves. This overlap between provisions and reserves may affect the fairness and truthfulness of financial statements as well.

By employing an accounting perspective, this paper presents additional evidence that the Islamic Financial Institutions are functionally indistinguishable from conventional banking institutions (Khan, 2010). Further research can be conducted in order to develop a different model than *mudarabah* contract to manage the UIAHS. This model may utilize the basis of mutual funds in compliance with Islamic principles, and will resolve the accounting concerns regarding profit allocation, classifications, reserves, corporate governance and the reliability and fairness of the financial statements.

Notes

1. Islamic banks in Malaysia have classified unrestricted investment deposits as liabilities which is not in line with standards established by AAOIFI (Abd Rahman and Zainuddin, 2009).
2. The International Accounting Standard Board (IASB) Framework for the Preparation and Presentation of Financial Statements defines equity as the residual interest in the assets of the entity after deducting all its liabilities. Hence, it is dependent on the measurement of assets and liabilities. This approach should be used to identify UIAHS equity by determining the related assets and liabilities.
3. Tahir (2007) criticized the Islamic banks for reporting all deposits as their liabilities, and all their advances (bank "investments") as assets in their balance sheets. This is because the ownership of funds under *Mudarabah* rests with the depositors and the bank control these funds for operational purposes. He suggested that the investment deposits and financing

from them should be off-balance sheet items for Islamic banks. He further argued that the present method used by Islamic banks, of pooling all types of deposits for investment and then distributing the generated profits to deposit holders is *Shariah* incompatible and violates the principle of equity and justice enshrined in the rules of *mudarabah*.

4. Islamic banks may face several problems in this regard. First, Islamic banks cannot use all the money available for investment either because the regulations do not allow them, or because funds available for investment are larger than the banks' investment portfolio. Second, how can the bank determine the actual profit of every holder of an investment account? The bank's money is invested in various projects, and some of these may be completed before the end of the financial year, and their profit known (Ahmed, 1996). However, the criteria that were used to allocate profit could be used backward to allocate the assets that generated profit among parties.
5. These amounts cannot be distributed to the stockholders since it is deducted from UIAHS profit, and cannot be distributed to the UIAHS because these amounts were accumulated during different periods of time with different UIAHS, so the current UIAHS do not have the right for such amounts.
6. According to International Accounting Standard 37, it is not allowed to provide any provisions to cater against future losses if there is no past event related to such expected losses.
7. Applicability of using donation in business is discussed in a later section.
8. This lack of information disclosure contradicts with the *Objectives of Financial Accounting for Islamic Banks and IFIs* issued by AAIOFI. According to the *objectives,* holders of investment accounts are considered one of the main categories of users of external financial reports for Islamic banks, and their information needs must be addressed and fulfilled. Archer *et al.* (2010) also emphasize this point and states that UIAHS returns and the use of reserves and transfers to smooth returns must be disclosed publicly in order to help the users in making decisions.
9. It is suggested in Section 2 that separating assets to UIAHS and to stockholders may achieve a better presentation.
10. For *Zakah* purposes, the *Zakah* should be paid on the assets controlled by the bank and subject to *Zakah*. Assets controlled by the bank belong to multiple parties (UIAHS, reserves, stockholders) and each party is responsible to pay *Zakah* for his assets. It is not clear who is responsible to pay *Zakah* for the assets resulted from investing reserves amounts; the stockholders (bank) are not responsible because these amounts are deducted from UIAHS and the UIAHS are not responsible because they cannot benefit from these amounts only to cover for any losses incurred by their investments, and these amounts could be donated to charitable causes when the *mudarabah* contract is terminated. Hence, the ownership of these assets is not obvious; it is controlled by the bank, deducted from UIAHS, and may end up in charitable funds.
11. *Tabarru* means a donation, charity, or gift which cannot be taken back.
12. AAOIFI uses this type of contract (donation) extensively to imitate conventional products that meet *Shariah* requirements, e.g. the main difference between Islamic insurance and conventional insurance relies on the existence of a donation contract. It is worth mentioning though, that no sufficient research has been conducted in this area.
13. C.U: currency unit.
14. Usually, Islamic banks in Jordan use the term Investment Risk Fund instead of Investment Risk Reserve. This is because neither the shareholders nor the UIAHS are owners of this fund balance.

15. The bank has the right to cease transfer to the investment risk when the total amount in such a fund becomes twice the amount of the paid-up capital of the Islamic Bank or reaches such other amount as may be determined by the Central Bank (Jordanian bank law).
16. The Islamic Bank of Jordan discloses in its 2009 annual report, note 27 of the financial statements, that this treatment is in line with article 55 of the Jordanian banking law and its related interpretations published by office of the interpretation of laws (Judicial Council).
17. This treatment is not in line with AAIOFI Standard No. 11. The investment risk reserve is distinct from assets impairment provisions.
18. The amount of this provision is calculated according to the instructions of the Central Bank of Jordan.

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