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EXPLORATORY STUDY ON THE IMPACT OF PROFIT EQUALISATION RESERVE GUIDELINES ON ISLAMIC BANKS' TAXABLE INCOME

BY

NORIZA ESA

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IIUM Institute of Islamic Banking & Finance
International Islamic University Malaysia

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ABSTRACT

Due to many criticisms on the accounting treatment for profit equalisation reserve (PER), Bank Negara Malaysia has issued a new 'Profit Equalisation Reserve Guidelines' for Islamic banks and financial institutions in Malaysia. Previously apportionment of the PER for both *raabul mal* and m*udharib* are expensed in the profit and loss account. In the new PER Guidelines, only the *rabbul mal*'s portion is expensed in the profit and loss account while the m*udharib*'s portion is reflected in the statement of changes in equity. The new accounting treatment is affecting the profit and loss account and will increase the profit before tax for the Islamic banks. Therefore, this paper explores the implication on tax that may result from the new PER accounting treatment. This paper analyses the annual reports of Islamic banks in Malaysia to determine the change in PER disclosure before and after the implementation of the new guidelines on PER. This paper observes changes in accounting disclosure in the financial report of some Islamic banks beginning from year 2012. Consequently, interviews with the relevant officers of the Lembaga Hasil Dalam Negeri Malaysia (Inland Revenue Board of Malaysia - IRBM) are conducted to gain inputs on the impact of the new PER Guidelines on taxation. The interviews revealed that PER affected Islamic banks' taxable income even before the new Guidelines are implemented. After the new PER Guidelines have been introduced, tax only affected the *rabbul mal*'s portion. As a result, adjustments to the taxable income of the Islamic banks are made prior and after the implementation of the new PER Guidelines, and this increases their tax payable. The findings also reveal that not all expenses that follow the statutory directives are allowable in the perspective of taxation.

Keywords: Profit Equalisation Reserve, *Mudharabah*, Taxation

كما تنشأ الانتقادات على المعالجة المحاسبية من أجل إحتياطي تسوية الأرباح, البنك المركزي المالزي أصدرت التوجيهي الجديدة بالنسبة للبنوك والمؤسسات المالية الإسلامية في ماليزيا. سابقا، القسمة في إحتياطي تسوية الأرباح الى كلتا الفئتين : رب المال و المضارب هي لإنفاقها في حساب الأرباح والخسائر. وفي المبادئ التوجيهية الجديدة لإحتياطي تسوية الأرباح الجزء من رب المال هو الآن لإنفاقها في حساب الأرباح والخسائر. وفي حين أن في المضارب هو أن تنعكس في العمود من " التغيرات في المساهمين". وبالتالي فإن المعالجة المحاسبية الجديدة تؤثر على حساب الأرباح والخسائر ويزيد من الأرباح قبل الضريبة للبنوك الإسلامية. لذلك، يستكشف هذه ورقة البحث الآثار المترتبة على الضرائب التي قد تنتج عن المعالجة المحاسبية لإحتياطي تسوية الأرباح الجديدة. يحلل هذه الورقة أيضا التقارير السنوية للمصارف الإسلامية في ماليزيا لتحديد التغير في إحتياطي تسوية الأرباح الإفصاح قبل وبعد تنفيذ المبادئ التوجيهية الجديدة للإحتياطي تسوية الأرباح. والى جانب ذلك، يلاحظ هذه الورقة التغييرات التي تحدث في الإفصاح المحاسبي يبدأ التقرير المالي في العام 2012 .وفي نهاية المطاف، وتجرى المقابلات مع موظفي (الإيرادات الداخلية مجلس ماليزيا) للحصول على المدخلات فكرة واسعة عن تأثير توجيهي جديد من الإحتياطي تسوية الأرباح على الضرائب. ونتيجة لذلك، كشفت المقابلات التي الإحتياطي تسوية الأرباح أثرت على الدخل الخاضع للضريبة المصارف الإسلامية على الرغم من أن المبادئ التوجيهية الجديدة ليست حتى الآن لتنفيذ. ومع ذلك، فإن الضريبة يؤثر فقط على جزء من رب المال، وبعد عرض توجيهي جديد من الإحتياطي تسوية الأرباح. فإنه يكشف أن التغييرات من الدخل الخاضع للضريبة في البنوك الإسلامية لا بد من تعديلها قبل وبعد تنفيذ المبدأ التوجيهي الجديدة من الإحتياطي تسوية الأرباح. وبالتالي يزيد ضرائبهم الواجبة للدفع. أنه يكشف أيضا أن ليس كل النفقات التي تتبع توجيهات قانونية المسموح به في منظور الضرائب

الكلمات الرئيسية: إحتياطي تسوية الأرباح ، المضاربة , الضرائ

APPROVAL PAGE

I certify that I have supervised and read this study and that in my opinion, it conforms to acceptable standards of scholarly presentation and is fully adequate, in scope and quality, as a dissertation for the degree of Master of Science in Islamic Banking and Finance.

....
Sheila Nu Nu Htay
Supervisor

This research paper was submitted to the IIUM Institute of Islamic Banking and Finance (IIBF) and is accepted as a partial fulfillment of the requirements for the degree of Master of Science in Islamic Banking and Finance.

....
Ahamed Kameel B. Mydin Meera
Dean, IIUM Institute of Islamic
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DECLARATION

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

Noriza Esa

Signature …………………………………… Date ……………………..

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CHAPTER ONE

INTRODUCTION

Islamic banking and finance began its appearance in Malaysia with the humble introduction of Islamic Banking Act 1983 and the establishment of the first Islamic bank in the country, Bank Islam Malaysia Berhad (BIMB). Over three decades, Malaysia has journeyed to emerge as the leader in Islamic banking and finance.

Islamic banking has changed the nature of conventional banking where banks are no longer just being intermediaries of allocating fund from surplus units to deficit units but involved in various contracts where banks also share the risks. In conventional banking, banks transfer risks to customers but Islamic banking promotes risks sharing.

One of the products of Islamic banks embracing risk sharing system is *mudharabah* account. In a classic *mudharabah* contract, one partner will provide capital (*rabbul mal*) and the other partner will provide labour (*mudharib*). In a *mudharabah* investment or savings account, the depositors as *rabbul mal* contribute the fund to be invested by the bank who acts as a *mudharib*. The profit derived from the investment will be shared between *rabbul mal* and *mudharib* according to a pre-agreed profit sharing ratio. Any losses will be borne by the *rabbul mal* unless there is negligence on the *mudharib*'s part and the bank will bear the loss.

In a *mudharabah* account, Islamic banks accept deposits from depositors and invest them in a profit-sharing investment account (PSIA) (BNM/RH/GL007-11). These depositors are grouped together and named investment account holders (IAH). The IAH may choose either to deposit in a general investment account (GIA) or

specific investment account (SIA). In a SIA, the IAH specifies the terms on how the investment should be invested. In contrast, the GIA account holders give discretion to the *rabbul mal* to invest the fund appropriately.

In return, the IAHs will receive their share of the profit which should depend on the performance of the investment of the fund. In Malaysia, the profit distribution is regulated by the Central Bank of Malaysia or Bank Negara Malaysia (BNM) as a standard measure to be followed by all Islamic financial institutions offering *mudharabah* investment products (BNM/GP2-i).

In managing the *mudharabah* funds, the risks faced by the Islamic banks are amplified because the Islamic banks' structure and products are relatively new and they have to compete with the conventional banks. Usually risks associated with conventional banks and financial institutions are market risks, credit risks, operational risks and liquidity risks. Islamic banks and financial institutions face the same risks but they are also exposed to unique risks like *shariah* non-compliant risks and rate of return risks.

The main difference of Islamic banking from the conventional is the interest based system which grounded the conventional financial and banking system. Unlike conventional banking where return is quoted in interest rate fixed at point of placement of deposit, Islamic banks may only provide indicative profit rate for depositors. Providing a fixed profit rate at point of deposit placement will violate the *mudharabah* principle. Profit rate will only be determined at the end of investment period. This will increase the risk to *mudharabah* deposits as investment returns are subjected to fluctuation of the investment of the *mudharabah* assets (BNM/RH/GL008-12).

A study conducted by Chong and Liu (2009) found that change in interest rate of conventional bank will cause the profit rate of Islamic banks and institutions to follow suit but not vice versa. There is a direct relationship between changes in the conventional interest rates and Islamic profit rate. However, changes in the profit rate of Islamic banks will not cause a change in the interest rates of conventional banks. The depositors of the Islamic banks will expect at par return to match the return from conventional banks. Therefore, the profit distribution of the *mudharabah* account will tend to match the conventional banks' rate rather than to reflect on its own performance.

Returns from investments fluctuate and Islamic banks need to do income smoothing to match those from the conventional banks. Islamic banks face the risk of bank run or massive withdrawal of fund from depositors if they fail to match the return of conventional banks. This situation exposes the Islamic banks to another unique risk known as displaced commercial risk (DCR) where they may have to utilise shareholders' fund to match the return of conventional banks to avoid massive withdrawal of funds from their depositors. DCR exists in dual banking environment where Islamic banks co-exist side by side with the conventional banking system. (Toumi, Viviani, & Belkacem, 2010 & Sundarajan, 2008)

DCR is the effect of volatility in rate of return of the Islamic banks due to varieties of tenure of banks' investments. Lack of investment avenues for Islamic investments also amplifies the risk of return. In Malaysia, to smoothen return volatility, BNM has ruled out guidelines on how Islamic banks to manage DCR in the Guidelines on the Recognition and Measurement of Profit Sharing Investment Account (PSIA) as Risk Absorbent (BNM/RH/GL 007-11). The guidelines will help to quantify the commercial risk borne by the Islamic banks and financial institutions.

To mitigate DCR, Islamic banks are allowed to appropriate a certain level of reserve from the gross profit known as profit equalisation reserve (PER) to maintain a certain level or return to the IAH. Monthly PER should be capped at 15% of total gross income and accumulated PER should be maintained a maximum 30% of total shareholders' fund.

The creation of PER may resolve DCR faced by Islamic banks. However, PER has been criticised as it deprives current IAHs from receiving their full profit distribution. If they withdraw the *mudharabah* savings before PER was fully released, they may not be getting their rightful share of the profit. In contrast, new *mudharabah* depositors may be getting the unjust claim to the reserve due to the right timing of deposit. Apart from that, PER was criticised from the accounting perspective as it fails to meet the requirements of Malaysian accounting standards provision requirement of the FRS 137 and definition of financial liability as per FRS 139. After many criticisms made by accounting practitioners, BNM has introduced new guidelines to eliminate ambiguities in the PER application.

The new Guidelines on Profit Equalisation Reserve (BNM/RH/GL 008-12) will specify new mechanism for PER alongside its related regulatory requirements. One of the main changes will be on the accounting treatment for PER apportionment in the income statement and it will affect profit before tax. Consequently, changes in the profit reported will affect taxable income. Therefore, this research is conducted to explore whether indeed there is effect on taxable income as a result of the new Guidelines on PER.

1.1 PROBLEM STATEMENT

PER is one of the techniques adopted by Islamic banks and financial institutions to mitigate DCR. PER however inflicted many criticisms and disagreements on the accounting treatments, governance and ethical aspects. BNM has introduced the new Guidelines on Profit Equalisation Reserve (hereinafter referred as "the new Guidelines") delineating PER new accounting treatment for all Islamic banks and financial institutions in Malaysia from the financial year 1 July 2011. The previous and new accounting treatment will affect the income statement (will be used interchangeably with profit and loss account).

Previously, both IAHs' and Islamic banks' apportionment of the PER was expensed in the income statement. The new PER Guidelines will only have the IAHs' portion expensed in the income statement. The Islamic banks' portion will be shown only in the statement of changes of equity which does not affect profit before tax. These changes will affect taxable income for the Islamic banks because it involves items in the income statement. It looks as if profit reported was lower prior to the new Guidelines but will increase after the new Guidelines are implemented. Change in reported profit will affect taxation. Therefore this research is conducted to see the impact of the change of the new Guidelines on Islamic banks' taxable profit.

1.2 RESEARCH OBJECTIVES

If based on the PER new Guidelines, it seems that the accounting changes made by BNM will affect taxable profit. PER apportionment of the Islamic bank previously recognised in the income statement can now only be shown in the statement of changes in equity. The objective of this research is to explore whether there is an impact on taxable income of Islamic banks due to the new changes of PER Guidelines

by BNM. Consequently, if there is effect on the taxable income, would the Inland Revenue Board of Malaysia (IRBM) take necessary actions to amend the calculation of taxable income of the Islamic banks.

1.3 RESEARCH QUESTIONS

This research is hoped to answer these questions;

1. Does PER affect profitability?
2. How is the treatment of PER from the taxation point of view?
3. Do the profitability and taxation of the Islamic banks affected after the new PER Guidelines implemented by BNM?
4. If the new PER Guidelines affect profitability, does the change in taxable income cause IRBM to review the calculation for taxable income for Islamic banks adopting PER prior to the change?

1.4 SCOPE OF RESEARCH

The new Guidelines is applicable to all Islamic banks under the Islamic Banking Act 1983 (IBA), all banking institutions participating in the Islamic Banking Scheme (IBS) or known as 'Islamic windows' licensed under Banking and Financial Institutions Act 1989 (BAFIA) and development financial institutions prescribed under the Development Financial Institutions Act 2002 (DFIA). For the purpose of this research, the scope will be focussed only on Islamic banks registered under the IBA 1983.

The scope of this research is to find out the effect of BNM's new proposal on treatment of PER on profitability of Islamic banks. Prior to the PER new Guidelines, PER was expensed in the profit and loss account before arriving to the taxable

income. After the new BNM's guidelines are in force, it is proposed that PER portion of the Islamic bank is created by debiting the retained earnings in the statement of changes in equity and no longer expensed in the profit and loss account. Financial reports of 16 Islamic banks which adopted PER prior and after the new PER Guidelines will be analysed to understand the effect of the change. Finally, interview with the relevant IRBM officers will determine whether there is tax effect after implementation of the new Guidelines.

1.5 SIGNIFICANCE OF THE STUDY

For regulator

One of the missions of the Inland Revenue Board of Malaysia (IRBM) is to provide taxation services with quality and integrity towards promoting voluntary compliance. The main objective is to create and implement a fair and effective tax management system in Malaysia. The IRBM as the administrator of tax will conduct tax audit to ensure businesses comply with the regulations set by the board. The outcome of this study may assist the IRBM to specify additional audit criteria pertaining to the PER mechanism among Islamic banks and financial institutions particularly after the new PER Guidelines has been implemented.

PER has been criticised as being a hidden reserve for banks to reduce taxable income. Literature reviews also highlighted lack of disclosure in Islamic banks' financial report of detailed accounting policy and appropriation of PER both for Islamic banks and the IAH. These may initiate misconduct or irresponsible management of the PER. In addition, the new PER Guidelines allow the reserves to be reinvested in low risk instruments or carries minimal risk to the PER. This will increase the PER fund.

It is hoped that highlighted information and findings from this research will value add IRBM's existing audit focus on Islamic banks particularly concerning PER issues.

For Researchers

Not many sources pertaining to taxation are available in Islamic finance and banking. The outcome of this research is hoped to enrich existing taxation literatures particularly on viability of PER and help propose solutions or alternatives to using PER.

CHAPTER TWO

LITERATURE REVIEW

This section will give background information on the related areas instigating PER. It will cover the discussion on *mudharabah*, income smoothing and displaced commercial risk which initiated the beginning of PER. This section will also compare the views on *mudharabah* and PER from various international and Malaysian accounting standards setters and criticisms against them. Finally this section will highlight the views from taxation perspective on PER accounting treatment.

2.1 BACKGROUND STUDY

2.1.1 M*udharabah*, income smoothing & displaced commercial risk

A *mudharabah* contract binds a capital provider (*rabbul mal*) and the entrepreneur (*mudharib*) in a profit and loss sharing agreement. The *rabbul mal* will provide funds and the *mudharib* will utilise the funds in investments and the proceeds or profit will be divided in pre-agreed ratios. The *mudharabah* principle assert full loss bearing on the *rabbul mal*'s account if the venture or investment is not fruitful unless it can be proven that happens due to the negligence of the *mudharib*'s part. Therefore this exposes both parties to various risks associated with a *mudharabah* contract. The *mudharib* is exposed to losing time and effort, while the *rabbul mal* risks losing the capital.

When entrusting Islamic financial institutions (IFIs) to manage *mudharabah* deposits, the *mudharabah* depositors will bear commercial risk on the assets financed

by their funds. The assets financed by the *mudharabah* funds are exposed to rate of return risk caused by fluctuations of the market price of investments (Deumic, 2011). This in turn will cause mismatching of actual asset yield and expected return on the asset and may lead to displace commercial risk. On the other hand, *mudharabah* funds used to fund financing may face credit risk if the borrower defaults on payments. This may also affect the return on *mudharabah* funds.

Risks in Islamic banking are systemic in nature and one risk will trigger other risks. Therefore, *mudharib* has fiduciary duty to manage the fund in the most prudent policies to protect the interests of the depositors. Apart from disbursing the funds for financing, the funds may be invested in short term, medium term, or long term *shariah*-compliant money market, capital market instruments, commodity or even real estate market. However, as the Islamic financial industry is still developing and still in its infancy stage in some countries, it is not easy to find s*hariah* compliant avenues to invest the *mudharabah* funds. If the availability of the instruments is limited in supply, the IFIs are exposed to liquidity problem.

IFIs need to balance liquidity of the balance sheet items to maintain sustainability of the operation. An asset is liquid if it can be converted into cash or cash equivalents without incurring large losses. Liquidity management of an IFI can be internally induced from having sound financing and operational policies (S.S.Ali, 2012). Islamic banks need to transform short-term deposits into long-term financing. Financing in the asset side is usually for long term but *mudharabah* deposits are callable at anytime by the depositors. Whenever depositors need to withdraw their money and the bank is unable to fulfil the demand, this will trigger liquidity risk. Therefore it is necessary to carefully balance deposits and financing to maintain cashflow of the Islamic bank. Ahmad,A.S, Mohammad,T.M, and Muhamad,L.S.

(2013) suggested Islamic banks to be selective in loan application policies to avoid liquidity risk.

Liquidity risks in Islamic banking may also emanate from macro factors due to lack of liquidity in the market and lack of access fund. Islamic money market is not mature and lacks suitable *shariah*-compliant instruments (S.SAli, 2012). Managing liquidity risks in IFIs can be challenging because no interest-based instruments should be considered. This restricts IFIs' options and as a result, income generated from the deposits is smaller than conventional banks.

Mudharabah deposits account for about 60% of total assets on average sample of Islamic banks in 12 countries in the Middle East and South East Asia. Due to the significant portion of the *mudharabah* deposits also known as profit sharing investment account (PSIA) funding the Islamic banks, it needs special investment account management in contrast from the conventional (Archer, AbdelKarim, & Sundararajan, 2010).

Mudharabah deposit accounts usually comprised of two types of accounts namely restricted investment accounts and unrestricted investment accounts. In Malaysia it is known as specific investment accounts and general investment accounts (BNM/RH/GL007-11).

2.1.1.1 Specific Investment Accounts –SIA (also known as restricted investment accounts)

The financing and investment activities of the SIA accounts are specifically mandated by the investment accounts holders (IAH). The IFIs are instructed to invest only in certain type of investments with pre-agreed profit-sharing ratio and a percentage of the management fee. SIA is usually for a specified term and may extends over several

IFIs' accounting period. The IAH may withdraw before maturity but may have to forego any undistributed profit. Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) suggests reporting the SIA as an off-balance sheet item.

2.1.1.2 General Investment Accounts –GIA (also known as unrestricted investment accounts)

In GIA, the IFIs are given sole discretion by the depositors to invest the fund for a management fee. The profit-sharing ratio is also pre-determined and the GIA fund may be pooled with other IFIs' fund as there no specific directions for investment unlike the SIA. GIA is a *shariah* compliant substitute of the conventional deposits.

As analysed by Chong & Liu (2009), they found evidence to suggest that profit-sharing characteristic of the *mudharabah* contract only exist in theory. In practice, *mudharabah* deposit rate is not really interest-free and closely linked with the conventional deposit rates. Changes in conventional deposit rates cause Islamic investment rates to change, but not vice versa. This behaviour is observed in Malaysian Islamic banks particularly because Islamic banks co-exist with conventional banks.

Mudharabah depositors may withdraw their funds whenever needed. Behaviour of the depositors in Islamic banks depend whether they are motivated by profit or religious beliefs. If they are based on religious beliefs, withdrawal will not occur if the return of the Islamic bank is lower than the conventional. Many studies have observed that *mudharabah* depositors are profit driven and are more sensitive towards the return or profit received and may compare them with conventional banks'

return. As a result, they may withdraw their deposits if the return is lower than the conventional rates (Toumi et al., 2010).

As quoted by Chong et al., (2009) BNM's Governor, Tan Sri Zeti Akhtar Aziz acknowledged in her keynote address on February 15, 2006 at the 2nd International Conference on Islamic Banking in Kuala Lumpur that IFIs need to put greater emphasis in managing their funds in most efficient and effective manner. This is to avoid IFIs' depositors shifting to conventional banks when the latter's return is higher. Thus, IFIs' deposit rate is pegged to the conventional banks' deposit rate. This is also to better manage the liquidity and to retain funds in the system.

The practice to peg Islamic banks' deposit rate to conventional deposit rates is done following regulatory requirement to avoid massive withdrawals and fund shifting from Islamic banks to conventional banks. Such proactive measure is to prevent systemic risk and to relieve competitive pressure off IFIs to maintain their market share and manage liquidity (Archer et al, 2010). However, this puts pressure on the IFIs to maintain high profit rate for depositors although actual profit from investing the funds is low. Chong et al., (2009) highlighted this predicament in the case of Bank Islam Malaysia Berhad in 2006. Albeit having reported loss of RM1.3 billion, the bank was able to pay RM0.371 billion profit share to its depositors.

If asset return is not sufficient to pay depositors, to avoid massive withdrawals by depositors, IFIs may have to use shareholders' fund or their share as *mudharib*. This act of transferring the risk of loss from investment which previously borne solely by depositors to IFIs is also known as displacement commercial risk. The IFIs will avoid this risk because this will impair their share of the profit and also shareholders' fund.

To cushion the impact of displaced commercial risk (DCR), IFIs may resort to income smoothing. There are two types of income smoothing: real and artificial smoothing (Siti Masnah, Rosmawati, & Henny, 2013). Real smoothing involves direct changes in the production to decrease income inconsistency while artificial smoothing involves using accounting practices. Artificial smoothing is the prevalent exercise among IFIs due to commercial pressure to maintain stable return to avoid massive withdrawals of deposits. In some jurisdictions income smoothing is made obligatory by the regulator to avoid depositors suffering loss on capital or impaired return (Toumi et al., 2010). This is also to counter the impermissibility of giving guarantee on *mudharabah* capital.

There are several income smoothing methods to mitigate DCR. AAOIFI suggests the use of two type of reserves namely Profit Equalisation Reserve (PER) and Investment Risk Reserve (IRR). Using IRR will cover the potential losses on assets invested with IAH funds while PER can smooth fluctuation of return to IAH (Sundarajan, 2008). Therefore, only PER will serve to mitigate DCR but not IRR. Besides PER and IRR, the IFIs may also utilise shareholders' fund or forgo part or the *mudharib*'s entire share of profit to stabilise the return to IAH.

2.2 WHAT IS PROFIT EQUALISATION RESERVE?

PER is a type of reserve suggested by Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) to smoothen return to *mudharabah* depositors. This reserve is apportioned from gross profit before allocating *mudharib*'s share. This means, PER is an expense in the profit and loss account. It comprises of both the IAH's portion and the *mudharib*'s portion as part of the profit-sharing arrangement. The PER is used to stabilise the profit payouts but not the profits