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An Evolution of Mudarabah Contract: A Viewpoint From Classical and Contemporary Islamic Scholars

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Abstract

Currently, in the competitive Islamic financial system, *mudarabah* (profit sharing) is seen as an alternative mechanism in financing techniques that differentiate it from the conventional financing that consist interest mechanism**.** Since its introduction, *mudarabah* (profit sharing) has gone through various evolution to fulfill the needs of the fast-developing Islamic financial market. However, in the current Islamic financial system, *mudarabah* (profit sharing) has become less preferable compared to Islamic debt financing instruments such as *murabahah* and *bai' bithaman ajil*. This is caused by the existence of asymmetric information that continuously presents in mudarabah (profit sharing) contracts and creates problems of adverse selection and moral hazard. Due to this, *mudarabah* (profit sharing) has declined it importance as a financing vehicle. Therefore, the objectives of this study are twofolds, first, to examine the thought and evolution of *mudarabah* (profit sharing) from the viewpoints of classical and contemporary Islamic scholars and second, to evaluate the asymmetric information that continuously exist in this type of contract.

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Keywords: Mudarabah (profit sharing) contract; evolution; classical; contemporary Islamic scholars

1. Introduction

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Equity financing instruments for Islamic business contracts are based on the *mudarabah* (profit sharing) and *musharakah* (profit loss sharing) principles. These financing methods are an alternative to conventional debt financing that is based on rate of interest (riba). Equity financing involves mutual sharing of risks and profits, depending on the performance of the investment project. In the case of *mudaraba*h (profit sharing), the contracting parties i.e. the fund provider (*rabbulmal*)-who supplies the financial capital and the entrepreneur (*mudarib*)-who supplies the expertise and management, will collectively take part in profit sharing venture. Profits derived from the project will be shared according to the predetermined profit-sharing ratio such as 60:40 or 70:30 by both parties. In the event of failure, all losses must be borne by the fund provider (*rabbulmal*), while the entrepreneur (*mudarib*) would have lost his time and effort.

However, from the practical side, *mudarabah* (profit sharing) contract is less preferred compare to debt financing instruments because of the asymmetric information problems that continuously exist in this mode of financing. The asymmetric information on *mudarabah* (profit sharing*)* contract, especially on the asset side, normally occurred as an entrepreneur (*mudarib*) who manage the *mudarabah (profit sharing)* fund have full control of the project and have more information regarding the project and its profitability which the Islamic bank (*rabbul mall*) does not usually have access to. The inefficiency in information delegation will generate two major problems, i.e. adverse selection and moral hazard that makes it difficult for the contracting parties to achieve an optimal contract. Due to this, there is a lack of interest among Islamic financial institutions to use mudarabah (profit sharing) as a financing vehicle. According to Bacha (1997), *mudarabah* (profit sharing) has lower expected returns and higher risks; this inequality in the distribution of risk and return has caused full-fledged and window Islamic banks to reduce the utilization of mudarabah (profit sharing) financing in their investment.

Therefore, the objectives of this study are twofolds: first, to examine the thought and evolution of *mudarabah* (profit sharing) contract from the viewpoints of classical and contemporary Islamic scholars, and second, to evaluate the inherent problems i.e. assymetric information that prevail in this type of contract.

The remainder of this paper proceeds as follows: Section 2 briefly reviews the *mudarabah* (profit sharing) from the classical islamic scholars viewpoint. Section 3 discusses the evolution of *mudarabah* contract from contemporary islamic scholar viewpoints. Section 4 highlights the asymmetric information problem in *mudarabah* (profit sharing) contract. Finally, section 5 concluded the study.

2. Mudarabah (profit sharing) From The Classical Islamic Scholars Viewpoint

Mudarabah (profit sharing) is one of the earliest business forms used by the pre-Arabs for trade activities. Different terms are used to mean mudarabah (profit sharing): muqaradah is commonly used by the Hanafi and Hambali scholars and qirad is used by the Maliki and Shafie scholars.

Even though *mudarabah* (profit sharing) has no basis in the Quran or the Sunnah, it was employed by the early Muslims to conduct trade. The term "*mudarabah* (profit sharing)" is derived from al-darb al-ard which means "traveling through the land" as mentioned in the following verse of the al-Quran:

"….others traveling the land seeking of Allah's bounty" (Al-Muzzammil: 20).

It was also approved by Prophet Muhammad (S.A.W) as reported by Suhayb r.a.:

"Three matters that have the blessing (of Allah (S.W.T)) i.e. a deferred sale, muqaradah (mudarabah (profit sharing)), mixing the wheat and barley for domestic use and not for sale" (Sunan Ibn Majan)

Mudarabah (profit sharing) is also known as "silent partnership" (Al-Zuhayli, 2007) whereby it involves a financier (*rabbulmal*), who provides a specific amount of capital and acts as a sleeping or dormant partner and an entrepreneur (*mudarib*), who acts as a trustee or a business agent. The *mudarib* is required to utilize and manage the capital in prudence and good manner to generate optimal profits for the *mudarabah* (profit sharing) investment, while adhering to the laws of Shariah. The *mudarib* does not invest any property in the business venture except for his knowledge and skills. He is also not entitled to claim any wage for conducting the business venture. *Mudarabah* (profit sharing) is one of the oldest business forms used by the pre-Arabs for trade activities. Literally, the word mudarabah (profit sharing) is derived from the phrase "*al-darbfi al-ard*" which means to make a journey (ISRA, 2011). The literal meaning of this partnership is that, in the past this contract required the parties involved to make a journey to run their business.

Generally, *mudarabah* (profit sharing) is a partnership in profit whereby one party provides capital (*rabbul maal*) and the other party (*mudarib*) provides labour. The profit, if any, will be shared between them at a mutually agreed ratio, In case of a loss, it will be borne by the fund provider (*rabbul maal*) and the *mudarib* will lose his efforts.

Different terms have been used for *mudarabah* (profit sharing) such as *muqaradah* that was commonly used by the Hanafi and Hambali scholars and *qirad* was used by the Maliki and Shafie scholars. *Mudarabah* (profit sharing) is also known as "silent partnership" (Al-Zuhayli, 2007) whereby it involves a financier/fund provider (*rabbul maal*), who provides a specific amount of capital and acts as a sleeping or dormant partner and an entrepreneur (*mudarib*), who acts as a trustee or a business agent.

2.1 Legitimacy of Mudarabah (profit sharing) Contract

The legitimacy of *mudarabah* (profit sharing) contract has been established in the Quran, Hadis and the consensus of Muslim scholars (Ijma'). The pesimissibility of *mudarabah* (profit sharing) contract has been mentioned in the following verse of the al-Quran:

"….others traveling the land seeking of Allah's bounty" (Surah Al-Muzzammil: 20)

There two hadiths which stated this partnership arrangement and approved by the Prophet Muhammad (S.A.W):

"Ibnu Abbas (may Allah be pleased with him) reported that: "When Abbas Ibn Abd al-Muttalib gave his property to someone for mudarabah (profit sharing), he stipulated conditions for his partner not to bring the capital onto the sea; and not to bring with him the capital crossing a valley; and not to buy livestock with the capital; and if his partner violates the conditions, he should guarantee the loss occurred. These conditions have been bought to the attention of Prophet Muhammad (peace be upon him) and he approved them".

(Narrated by Al-Bayhaqi in Al Sunan al-Kubra, as cited in Abdul Rahman, 2012)

2.2 Pillars and Conditions of Mudarabah (profit sharing)

2.2.1 Sighah (Ijab and Qabul)

Basically, the condition related to the *sighah* of *mudarabah* (profit sharing) is similar to those other contracts which constitute an offer and acceptance. *Mudarabah* (profit sharing) is concluded when the parties use words that clearly indicate the contract of *mudarabah* (profit sharing) in their offer and acceptance.

2.2.2 The Contracting Parties

The contracting parties consist of fund provider (*rabbul maal*) and entrepreneur (*mudarib*) that have a sound mind and able to take responsibilities. Fund provider (*rabbul maal*) will provide capital to the entrepreneur (*mudarib*) for investing it in a business enterprise by applying his skills and efforts.

2.2.3 Subject Matter and Conditions of Mudarabah (profit sharing)

(i) Types of Capital

There are various opinions on the types of capital for *mudarabah* (profit sharing) contract. *Mudarabah* (profit sharing) capital is the wealth entrusted to the *mudarib* for productive use and at the same time to promote mutual goodwill between the contracting parties. According to Ibn Rushd, one of Maliki scholar, the majority of the jurists agree that the investment capital should be in the form of monetary assets or currency (dinar or dirham) as it possesses intrinsic value as a medium of exchange and legal tender that is accepted by all parties involved in the contract (Borhan & Sa'ari, 2007).

Meanwhile, most Islamic scholars rule out the use of non-monetary assets or in kind as capital, as it generates uncertainty (*gharar*) on the estimation of the initial value of the assets, which may be different according to the persons evaluating the said property. Furthermore, the fluctuation of prices of non-monetary investments may lead to inequitable advantages and disadvantages between the contracting parties. For example, if the prices of commodities increase when the contract is executed, the entrepreneur will benefit from the price rise as his share of

profits will increase upon termination of the contract. Meanwhile, if the price declines, the market value of the commodities drops and investors have to face losses and less profit distribution (Borhan and Sa'ari, 2007). However, two legal scholars, Ibn Abi Layla and Al-Awzai both dissents on the issue, permitting the use of non-monetary assets as capital (Al-Zuhayli, 2007).

On the other hand, Abu Hanifa, Malik and Ibn Hanbali permit listing the price of non-monetary assets as *mudarabah* (profit sharing) capital. The *mudarib* can sell the assets provided by the fund provider *(rabbulmal)* and use the price as capital for the contract. However, al-Shafie disagrees with this idea due to the inexistence of physical assets upon the contract (al-Zuhayli, 2007).

Most Islamic scholars also agreed that the capital should not be in the form of debt owned by the potential entrepreneur from the fund provider *(rabbulmal)* (Al-Zuhayli, 2007). The rationale of this ruling is to prevent *mudarabah* (profit sharing) from becoming a mode for the *rabbul maal* to recover his debt and as a result gain benefit from the charge or interest. However, if the debt has been paid to the *rabbul maal* and then the money delivered again to the entrepreneur upon his need, the silent partnership remains valid. If the creditor instructs the debtor to use the money that he owes him as capital, the contract is rendered defective. Abu Hanifa, the Malikis, the Shafies and the Hanbalis agree that if the debtor continues to use the money he is owed, all profit and losses from the investment would be his and the debt remains intact (Al-Zuhayli, 2007).

In order to collect debt from debtors, all scholars agree that the capital provider or creditor may hire an agent to do the task on his behalf and then use the money as capital in the silent partnership. In the case of deposit money, the Hanafis, Shafies and Hambalis, if someone is entrusted with a deposit and the depositors ask him to use the money as capital in silent partnership between them, the contract is valid. However, the Maliki scholars believe that pawned and deposited money is too similar to debts and thus do not qualify as capital.

Meanwhile, in terms of capital protection, all classical scholars collectively agree on the prohibition of a guarantee scheme for *mudarabah* (profit sharing) because it is not relevant to *mudarabah* (profit sharing) ventures. Since *mudarabah* (profit sharing*)* operates under a profit-loss-sharing scheme and not a loan, therefore collateral and guarantees are not required. According to Rosly (2005) the idea of giving guarantees on *mudarabah* (profit sharing) contracts diverges from the basic philosophy of profit, loss sharing, i.e. *al-ghorm bil ghonm* (no reward without risk).

(ii) Distribution of Profits and Losses

The entrepreneur (*mudarib*) is required to utilize and manage the capital in prudence and good manner to generate optimal profits for the *mudarabah (profit sharing)* investment, while adhering to the laws of *Shariah.* The entrepreneur (*mudarib*) does not invest any property in the business venture except for his knowledge and skills. He is also not entitled to claim any wage for conducting the business venture.

The fund provider *(rabbulmal)* and entrepreneur (*mudarib)* are eligible to attain shares of profits in return for the investment capital of the former and the latter, for his effort to materialize the profit through business ventures. All Islamic scholars agree that the ratio in which the profits are to be distributed needs to be determined ex-ante to avoid any disagreement after the business has been conducted. The ownership of the capital or invested assets remain with the fund provider *(rabbulmal)* at all times. The fund provider *(rabbulmal)* is liable in the event of losses incurred by market risks, while the entrepreneur (*mudarib)* will lose his time and effort. The liability of the fund provider *(rabbulmal)* in *mudarabah (profit sharing)* is limited to the extent of his contribution to the capital and no more. However, if the loss is due to negligence or moral hazard (*ghasib*), the loss will be absorbed by the entrepreneur (*mudarib)*.

(iii) The Role of Contracting Parties in Mudarabah (profit sharing) Contract

Mudarabah (profit sharing) contracts can be divided into two types, namely unrestricted (*al-mudarabah al-mutalaqah*) and restricted (*al-mudarabah al-muqayyadah*). In the unrestricted case, the agreement does not specify the time period, the location of the business and the specific type of trade or service to be carried out. Meanwhile, under restricted *mudarabah* (profit sharing*)*, the entrepreneur (*mudarib)* is confined to certain conditions set forth by the fund provider *(rabbulmal)*. If the entrepreneur (*mudarib)* fails to comply with the restrictions of the fund provider *(rabbulmal)*, he will be fully responsible for any resulting losses.

The Maliki and Shafie scholars approve that *mudarabah* (profit sharing) contract should be unrestricted as it encourages the entrepreneur to find more opportunities for better profit-earning. However, Abu Hanifa and Ahmad Ibn Hambali agree on restricting certain aspects of the *mudarabah* (profit sharing) contract, e.g. the time period and choice of the right agent in order to reduce business risks (Al-Zuhayli, 2007).

(iv) The Dissolution and Termination of Mudarabah (profit sharing) Contract

The *mudarabah* (profit sharing) contract is designed to fulfil the needs of the fund provider *(rabbulmal)* and the entrepreneur (*mudarib)* and to protect their interests. The contract is normally dissolved when both parties have agreed on the completion of the business venture with the settlement of profit distribution and closing of accounts.

All the *Islamic* scholars agree that *mudarabah* (profit sharing) is non-binding before commencement of the work and may be dissolved by either party. According to al-Zuhayli (2007), the Hanafi, Hambali and Shafie scholars agree that either party can dissolve the contract at any time and that the contract is automatically terminated with the death of either party. But the Maliki scholars disagree with the other scholars and assert that once work begins, the contract becomes binding on both parties. In the case where one of the parties dies, the contract can be inherited by his heirs. According to non-Shafie scholars, the contract is also terminated if one of the parties becomes mentally unstable; however, the Hanafis rule that the *mudarabah* (profit sharing) contract will not be void if the *rabbul maal* is put under legal guardianship.

In terms of capital requirement, the Hanafi scholars rule that the contract can be dissolved only if the partnership capital is in monetary form. But the Shafie and Hambali scholars agree that the dissolution of the partnership is valid even though the capital is non-monetary, as long as both parties agree to sell it and share the profit according to the pre-determined ratio.

3. Contemporary Islamic Scholar Viewpoints

3.1 The Dynamic Evolution of Mudarabah (Profit Sharing) Contract

The development of new products in the modern Islamic financial system is based on the rulings of contemporary scholars that the contract is valid as long as it does not contradict the provisions in the al-Quran and Sunnah. This belief is consistent with the opinion of Ibn Taymiyya (peace be upon him).

"The underlying principle in contracts and stipulations is permissible (ibaha) and valid. Any (contracts and stipulations) is prohibited and void only if there is an explicit test (from al-Quran, the Sunnah and consensus) or a qiyas, proving its prohibition and voiding."

(Narrated by Ibn Taymiyya in al-Fatawa, as cited in Abdul Rahman, 2012)

Generally, many contemporary Islamic economic scholars encourage the usage of profit loss sharing (PLS) i.e. *mudarabah* (profit sharing) and *musyarakah* (profit loss sharing) instruments due to its absence of *riba* and *gharar* for the development of current economic activities. However, in reality the PLS contract is less favoured by financial institutions because of various barriers such as legal requirements and moral hazard problems.

3.1.2 Two-Tier Mudarabah

Generally, the *mudarabah* (profit sharing) contract consists of one *rabbul maal* and one *mudarib.* However, according to Maliki scholars there is no restriction on the number of investors (*rabbul maal*s) or entrepreneurs (*mudarib*s) in the same contract with the permission of the capital provider.

According to the Hanafi scholar al-Sarakhsi, in the case of several entrepreneurs (*mudaribs*), the *mudarib*s can only act in accordance with mutual agreement and approval of the investor. If one of the entrepreneur (*mudarib*) act independently without his colleagues' or investors' permission, he becomes liable to the investor for any losses due to the independent and the unauthorised action (Borhan, 2004).

However, the Shafie jurists have different views on multi-tier *mudarabah* (profit sharing). Most Shafie scholars prohibit the use of *mudarabah* (profit sharing) contract with several entrepreneur (*mudarib*) regardless of any permission given by the capital provider. Such contract is regarded as void if it is implemented. Yet, a few Shafie jurists such as al-Shirazi allow the implementation of this contract (Borhan and Sa'ari, 2007).

Many new contracts have emerged in the contemporary period. Basically, modern PLS instruments are formed based on studies by the classical Islamic scholars; however, new developments are introduced to fulfil the requirements and demands of modern industries. According to Al-Zuhayli (2007), among the contracts currently available that use the *mudarabah* (profit sharing) concept are; simple partnership (*sharikat al-tawsiyah al-basitah*), particular partnership (*sharikat muhassah*), joint stock companies (*sharikat musahamah*) and hybrid limited partnership (*sharikat al-tawsiyah bi-l-ashum*).

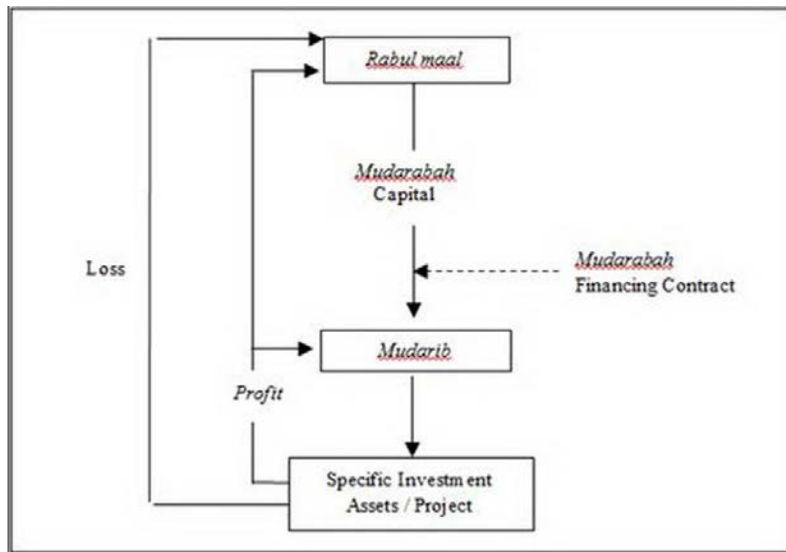

Figure 1: Financing Process under *Mudarabah (profit sharing)* Contract

Contemporary scholars agree that capital can be in the form of monetary or non-monetary assets. Nevertheless, debts or loans cannot be accepted as capital. *Mudarabah* (profit sharing) contracts can be either single-tier or multi-tiered. In a single-tier contract, the fund provider *(rabbulmal)* deals directly with the entrepreneur (*mudarib*), meanwhile in two-tier contracts (Refer to Figure 1), fund provider *(rabbulmal)* entrust their funds to an agent, who acts as an intermediary and who later deals with the entrepreneurs chosen to execute the projects. The entrepreneur (*mudarib*) of a *mudarabah* (profit sharing) contract may assign the capital to another entrepreneur (*mudarib*) in another *mudarabah* (profit sharing) contract with the permission of the primary capital provider. The profit gain from the investment will be shared between the fund provider *(rabbulmal)* and the first entrepreneur (*mudarib*) based on the pre-determined ratio between them and the balance will then be shared with the other *mudarib*s. However, in the case of losses, it will be borne solely by the *rabbul maal* except if the loss was due to the negligence of the *mudarib*. The application of unrestrictive *mudarabah* (profit sharing) i.e. a*l-mudarabah al-mutalaqah* is considered the most suitable contract to be implemented in the modern investment structure whereby it would allow the entrepreneur (*mudarib*) more innovation and creativity in executing the business venture.

3.1.2 Capital Guaranteed

Contemporary scholars also approve on the idea of giving a third party guarantee (al-*kafala*) to the *mudarabah* (profit sharing) capital as it would be able to mitigate risk exposures and secure the return of the capital. The guarantee can protect investors (*rabbul maal*) from misconduct or fraud, but not from market risk. According to Dalla Albaraka, giving a guarantee to the entrepreneur (*mudarib*) in *mudarabah* (profit sharing) capital is prohibited. Yet, if the guarantee is given by the government, then it is allowed (Rosly, 2005). Currently, third party guarantees can be obtained from the government or from private entities.

In June 2002, the Shariah Advisory Committee of Bank Negara Malaysia ruled that third party guarantee is permissible for Islamic deposits. This guarantee scheme is based on the concept of mutual guarantee (*al-kafala*) among Islamic financial institutions as participants of the scheme. This scheme does not violate the Shariah

principles since its objective is to protect the public interest (*maslahah*), especially the depositors and the banking industry. However, Islamic banking institutions need to ensure that the funds gained from Islamic deposit insurance schemes are invested in Shariah-compliant instruments. In line with this, the government of Malaysia has introduced Perbadanan Insurans Deposit Malaysia (PIDM) or the Malaysia Deposit Insurance Corporation (MDIC), a fully guaranteed government agency as a third party to offer insurance coverage on deposits based on Shariah principles.

Furthermore, in 2005, Bank Negara Malaysia (BNM) approved Credit Guarantee Corporation Berhad (CGC) as a third party-guarantor for business ventures with the implementation of Islamic Direct Access Guarantee Scheme (DAGS-i). In this scheme, the guarantor will charge fees for the guarantee services given exclusively to Islamic financing products offered by Islamic financial institutions to their customers (BNM, 2008).

3.1.3 Establishment of Profit Equalization Reserve

In year 2004, the Malaysian Islamic banks have introduced a new mechanism in distributing profits for the *mudarabah* (profit sharing) investments. The new mechanism is known as Profit Equalisation Reserve (PER). The profit equalisation reserve is the amount appropriated by the Islamic bank (*rabbul maal*) out of the their gross profit such as from *mudarabah* (profit sharing) profit, before allocating it as an entrepreneur (*mudarib*) share, in order to maintain a certain level of return on investment for the Investment Account Holders (IAH) and to increase owners' equity (ISRA, 2011).

According to Shaharuddin (2010), in the real banking business, the monthly rate of return recorded by the Islamic bank (*rabbul maal*) throughout a year is inconsistent due to the flux of bad debt profit, provisioning and total deposit. Thus, in order to mitigate the fluctuation of the rate of return, the Central Bank of Malaysia has demanded all the Islamic bank (*rabbul maal*) in this country to implement the PER mechanism.

This provision/reserve will be used whenever Islamic bank (*rabbul maal*) record a low profit. As such PER is viewed as a reserve that is built up in good times to cater for the need in a bad times (Ismail and Shahimi, 2006). This reserve is created with the purpose of covering the potential losses or as a face of fluctuations in return for the transaction conducted (Che Arshad and Ismail, 2011). It is also to ensure that Islamic banks have a fixed and competitive returns to the Investment Account Holders (IAH). Therefore, indirectly profit equalisation reserve similarly performs as a guaranteed (*daman*) on *mudarabah* (profit sharing) capital taken from the *mudarib*'s profit.

Although the purpose of PER is undeniably important, its implementation, however causes more confusion. The Islamic banks may argue that they obtain the depositor's permission based on the standard form signed at the beginning of the contract. But, the level of transparency pertaining to this matter is very low. The acceptance of the PER method in the Malaysian Islamic banking practices indicates the flexible approach adopted by their Supervisory Shariah Board members in modifying the Islamic commercial contracts (Shaharuddin, 2010).

4. Asymmetric Information Problem in *Mudarabah* (Profit Sharing) Contract

Generally, Islamic financial institutions prefer to use debt financing instruments such as *murabahah* (short term debt) or *bai' bithaman ajil* (long term debt) in their business activities as compared to equity financing tools. Adverse selection and moral hazard problems are the reasons why equity financing, especially *mudarabah* (profit sharing) is a less popular choice as a financing method in Islamic financial institutions.

In reality, investments using *mudarabah* (profit sharing) are very risky as the entrepreneur (*mudarib*), often has more information about the proposed project and its profitability which the Islamic bank does not usually have access to. Hence, it leads to imperfect information between the contracting parties (Siddiqui, 2008). Meanwhile, Ismail and Tohirin (2008) and Khalil, Rickwood and Murinde (2002) discovered *mudarabah* venture can become unproductive when Islamic banks fail to embark effective screening process in the selection of suitable entrepreneur to manage a business venture before contracting and at the same time failed to monitor the entrepreneur's actions after the contract is implemented. This generally related to the ability of entrepreneur to conceal information regarding his background and capabilities before contracting and his disguise actions after the contract is implemented.

Sarker (2000) also revealed that the asymmetric information in *mudarabah* contract also cause by the untruthful behaviour of entrepreneur that failed to report the outcome accurately. Meanwhile, Iqbal and Lewis (2009) discovered that entrepreneurs with below average profit favour equity contract after debt contract in order to minimize losses in case of failure. In contrast, managers with above average earning prefer to use debt financing in

order to maximize their gains in case of success. This is in line with the finding from Allen and Gale (1992) where better quality firms use debt financing as a signal of their superior quality. The problem becomes more serious as the existence of restriction of using collateral for these assets by the regulator. Investment using *mudarabah* contract is also very risky as there is no certainty on returns.

Adverse selection is the true risk of the entrepreneur (*mudarib*) before the investment is executed. Meanwhile, the problem of moral hazard arises when the *mudarib* is not motivated to fulfil the interests of the project other than for his benefit. It is also related to the risk that the entrepreneur would conceal information concerning his abilities and background before the contract and that he would perform independently after the contract is executed (Ismail and Tohirin, 2008). Furthermore, according to Dar and Presley (2000), such problems can also exist when the entrepreneur dishonestly under-reports or reduces the declared profits.

4.1 Remedial Action to Reduce Asymmetric Information in Mudarabah (Profit Sharing) Contract

Since the Islamic financial system runs on the principle of risk-sharing, disclosure of information between parties is very critical. Information regarding the possible combination on how the capital is used, the objective of the *rabbulmal* and performance of the venture, among others, must be transparent. According to Siddiqui (2008), risk and equity sharing contracts are related to various investment risks such as credit, market and operating risks which are the results of information imbalance, leading to a problem of adverse selection and moral hazard. Ismail and Tohirin (2008) reveal that the reason behind unsuccessful *mudarabah* (profit sharing) business ventures in Islamic banking is lack of expertise in monitoring the entrepreneur's operations. Investments using *mudarabah* (profit sharing) contract are also very risky as there is no certainty on returns.

4.1.1 Incentive Compatible Contract

Presley and Sessions (1994) and Ahmed (2002) recommended the implementation of incentive-compatible contracts to allow more efficient disclosure of information between the contracting parties. The agency theory states that the agent may not always act in the best interests of the financier. Therefore, the investor needs to set appropriate incentives for the agent to earn higher return for the project.

4.1.2 Screening and Monitoring Process

Abalkhail and Presley (2002) emphasized on the use of screening process to overcome the problem of incomplete contract that create an adverse selection and moral hazard problems. Sarker (2000) and Ismail and Ahmad (2006) suggested the usage of screening as well as monitoring process to supervise the actions of the entrepreneur in the financing and investment activities. According to Jensen and Meckling (1976), monitoring expenditure is an agency cost that is directly related to the financier's monitoring of the agent's behavior. Effective monitoring will reduces the agency costs even if the agent's information and actions cannot be fully monitored. Various benefits can be shared by both principal (capital provider) and agent (entrepreneur) when the agency costs been minimize. Ahmed (2002) stated that asymmetric information can be resolved if the *rabbul maal* can gather more information on the operations of the firm especially through the monitoring process. *Rabbul maal* should evaluate and monitor the *mudarib's* visions, objectives, market strategy, financial strategy and production process when the contract being executed. Recent studies by Muda and Ismail (2010) and Wan Kamaruddin and Ismail (2013) had proved that Mudharabah contract can achieve optimality and mitigate asymmetric problem as well as minimise transaction cost.

4.1.3 Muslims' Behavior

From the Islamic perspective, risk and uncertainty can be mitigated through good behavior, as recommended by Islamic teachings. The al-Quran instructs trustworthiness (*amanah*) (Al.Baraqah, 282) and insists on fairness and justice in economic activities. Allah (S.W.T) commands such behaviour to generate harmony among mankind to achieve *Maqasid as Shariah*. As mentioned by Metwally (1997), the objective of an Islamic firm is not profit

maximization; nevertheless, Islamic firms aim to achieve reasonable (fair) profit since Islam instructs Muslims to be moderate in pursuit of profit and wealth.

4.1.4 Corporate Governance in the Management of Contract

Basically, corporate governance is related to the internal integrity of a corporation that promotes a corporate fairness, transparency and accountability in the management. Meanwhile, Islamic corporate governance is established from the epistemological aspect of Tawhid, embedded the Shari'ah rules and emphasize on the principle of consultation (*shura*) between every stakeholder that involved in the investment activities.

Currently, many Islamic scholars try to emphasize on the role of Islamic corporate governance to mitigate agency problems in Islamic financing instruments especially in *mudarabah* (profit sharing) contract. The special criterion that is highlighted in Islamic corporate governance is the role of *sharia* (the latter will be known as *shuratic* process in the decision making process.

In the contemporary practice, *shura* have been suggested as one of the monitoring mechanism to attain accountability, fairness and transparency in the governance of Islamic corporations (Abdul Rahman, 1998; Iqbal and Mirakhor, 2004; and Hasan, 2009).

The member of *shura* will comprises of Islamic banks, shareholders, employees and the managers of firms. Through *shura*, every party involved will participate in the discussion and will open the door for information to be disclosed and delivered efficiently from the manager to the stakeholders, thus this will narrow down the asymmetric information in the venture. This is consistent with the spirit of Islam that emphasis on the importance of trustworthiness and cooperative among Muslim. At the same time, it is to ensure that every activity and decision on the business venture, especially that based on *mudarabah* (profit sharing) contract are mutually agreed by all parties involved before the realization of the contract as the capital provider cannot participate in the management activities.

5. Conclusion

Mudarabah (profit sharing) has through various evolutionary changes and modernizations since its practice in the pre-Islamic era. The improvement on existing *mudarabah* (profit sharing) conditions in modern *mudarabah* (profit sharing) is acceptable provided that it does not contradict with the provisions in the al-Quran and Sunnah. The intention of this development is to fulfil the needs of the modern communities and the fast-growing Islamic financial market. However, in reality, *mudarabah* (profit sharing) is less preferable compared to Islamic debt financing instruments. This is due to the existence of imperfect information that is inherent in *mudarabah* (profit sharing) contracts and creates problem of adverse selection and moral hazard, also known as agency problems. As a result, *mudarabah* (profit sharing) has declined in importance as a financing vehicle.

In order to overcome the agency problem, screening, monitoring and supervision of the *mudarib* (entrepreneur) by the capital provider have been suggested as the best tool to mitigate this problem. Meanwhile, from the Islamic perspective, the principle of *amanah* (trusteeship), fairness and *shura* (mutual consultation) have also been pointed out as part of reliable solutions to reduce the agency problem in *mudarabah* (profit sharing) contracts. As a faithful Muslim, the entrepreneur needs to work in a trustworthy manner and carry out his responsibility truthfully with the intention of obtaining Allah's blessings and not for his self-interest.

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