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Dissecting implementation musharakah in Islamic bank in Indonesia: a case study

Inten Meutia[1], Mohamad Adam[2]
[1]Accounting Department, Faculty of Economics, Universitas Sriwijaya, Palembang, Indonesia
[2]Management Department, Faculty of Economics, Universitas Sriwijaya, Palembang, Indonesia
e-mail: [1] inten.26@gmail.com; [2] mr_adam2406@yahoo.com

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ABSTRACT

This study aims to analyze whether musharakah financing applications implemented by Islamic banks in Indonesia have met the requirements of Sharia standards as stipulated in the National Sharia Council Fatwa (DSN) Number 8, Sharia Accounting Standard Number 106 and Financial Accounting Standards (FAS) Number 4. This research used a case study approach that analyzes the case of musharakah in one of Islamic banks. This study found the existence of Islam in practice deviated from the paradigm of profit sharing. Calculations for results on musharakah financing tend to determine the fixed amount in advance. The portion of profit sharing is determined largely by the amount of funds provided by the bank, not those set by PSAS Number 106 or FAS Number 4.

ABSTRAK

Penelitian ini bertujuan untuk menganalisis apakah aplikasi pembiayaan musyarakah yang diterapkan oleh bank Islam di Indonesia telah memenuhi aspek kepatuhan syariah sebagaimana ditetapkan dalam Fatwa Dewan Syariah Nasional (DSN) nomor 8, Pedoman Standar Akuntansi Syariah nomor 106 serta *Financial Accounting Standard* (FAS) nomor 4. Penelitian ini merupakan penelitian dengan pendekatan studi kasus yang menganalisis kasus pembiayaan musyarakah di salah satu bank Islam. Penelitian ini menemukan bahwa perbankan Islam dalam prakteknya cenderung menyimpang dari paradigma bagi hasil. Perhitungan bagi hasil pada pembiayaan musyarakah cenderung mengarah pada hasil yang tetap dan ditentukan di awal. Porsi bagi hasil lebih ditentukan oleh berapa besar jumlah dana yang diberikan oleh bank, bukan seperti yang ditetapkan oleh PSAS nomor 106 ataupun FAS nomor 4.

Introduction

In the last decade, the development of Islamic banking in Indonesia has shown positive growth and quite encouraging. This is reflected by volume of business, investment funds, public deposit funds, and continued expansion of financing. The existence of these developments is expected to make an important contribution in economic activity in Indonesia.

Nevertheless, the development of Islamic banking business in 2015 is entering a bleak period. The growth of assets that had reached 49 percent in 2013, cannot be repeated again and must be satisfied with the growth rate of 7.98 percent in July 2015. In the five-year period, the 2009-2013 growth of Islamic bank assets averaged 43 percent, but currently the growth has dropped dramatically.

The decline in the growth of Islamic banking is not only in terms of assets, but also in financing and third-party funds (DPK). Even the growth is well below conventional banking. In July 2015, the growth of financing in Islamic banks is only 5.55 percent, much lower than conventional banks with the growth of 8 percent. This slowing growth is exacerbated by an increase in non-performing financing (NPF) ratio. The position of January 2017, Islamic banking NPF is at 4.72 percent.

Islamic bank is a bank that runs its activities based on Islamic sharia guidelines (Siddiqi 2006). Various studies Yusof et al. (2015) and Jedidia (2016) show that sharia compliance is the only factor in consideration when choosing an Islamic bank. Sharia compliance will ensure the credibility of Islamic banks and increase the trust of both shareholders and stakeholders.

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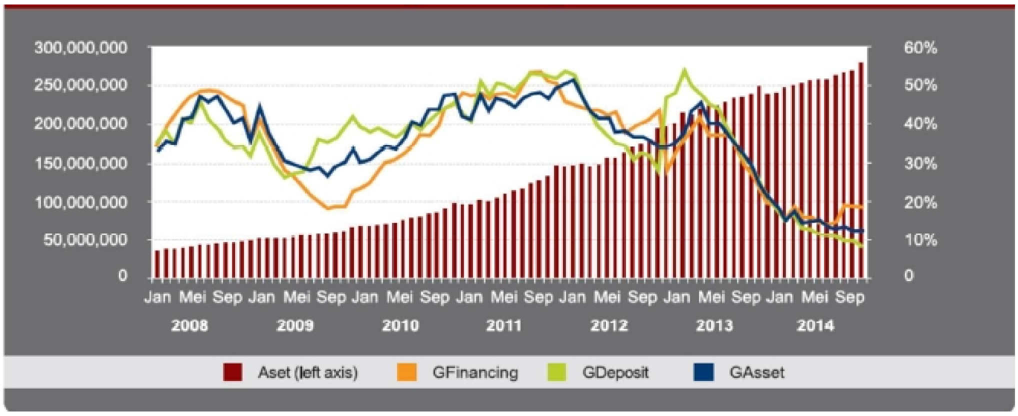
Table 1. The development of Islamic banking in Indonesia



Source: OJK (Financial Service Authority) (2017)

However, research conducted by Malik et al. (2011) found that the financing offered by Islamic banks actually resembles more of debt instruments than profit-sharing principles. In addition to that, Chong and Liu (2009) also found that in theory Islamic banks are supposed to operate on the basis of profit sharing but are practically not much different from conventional banks. Research conducted in Malaysia revealed that only a small portion of financing in Islamic banks that use the principle of profit-sharing.

Islamic bank is a bank operating on the principle of non-interest. Based on this principle, the bank earns its income from margin and profit sharing. Based on the margin principle, the bank conducts buying and selling activities known as murabahah, salam and istishna. While based on the principle of profit sharing the bank perform activities in the form of financing musharakah and mudharabah. Table 2 shows the amount of financing channeled by Islamic banks in Indonesia.

Table 2. Financing of Islamic banks by type of contract (Billion Rp)

Type of Contract	2014	2015	2016
Mudharabah	14,354	14,820	15,292
Musharakah	49,336	60,713	78,421
Others	51		
Murabahah	117,371	122,111	139,536
Qard	5,965	3,951	4,731
Isthisna	633	770	878
Ijarah	11,62	10,631	9,150
TOTAL	199,33	212,996	248,007

Source: OJK (2017)

Table 2 shows that the largest portion of the financing disbursed by Islamic banks in Indonesia is murabahah financing that reaches more than 50 percent of financing disbursed. While financing based on the principle of profit sharing mudharabah and musharakah only reach about 35% of total financing.

Musharakah financing is a contract of cooperation between two or more parties for a particular business, in which each party contributes funds. Profits are divided by agreement while losses are based on the contribution of funds in the form of cash and non- cash assets allowed by sharia. While mudharabah financing is a business cooperation between two parties where the first party (the owner of the fund) provides all funds, while the second party (manager of funds) acts as the manager, and profit is divided between them based on the agreement while the financial loss is borne by the fund owner.

Echchabi and Aziz (2014) states that musharakah is generally used to finance the working capital of entrepreneurs to buy raw materials or goods and also to finance service transactions in the form of Letter of Credit (L/C). Usmani (1999) also states that musharakah can be used to finance export and import.

In Indonesia the practice of musharakah and mudharabah financing is set out in PSAK No. 105 and No. 106; Fatwa DSN Number 08/DSN-MUI/IV/2000 and Fatwa DSN Number 07/DSN-MUI/IV/2000 as well as in Accounting Guidelines for Indonesian Islamic banking (PAPSI) 2013. However, many indications show that both types of financing are not so attractive to Islamic banking. It can be seen from the low financing using both this contract compared murabahah (buying and selling on margin). In addition, some research results also found indications of lack of sharia compliance aspects in financing by using musharakah and mudharabah (Abushareah and Naim 2015; Arshad and Ismail 2010). Ahmed (2014) even said Islam's banking products have been heavily criticized for failing to comply with sharia principles.

Putriandini and Irianto (2012) also revealed the unification of conventional value and sharia value in the stage of the musharakah financing process at Islamic bank due to the bank's desire to achieve the maximum profit (profit oriented). Therefore, this research will analyze whether the application of musharakah financing implemented by Islamic bank has fulfilled the aspect of Sharia compliance based on Fatwa DSN no 8 and PSAK no 106. By knowing it then for the next can be done the policies that need to be taken to improve Sharia compliance on musharakah financing.

Literature Review

Askari et al. (2015) states that there are some things that become basic concepts in Islamic finance. The basic concepts are: 1) Prohibition on interest, 2) Profit sharing, 3) Prohibition against speculation, 4) Asset-Based, 5) Purification of Commitment and Protection of Property Right.

The prohibition against "usury" which literally means "Excess" and interpreted as "any capital increase can not be justified whether it comes from a loan or a sale" is the main principle of the system of Islamic finance. More precisely any specified additions or predetermined rates inherent in maturity and the principal amount (which is unrelated to investment performance) are considered usury and prohibited.

General agreement among Islamic scholars is that usury in the form of "interest" as usually practiced today. Another consequence of this prohibition of interest is that the debt with interest definite in the beginning is also forbidden. This prohibition is based on social justice thoughts, equality and property rights. Islam advocates income derived from profits but prohibits interest, since profits are earned after the trading activity is done which is a success of traders and creates additional wealth. While the concept of interest is contrary to this, interest is the cost to be paid regardless of the outcome to be derived from business activity and may not result in additional wealth if the business suffers a loss. The concept of social justice wants the borrower and the owner of the fund to share the proceeds in a fair way. The process of wealth accumulation and distribution must be made fairly and show the actual productivity. Since interest is forbidden in Islam, the pure debt system is abolished in the Islamic economic system. Fund providers act more as investors than as creditors. Fund providers and entrepreneurs share business risks in the form of profit and loss sharing.

The advice to avoid debt and risk sharing recommends a financial system that connects directly between the real sector and the financial sector. As a consequence, this system initiates the "materiality" aspect that connects finance with assets so that financial activity can be clearly identified through the activity of the real sector. There is a close relationship between performance in the form of assets and the return of capital that used to finance the activities of the real sector.

Islam upholds the sanctity of contract and disclosure of information as sacred. This is proposed to lessen the risk of information asymmetry and moral hazard. Islam emphasizes the importance of protection of property rights, the balance between individual rights, society and the State and strictly prohibits the acquisition of any property (Lewis and Algaoud 2001).

Islamic banking is a banking system that runs its activities under Islamic law (Zainol and Kassim 2012). The establishment of this system is based on the prohibition in Islam to lend or collect loans by borrowing interest (usury), and prohibition to invest in categorized as illicit (haram) (Atmeh and Ramadan 2012). Conventional banking systems cannot guarantee the absence of such matters in their investments, for example in businesses relating to the production of illicit food or beverages, un-Islamic media or entertainment ventures, and so on.

El-Gamal (2006) states that musharakah is a form of partnership contract where profits and losses are shared among parties involved in the contract. In this case, there is the notion that the essence of true Islamic banking is the existence of participation both in risk and return rather than investment, which is done jointly both based on musharakah and mudharabah contracts. Hence there is also an expectation that Islamic banks should further expand financing based on both types of contracts.

Hassan and Soumare (2015) also stated that contracts in Islamic financing should be designed to avoid risk-free returns and usury, uncertainty (gharar) and gambling (maysir). Financing in an Islamic bank should be made in such a way that the exchange involves goods for money or profit sharing.

Sharia compliance is a matter that must be considered by Islamic banking in carrying out its activities. If the Islamic bank cannot fulfill that aspect, then the bank's activities will become questionable. In Indonesia, the rules governing financing in Islamic banking are sourced from the National Sharia Council (DSN) in the form of the National Sharia Board Fatwa and PSAK issued by the Indonesian Institute of Accountants (IAI).

The fatwa of the DSN which governs musharakah financing is Fatwa Number 08/DSN-MUI/IV/2000. This fatwa regulates some provisions on musharakah financing, namely: the provisions of the necessity of ijab qabul (mutual agreement), the competence of the party who do the contract and the object of his own ‘aqd (contract/promise).

With regards to profits, it is stipulated that each partner's profit shall be proportionately distributed on the basis of all profits and no pre-determined amount for a partner. The DSN fatwa does not set in detail how to determine the profit-sharing ratio. It is only said that: The profit-sharing system should be clearly stated in the contract. How the process of determining the distribution of profits is is not provided herein.

PSAK Number 106 on musharakah regulates the definition of musharakah and how the accounting treatment for musharakah financing. Musharakah is a contract of cooperation between two or more parties for a particular business. Each party contributes funds where the profit is divided by agreement while the loss is based on the contribution portion of the fund.

The funds include cash or non-cash assets that are permitted by Sharia (Islamic law). The profit of musharakah enterprises is shared among the partners proportionally with the funds deposited (either in cash or non-cash assets) or in accordance with the ratio agreed by the partners. While the losses are charged proportionally in accordance with the data deposited (in the form of cash and non-cash assets). The other thing set out in PSAK 106 is about the share of profit sharing. The portion of profit sharing for partners is determined based on the agreed ratio of the results of operations acquired during the contract period, not the amount of the investment disbursed.

In the application of Islamic banking, musharakah is mainly applied in financing, where the bank as the owner of capital in cooperation with entrepreneurs. Capital contribution and profit sharing arranged according to an agreement. Regarding the results, there are two methods that can be used, namely profit sharing and revenue sharing. If using the method of revenue sharing, means that divided the results between banks and customers financing is income without deducting the costs. If using profit-sharing method, then the amount divided as the result between the bank and the partner is income after deducting expenses. However, what is currently used in Islamic banking practices is the method of revenue sharing. This is in accordance with the Fatwa DSN Number 15/DSN-MUI/IX/2000 on the principle of distribution of profit sharing in Islamic financial institutions.

Prior Research

Several studies have been conducted regarding Islamic banking products. Among them are research that seeks to assess or compare the performance of sharia and conventional banks (Hassan and Latiff 2009; Alqahtani et al. 2017; Noor et al. 2015) or assess the social reporting of Islamic banks (Meutia and Febrianti 2017; Bukair and Rahman 2015 ; Zarrouk et al. 2016). However, there are not many studies that try to explore the aspect of Sharia compliance of financing in Islamic banks.

Rahman and Anwar (2014) in his research that evaluates the implementation of musharakah mutanaqishah in Islamic finance institutions in Malaysia revealed that the financing is more in line with the principles and rules of sharia. Rahman and Anwar (2014) even suggested the use of this financing to replace Bai' Bithaman Ajil financing. Ullah (2014) in his research on Islamic banking syariah compliance in Bangladesh states that the status of Sharia compliance in a vulnerable condition. Sharia compliance varies greatly between Islamic banks in Bangladesh and the violation of Sharia compliance mainly occurs in investment activities. This is due to lack of knowledge, lack of seriousness in complying with sharia, low attention in sharia audits and the absence of a competent Sharia Supervisory Board.

Anuar et al. (2014) found that the profitability of Islamic banks was significantly related to the interest rate of conventional banks. The findings also indicate that the profitability of Islamic banks is influenced by interest rate movements of conventional banks and other financial companies, and not vice versa. This finding implies that there is a gap between the theory of Islamic banks and existing practices.

Subsequent studies of Ibrahim (2015) and Jedidia and Hamza (2014) also support this conclusion. This proves that the issue of Islamization (Islamic compliance) of Islamic banks is an issue that does not fade and continues to be a debate. Some research on financing in Islamic banks generally try to see the advantages of financing based on the concept of profit sharing that is mudharabah and musharakah compared with murabahah financing.

Other studies on financing in Islamic banks have seen the risk aspect of mudharabah and musharakah financing. Nevertheless, there are no studies that try to dissect more detail about how the compliance of sharia financing applied by Islamic banks as will be done in this study.

This study tried to deepen the aspects of Sharia compliance, especially the implementation of musharakah financing. Musharakah financing is chosen in this case because the structure of musharakah financing wants the capital contribution from both parties (banks and customers). The existing indication of this financing, often no capital from customers. So that the financing is more like mudharabah financing. Implementation of musharakah financing to be analyzed is how the process of determining the profit sharing, how the process of the contract, how the process of sharing the results and other aspects that are determined based on sharia principles. This has not been done in previous studies.

Research Method

This research is a qualitative research with a case study approach where researchers will observe and analyze cases related to financing using musharakah contracts in Islamic bank in Indonesia. The data that will be used are primary and secondary data sourced from Islamic bank namely musharakah financing contract in the bank. Primary data were obtained directly through interviews with banking analysts on calculation and financing analysis. While secondary data in the form of contracts of musharakah contracts obtained from the bank. The analysis will be done using a quantitative and qualitative approach. Where the existing practice will be analyzed by using the theory and rules of both the fatwa of the National Sharia Council and the applicable Accounting Standards related to musharakah financing.

Result and Discussion

As stated earlier, this study is a case study, in which the researcher will take a case of musharakah-based financing conducted by one of the Islamic banks. This case represents all types of transactions using musharakah financing. In this case, the researcher only uses one case because the method applied by the bank is the same for all transactions based on musharakah. Here is one of the cases analyzed from a musharakah transaction applied by one of the Islamic banks in Indonesia.

Table 3. Musharakah financing case

Description	IDR
Bank Capital / Financing Value	IDR 96,000,000
Client's Capital	IDR53,880,000
Capital Ratio of Bank and Customer	64 : 36
Profit Sharing Ratio	69.5 : 30,5
Gross Project Value	IDR 149,880,000

Source: Data processed from Bank

Financing with this musharakah contract is given to one of the customers to finance the project with the local government. Bank termed as Working Capital Financing (PMK). Value of the Project is IDR 149,880,000. The financing period is for 8 months. Determination of capital ratio of bank and customer at the request of financing from the customer, the bank performs a cash flow analysis to determine the financing to be provided by the bank (bank capital).

Table 4. Cash flow analysis

Description	Nominal (IDR)
Project Gross	149,880,000
PPN 10%	13,625,455
PPH 2%	2,725,091
Net Project Value	133,529,455
Estimated Earnings (10%)	13,352,945
Working Capital Needs	120,176,509
Self financing	24,035,302
Bank Financing	96,000,000

Source: Data processed from banks

Based on the gross project the bank estimates the net project value. Assuming a 10% profit rate will be obtained working capital needs. Furthermore, assuming the self-financing customer by 20% (minimum value determined by the bank) will be obtained financing to be provided by the bank.

In this transaction bank financing is IDR 96,000,000. Based on the value of financing provided by this bank, then determined the ratio of bank capital and customers which consist of IDR 96,000,000 and IDR

53,880,000 respectively. The ratio of capital in this case is 64: 36. The calculation of the Customer's capital is derived from the total project value minus bank financing. Meanwhile, when determining the value of bank financing, self-financing of customers is determined at only 20% of working capital needs. Self-financing is essentially its own capital or in this case can be said as the customer's capital. The total required capital should be only IDR 120,176,509 with the capital ratio of 80:20. Or in other words bank capital of IDR 96,000,000 and customer's capital IDR 24,035,302.

In accordance with the amount of self-financing determined by the bank, there are inconsistent methods used in determining the capital ratio. The customer's capital is stated in the contract amounting to IDR 53,880,000. There is an estimated profit, income tax and VAT which is certainly not part of the customer's capital.

Determination of Profit Sharing Ratio

Furthermore, to determine the ratio of profit sharing used calculation (Table 5).

Table 5. Determination profit sharing ratio

Description	12 months	8 months
Amount of financing	IDR 96,000,000	
Expectation of profit rate	10%	7%
Bank Rate Expectation	14.50%	9.67%
Expected profit expectations	IDR 13,352,945	IDR 8,901,964
Bank Rate Expectation	IDR 13,920,000	IDR 9,283,200

Source: data processed from banks

Profit expectations are determined based on 10% of the net project value (IDR 133,529,455). Meanwhile, bank rate expectation is calculated from 14.5% from financing value given by bank or in this case considered bank capital. 14.5% represents the rate of return determined by the bank.

Based on the above values, the profit sharing ratio of banks and customers is determined, which is the ratio of bank profit sharing to bank rate expectations for 8 months divided by expected profit for one year. So that obtained 69.52% for banks and for customers 100% -69.52% i.e. 30.48%.

In this case, there are inconsistencies when the 8-month bank rate expectation is compared to expectation of expected profit of 12 months. Supposedly the 8-month bank rate expectation is compared with the 12-month bank rate expectation. Or if you want to use the profit expectations should be compared also expected profit of 8 months compared to expectations of a profit of 12 months.

Based on the above calculation, the customer as an active partner must refund the amount of IDR 96,000,000 (bank capital) plus the bank rate expectation for 8 months which is IDR 9,283,200. The total to be returned by the customer after 8 months is IDR 105,283,200.

When considered the calculation techniques performed above, at first glance appears to be calculated based on expected profit expect from the existence of the shirkah. However, when considered in more detail, there are two rates used by the bank that is the expected rate of profit from shirkah, and the rate of return determined by the bank. This rate of return is determined under the terms of ALCO (Asset and Liability Committee).

Researchers reconfirmed this through in-depth interviews with banks and customers. From the confirmation result, it is true that the total amount must be returned by the customer is IDR 105,283,200 when the term of the contract expired. This means that the amount to be returned by the customer is determined based on profit expectations.

If we try to simply calculate as applied in the conventional bank, then the value to be received by the bank is the principal loan plus interest determined based on the interest rate multiplied by the principal. Using the calculation will be obtained a value of IDR 105,283,200 derived from IDR 96,000,000 (principal) plus 9.67% (rate 8 months) multiplied by IDR 96,000,000. In which of these calculations are exactly the same as the results previously described. This suggests that however, the analysis performed by the Islamic bank in this case is ultimately the end result being the value equal to the value that can be obtained by conventional interest calculation.

Based on the above case analysis and compliance with Fatwa DSN Number 08 it can be said that what is done by Islamic banks in running musharakah contracts from the calculation does not violate the provisions in the fatwa because the Fatwa DSN does not set in detail about how to determine the ratio of profit or profit share. It is only said that: The profit-sharing system should be clearly stated in the contract. Meanwhile, the process of determining profit sharing is not regulated in the fatwa.

However, it is different with PSAK 106 on musharakah which states that the profit of musharakah business is divided among the partners proportionally in accordance with the deposited funds (either in cash or non-cash assets) or according to the ratio agreed by the partners. The profit sharing ratio applicable in Islamic banks as in the above case is not determined based on the deposited funds but based on the ratio of bank rate expectations with expected profit expectations. And of course, this is also not the ratio agreed by both partners, because the process of determining the profit-sharing ratio has been determined early on by the bank, based on the system.

PSAK 106 also clearly states that the portion of profit sharing for partners is determined based on the agreed ratio of the results of operations acquired during the contract period, not the amount of the investment disbursed. AAOIFI Sharia Standards and Sharia Governance on Musharakah clearly also stipulates that the profit shared is the actual profit rather than the expected profit (AAOIFI 2017: 108). Referring to what is stated in PSAK 106 and AAOIFI, then what is done in the above case is profit sharing based on the amount of investment issued by the bank. Although in the calculation of the analysis made as if not so.

What is found in this study is consistent with what is said by Malik et al. (2011), which states that much of the financing offered by Islamic banks is more like a debt instrument than the profit-sharing concept. Seho and Masih (2015) said that the pressure of supervision and competition in the market that makes the practice of Islamic banking today has deviated from the theoretical model that was originally considered.

Chong and Liu (2009) said that only a small portion of Islamic bank financing based on Profit and Loss Sharing (PLS). This is confirmed by Rahman and Anwar (2014) who conducted research in Malaysia that the proportion of PLS-based financing is not more than 3% of all financing in Malaysia. Andriana et al. (2015) as well as Meutia and Febrianti (2017) also stated that in many aspects including existing financing products in Islamic banks tend to mimic what is in conventional banks.

Conclusion

From a theoretical perspective, there is a principle difference between Islamic banking and conventional banks. Interest is forbidden in Islamic concept, therefore Islamic banks are forbidden to offer a fixed rate of return and are also prohibited to charge interest on loans. Islamic banks have their own unique concepts, which are the results and risks that underlie musharakah and mudharabah financing. However, what happens in practice is not the case.

The main advantage of PLS is that it leads to a more efficient allocation of capital. This is because the return on capital and its allocation depends on the productivity of the project. However, in reality does Islamic banks surely operate according to the PLS concept? The study found that in practice especially musharakah, Islamic banks substantially tend to deviate from the concept of PLS. The practice tends to direct the profit-sharing calculation to a false share that results in fixed and predetermined returns. This study found that the calculation and profit sharing analysis performed did not comply with PSAK 106 and FAS no 4 AAOIFI. The limitation of this study is the sample research which only restricted to one Islamic bank in Indonesia. The results of this study require support from future research with case studies from several other Islamic banks to identify whether this practices also occurs in other Islamic banks. Practices that are not in line with the PLS paradigm will lead many people questioning sharia compliance of Islamic banks. It, therefore, becomes urgent to reposition Islamic banking to stay on the right track.

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