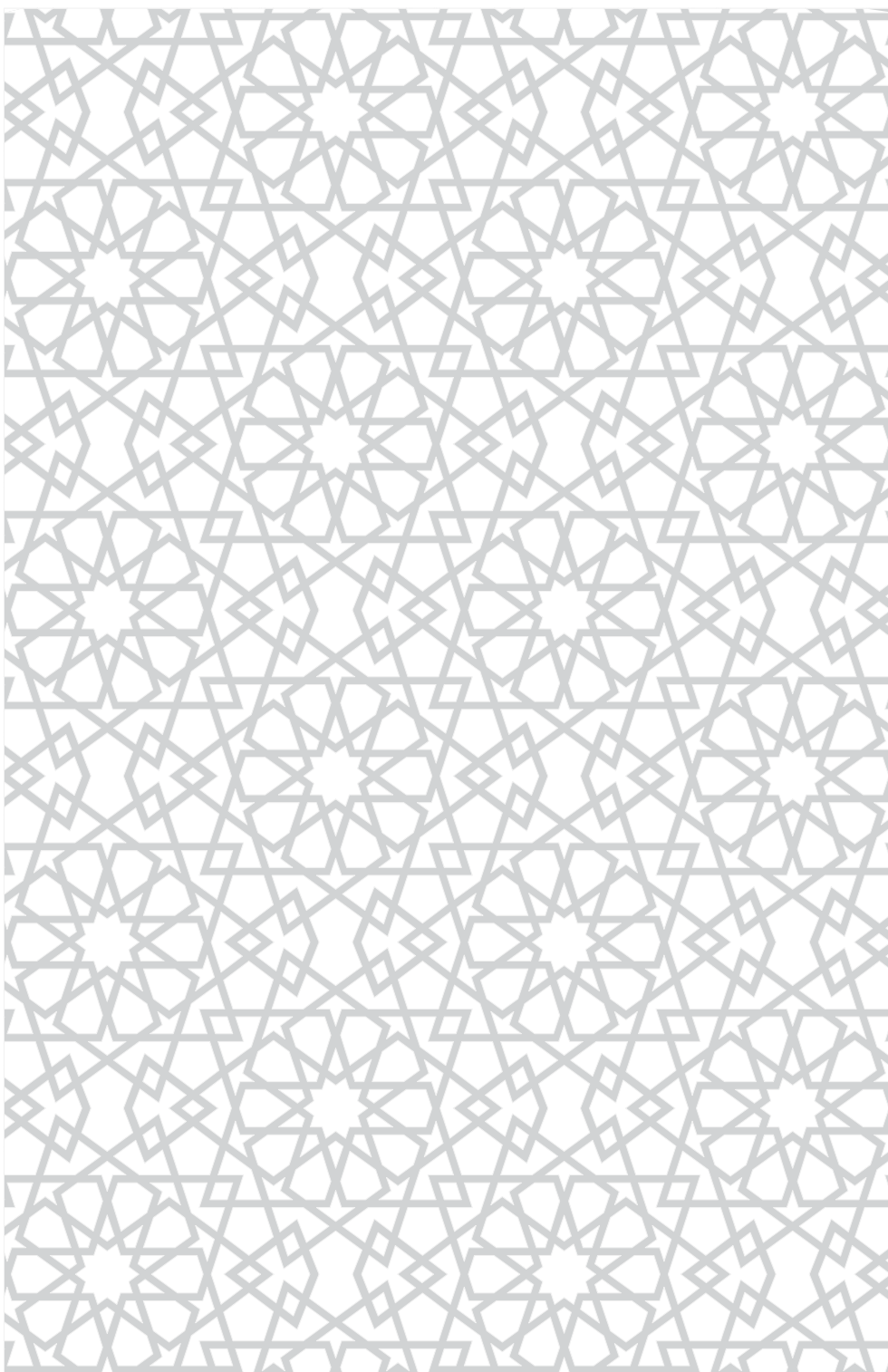


Financial Accounting Standard No. (4)

Musharaka Financing



Contents

Subject	Para.	Page
Musharaka Financing		
Preface		231
Statement of the Standard.....		232
1. Scope of the Standard	(1-21)	232
2. Accounting Treatments of Musharaka	(3-16)	232
2/1 Recognition of the Islamic bank's share in Musharaka capital at the time of contracting.....	(3)	232
2/2 Measurement of the Islamic bank's share in Musharaka capital at the time of contracting.....	(4-6)	233
2/3 Measurement of the Islamic bank's share in Musharaka capital after contracting at the end of a financial period	(7-1)	233
2/4 Recognition of the Islamic bank's share in Musharaka profits or losses.....	(11-16)	234
2/5 Disclosure requirements	(17-18)	235
3. Effective Date	(19)	235
Adoption of the Standard.....		236
Appendix (a): Brief History of the Preparation of the Standard.....		237
Appendix (b): Juristic Rules for Musharaka Financing Transactions		241
Appendix (c): Reasons for the Standard.....		251
Appendix (d): Basis for Conclusions.....		253
Appendix (e): Definitions.....		255



Preface

This standard aims at setting out accounting rules for recognizing, measuring and disclosing the transactions of Musharaka financing that are carried out by Islamic banks and financial institutions.⁽¹⁾ The standard also provides details of the juristic principles on which the development of the proposed accounting treatment is based. It also highlights the different accounting alternatives which have been considered and the justifications for the alternative chosen for the accounting treatment of Musharaka financing.

(1) Referred to hereafter as Islamic bank or Islamic banks.

Statement of the Standard

1. Scope of the Standard

This standard shall apply to Musharaka financing transactions carried out by Islamic banks whether by means of a constant Musharaka (short or long-term) or a diminishing Musharaka (one which ends with transferring ownership to one party). This shall apply whether the Islamic bank finances its share in Musharaka capital exclusively out of its own funds, out of the pool of commingled funds comprising the Islamic bank's own funds and unrestricted investment accounts or out of restricted investment accounts. The standard shall also apply to the transactions pertaining to the Islamic bank's share in Musharaka profits or losses.

Should the requirements of this standard contradict the Islamic bank's charter or the laws and regulations of the country in which it operates, a disclosure should be made of the contradiction. (para. 1)

This standard does not include the following:

- a) Mudaraba;
- b) Participations;
- c) Zakah on Musharaka funds; and
- d) Accounting treatment of Musharaka transactions in the partner's (client's) books and the Musharaka records. (para. 2)

2. Accounting Treatment of Musharaka Financing

2/1 Recognition of the Islamic bank's share in Musharaka capital at the time of contracting

The Islamic bank's share in Musharaka capital (cash or kind) shall be recognized when it is paid to the partner or made available to him on the account of the Musharaka. This share shall be presented in the Islamic bank's books under a Musharaka financing account with (name of client) and it shall be included in the financial statements under the heading "Musharaka Financing". (para. 3)

2/2 Measurement of the Islamic bank's share in Musharaka capital at the time of contracting

2/2/1 The Islamic bank's share in the Musharaka capital provided in cash shall be measured by the amount paid or made available to the partner on the account of the Musharaka. (para. 4)

2/2/2 The Islamic bank's share in Musharaka capital provided in kind (trading assets or non-monetary assets for use in the venture) shall be measured at the fair value of the assets (the value agreed between the partners), and if the valuation of the assets results in a difference between fair value and book value, such difference shall be recognized as profit or loss to the Islamic bank itself. (para. 5)

2/2/3 Expenses of the contracting procedures incurred by one or both parties (e.g., expenses of feasibility studies and other similar expenses) shall not be considered as part of the Musharaka capital unless otherwise agreed by both parties. (para. 6)

2/3 Measurement of the Islamic bank's share in Musharaka capital after contracting at the end of a financial period

2/3/1 The Islamic bank's share in the constant Musharaka capital shall be measured at the end of the financial period at historical cost (the amount which was paid or at which the asset was valued at the time of contracting). (para. 7)

2/3/2 The Islamic bank's share in the diminishing Musharaka shall be measured at the end of a financial period at historical cost after deducting the historical cost of any share transferred to the partner (such transfer being by means of a sale at fair value). The difference between historical cost and fair value shall be recognized as profit or loss in the Islamic bank's income statement. (para. 8)

2/3/3 If the diminishing Musharaka is liquidated before complete transfer is made to the partner, the amount recovered in respect

of the Islamic bank's share shall be credited to the Islamic bank's Musharaka financing account and any resulting profit or loss, namely the difference between the book value and the recovered amount, shall be recognized in the Islamic bank's income statement. (para. 9)

2/3/4 If the Musharaka is terminated or liquidated and the Islamic bank's due share of the Musharaka capital (taking account of any profits or losses) remains unpaid when a settlement of account is made, the Islamic bank's share shall be recognized as a receivable due from the partner. (para. 10)

2/4 Recognition of the Islamic bank's share in Musharaka profits or losses

2/4/1 Profits or losses in respect of the Islamic bank's share in Musharaka financing transactions that commence and end during a financial period shall be recognized in the Islamic bank's accounts at the time of liquidation. (para. 11)

2/4/2 In the case of a constant Musharaka that continues for more than one financial period, the Islamic bank's share of profits for any period, resulting from partial or final settlement between the Islamic bank and the partner, shall be recognized in its accounts for that period to the extent that the profits are being distributed; the Islamic bank's share of losses for any period shall be recognized in its accounts for that period to the extent that such losses are being deducted from its share of the Musharaka capital. (para. 12)

2/4/3 Item 2/4/2 shall apply to a diminishing Musharaka which continues for more than one financial period, after taking into consideration the decline in the Islamic bank's share in Musharaka capital and its profits or losses. (para. 13)

2/4/4 As implied by item 2/3/4 above, if the partner does not pay the Islamic bank its due share of profits after liquidation or after settlement of account is made, the due share of profits shall be recognized as a receivable due from the partner. (para. 14)

2/4/5 If losses are incurred in a Musharaka due to the partner's misconduct or negligence, the partner shall bear the Islamic bank's share of such losses. Such losses shall be recognized as a receivable due from the partner. (para. 15)

2/4/6 The Islamic bank's unpaid share of the proceeds as mentioned above in items 2/3/4 and 2/4/4 shall be recorded in a Musharaka receivables account. A provision shall be made for these receivables if they are doubtful. (para. 16)

2/5 Disclosure requirements

2/5/1 Disclosure should be made in the notes to the financial statements for a financial reporting period if the Islamic bank has made during that period a provision for a loss of its capital in Musharaka financing transactions. (para. 17)

2/5/2 The disclosure requirements stated in Financial Accounting Standard No. (1): General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions should be observed. (para. 18)

3. Effective Date

This Standard shall be effective for financial statements for fiscal periods beginning 1 Muharram 1418 A.H. or 1 January 1998 A.D. (para. 19)

Adoption of the Standard

The Standard of Musharaka Financing was adopted by the Board in its meeting No. (10) held on 14-16 Ramadan 1416 A.H., corresponding to 3-5 February 1996 A.D.

Members of the Board:

- | | |
|--------------------------------|-----------------|
| 1. Abdul Malik Yousef Al Hamar | Chairman |
| 2. Noor ur Rahman Abid | Deputy Chairman |
| 3. Dr. Ahmed Ali Abdallah | |
| 4. Anwar Khalifa Sadah | |
| 5. Dr. Hussein Hussein Shehata | |
| 6. Khalid Abdulla Janahi | |
| 7. Khalid Mahmood Saleem | |
| 8. Salah Eldin Ali Abu Naga | |
| 9. Dr. Abdul Sattar Abughoddah | |
| 10. Dr. Omar Zuhair Hafez | |
| 11. Mohammed Alawi Thiban | |
| 12. Mustapha Bin Hamat | |
| 13. Musa Abdel Aziz Shehadeh | |
| 14. Nabil Abdul Elah Nassief | |

Appendix (A)

Brief History of the Preparation of the Standard

In its meeting No. (3) held in Tehran on 13 Jumada I, 1413 A.H., corresponding to 8 November 1992 A.D., the former Financial Accounting Standards Board decided to start with the preparation of the following standards:

1. Murabaha and Murabaha to the Purchase Orderer.
2. Musharaka Financing.
3. Mudaraba Financing.

In February 1993, a list was compiled of consultants who could be assigned by the (former) Executive Committee for Planning and Follow-up to prepare the above three standards. The issue was submitted to the Committee in its meeting No. (28) held in Makkah during the period of 10-11 Ramadan 1413 A.H., corresponding to 3-4 March 1993 A.D., and a consultant was selected to carry out a study on the juristic and accounting aspects of the Musharaka financing standard.

On May 25, 1993 the consultant was formally notified of his assignment to prepare the standard and its requirements. The preliminary study of the standard was discussed in the Committee meeting No. (31) held in Bahrain on 6 Rabi' II, 1414 A.H., corresponding to 23 September 1993 A.D. The Committee members gave their comments and some details thereon and the consultant was asked to take them into consideration. The revised version of the juristic and accounting aspects of the study was prepared in Jumada II, 1414 A.H., corresponding to November 1993 A.D.

The consultant was asked on 4 Rajab 1413 A.H., corresponding to 18 December 1993 A.D., to prepare a field survey plan of the standard comprising a questionnaire on the data to be collected, the countries in which the

study will take place, and the number of Islamic banks to be covered by the study. The plan and the field study questionnaire were prepared in Sha'ban 1414 A.H., corresponding to January 1994 A.D., and were discussed by the Committee in its meeting No. (32) held in Makkah on 18 Ramadan 1414 A.H., corresponding to 28 February 1994 A.D. The Committee members and consultants were assigned to send the questionnaires to Islamic banks in the countries specified for each member. Each member was also asked to follow up, collect and send the completed questionnaires to the Organization.

Responses to the field study questionnaire were received during the period from Dhul-Qa'dah 1414 A.H., to Rabi' II, 1415 A.H., corresponding to April-September 1994 A.D., from the following Islamic banks:

1. Bahrain Islamic Bank
2. Faysal Islamic Bank – Bahrain
3. Al Baraka Islamic Investment Bank – Bahrain
4. Tadamon Islamic Bank – Sudan
5. Omdurman National Bank – Sudan
6. Khartoum Bank – Sudan
7. Al Shmal Islamic Bank – Sudan
8. Faisal Islamic Bank – Egypt
9. International Islamic Bank for Investment & Development – Egypt
10. Egyptian Saudi Finance House
11. Qatar Islamic Bank
12. Al Rajhi Banking and Investment Corporation
13. Jordan Islamic Bank
14. Dubai Islamic Bank

A memo was presented to the (former) Financial Accounting Standards Board in its meeting No. (6) held in Bahrain on 16 Dhul-Qa'dah 1414 A.H., corresponding to 26 April 1994 A.D., comprising the preliminary suggestions for accounting treatments. The Board's members commented on those suggestions.

The consultant revised the draft of juristic and accounting aspects of the standard in light of the comments made in the Board meeting. The revised draft was issued in Muharram 1415 A.H., corresponding to June 1994 A.D.

In its meeting No. (36) held in Cairo on 3-4 Rabi' I, 1415 A.H., corresponding to 10-11 August 1994 A.D., the Committee discussed the draft of the accounting and juristic aspects of the standard and made comments and additions which were used as a basis for preparing a revised draft of the study. The revised draft was completed in Jumada I, 1415 A.H., corresponding to November 1994 A.D., and presented to the Committee in its meeting No. (38) held in Bahrain during the period of 25-27 Jumada II, 1415 A.H., corresponding to 27-29 December 1994 A.D. In that meeting, the consultant was asked to prepare an exposure draft of the standard in light of the alternatives agreed on by the Committee. Thereafter, the juristic study was submitted to the Shari'a Committee which highlighted in its meeting held in Makkah during the period of 7-8 Ramadan 1415 A.H., corresponding to 6-7 February 1995 A.D., the need for reviewing and amending the juristic aspects by a Shari'a consultant.

The exposure draft of the standard was discussed by the Accounting Standards Committee of the Accounting and Auditing Standards Board in its meeting held in Bahrain during the period of 26-28 Muharram 1416 A.H., corresponding to 24-26 June 1995 A.D. The Accounting Standards Committee revised the exposure draft and referred it to the Shari'a Committee which discussed it in its meeting held in Bahrain during the period of 1-2 Safar 1416 A.H., corresponding to 29-30 June 1995 A.D.

The Accounting and Auditing Standards Board met on 24-26 Rabi' II, 1416 A.H., corresponding to 19-21 September 1995 A.D., and discussed the exposure draft and made changes to it. The Board decided that the exposure draft should be distributed to specialists and interested parties to obtain their comments on the exposure draft in order to discuss them in a listening session. The latter was held on 25-26 Rajab 1416 A.H., corresponding to 17-18 December 1995 A.D., in Bahrain. The listening session was attended by more than 40 participants representing central banks, Islamic banks, accounting firms, Shari'a scholars, academics and others who are interested in this field. Members of the Accounting Standards Committee responded in the listening session to the written comments received prior to the listening session as well as the oral comments expressed in the sessions.

The Accounting Standards Committee held a meeting on 20-21 Sha'ban 1416 A.H., corresponding to 12-13 January 1996 A.D., to discuss the comments made about the exposure draft. The Committee made the necessary amendments which it deemed necessary in light of the discussions that took place in the listening session.

The Accounting and Auditing Standards Board adopted the proposed standard in its meeting No. (10) held on 14-16 Ramadan 1416 A.H., corresponding to 3-5 February 1996 A.D.

Appendix (B)

Juristic Rules for Musharaka Financing Transactions

1. Definition of Musharaka in Fiqh (Jurisprudence)

It is the commingling of funds for the purpose of sharing in profit.

1/1 Categories of Musharaka

Partnerships are of two types: Holding Partnership and Contract Partnership.

A holding partnership is created by means of inheritance or wills or other circumstances resulting in the holding by two or more persons of an asset in common. In a holding partnership two or more persons share in a real asset and in the returns arising therefrom.

A contract partnership is created by means of an agreement whereby two or more persons agree that each of them contributes to the capital of the partnership and shares in its profit or loss.⁽²⁾

Contract partnerships are divided into: Al-Mufawada, Al-'Inan, Al-A'mal and Al-Wujuh. Fuqaha (jurists) have differed on whether Mudaraba is a partnership in this sense or not. Some Fuqaha consider Mudaraba to be such a partnership because in general it fulfils the elements and terms of a partnership contract. Others, however, do not consider Mudaraba to be one of the types of contract partnership.

Following is a brief definition of each of the above types in light of what is reported in Fiqh texts.

(2) Sayyid Sabiq, *"Fiqh Al-Sunnah"*, [3: 294], (Dar Al-Turath Printing House, Cairo 1977); Abdul-Aziz Al-Khayyat, *"Companies in Islamic Shari'a"*, 1390 A.H.-1970 A.D., first edition, [1: 23, 41 and after].

1/1/1 Al-'Inan partnership

It is a contract between two or more persons. Each of the parties contributes a portion of the overall fund and participates in work. Both parties share in profit or loss as agreed between them, but equality is not required either in the contribution to the fund or in work or in sharing of profit (these being subject to agreement between the parties). This type of partnership is approved by all Fuqaha.

Hanafis and Hanbalis allow any of the followings: Profits of the two parties to be divided in proportion to their contributed funds; profits may be divided equally but contributed funds may be different; and profits may be unequally divided, but contributed funds are equal. Ibn Qudamah said: "Preference in profit is permissible with the existence of work, as one of the two parties may be more informed as to trade transactions than the other party and/or physically capable of achieving greater deal of work, which allows him to make an increase in his profit share a condition of his work". Malikis and Shafis make the acceptance of this type of partnership conditional on profits and losses being proportionate to the size of contributions to the overall fund because (according to them) profit in this type of partnership is considered to be return on capital.⁽³⁾

1/1/2 Al-Mufawada partnership

It is a contract between two or more persons. Each of the two parties contributes a portion of the overall fund and participates in work. Both parties equally divide profit or loss. It is a condition of this type of partnership that contributed funds, work, mutual responsibility and liability for debts be equally shared by the parties. Both Hanafis and Malikis have permitted this type of partnership but have stipulated many restrictions for it.⁽⁴⁾

(3) Sayyid Sabiq, "*Fiqh Al-Sunnah*", [3: 296]; Abdul-Aziz Al-Khayyat, op. cit., [2: 30-31]; Al-Kasani, "*Bada'i' Al-Sana'i' Fi Tartib Al-Shara'ie*", [6: 57].

(4) Al-Kasani, op. cit., (P. 56); Ibn Qudamah, "*Al-Mughni*", [6: 30].

1/1/3 Al-A'mal partnership

It is a contract between two persons who agree to accept work jointly and to share the profit from such work. For example, two persons of the same profession or craft may agree to work together and to divide the profit arising from such work on an agreed basis. It is sometimes called Al-Abdan or Al-Sana`i partnership.

Al-A'mal partnership is considered permissible by Hanafis, Malikis, Hanbalis.⁽⁵⁾ It is considered valid within the same profession or otherwise. Its permissibility is based on much evidences, including explicit approval thereon by the Prophet (peace be upon him). In addition, it is based on agency which is permissible. This type of partnership has been used throughout without being disapproved of.⁽⁶⁾

1/1/4 Al-Wujuh partnership

It is a contract between two or more persons who have good reputation and prestige and who are expert in trading. Parties to the contract purchase goods on credit from firms, depending on their reputation, and sell the goods for cash. They share profit or loss according to the guarantee to suppliers provided by each partner. Accordingly, this type of partnership does not require capital since it is based on credit backed by guarantee. Hence, it is sometimes called a "Receivables Partnership".

Al-Wujuh partnership is considered permissible by Hanafis and Hanbalis. Those who support its permissibility argue that it includes an agency guarantee which is also acceptable. It has been used throughout without being disapproved of.⁽⁷⁾

(5) Ahmad Ali Abdullah, *"Legal Entity in Islamic Fiqh"*, (Sudanese Printing Press House, Khartoum, undated), (pp. 217 and after).

(6) Abdul-Aziz Al-Khayyat, op. cit., [2: 37]; Ibn Qudamah, *"Al-Mughni"*, op. cit. [5: 6]; Sayyid Sabiq, *"Fiqh Al-Sunnah"*, op. cit., (P. 297).

(7) Abdul-Aziz Al-Khayyat, op. cit., [2: 46-48].

1/2 Musharaka elements and conditions

1/2/1 Musharaka elements

The elements of Musharaka are: Wording (offer and acceptance), contract parties (the two contracting parties) and the subject matter of the agreement (funding and work).

1/2/2 Terms of Musharaka

1/2/2/1 Wording

There is no specified form of Musharaka contract. It may be formed by any utterance expressing the purpose. Contracting is considered to be valid if made verbally or in writing. The Musharaka contract is notarised in writing and witnessed.

1/2/2/2 Contracting parties

It is a requirement that the partner should be competent to give or be given power of attorney.

1/2/2/3 Subject matter of the contract (funding and work)

There are the following requirements:

a) Funding

Capital contributed shall be in cash, gold, silver or their equivalent in value. There is no difference among Fuqaha in this respect.

Capital may consist of trading assets such as goods, property and equipment, etc. It may also be in the form of intangible rights, such as liens, patents and suchlike. It is considered permissible by some Fuqaha that the capital of a company can be contributed in the form of these types of assets provided they are valued at their cash equivalent according to what the partners agree upon.

Shafis and Malikis argue that the funds provided by partners should be commingled in order that

no privilege be given to the share of either of them. However, Hanafis do not stipulate this condition provided the capital is in cash, while the Hanbalis do not require commingling of funds.⁽⁸⁾

b) Work

Participation of partners in the work of a Musharaka is a basic rule and it is not permissible for one of the partners to stipulate the non-participation of the other partner. However, equality of work is not a requirement. It is permissible that one of the partners exert more work than the other, and in that case he may be entitled to additional share of profit.

1/3 Musharaka rules

1/3/1 Rules of capital

Following are the most significant rules which control the operation of capital and its maintenance:

a) Power of attorney and disposition of funds

Any partner has the right to dispose of the partnership's assets in the normal course of business. A partnership with a contributed capital (e.g., Al-'Inan) constitutes an entity and once the capital has been contributed, it comprises a single fund. Each partner empowers his other partner(s) to dispose of the assets and he is thus considered to be authorised to employ them in the activity of the Musharaka provided he does so with due care to the interests of his partner(s) and without misconduct or negligence. A partner is not allowed to disburse or invest the funds for his personal purposes.

b) Non-guarantee of capital

Neither partner can guarantee the other partner's capital, because Musharaka is based on the principle of Al-Ghurm

(8) Ibn Qudamah, *"Al-Mughni"*, op. cit., [5: 17].

Bil-Ghunm (the entitlement to return is related to the exposure to risk). However, a partner may request another partner to provide guarantees against the latter's negligence or misconduct.

- c) It is not permissible to agree in a Musharaka contract that the transfer of the Islamic bank's portion to the other partner or vice versa should be at historical cost. Normally, the transfer should take place on the basis of fair value at the time of transfer.

1/3/2 Work rules

In a partnership with a contributed capital, the partners shall provide both funds and work, and each partner shall undertake work as an agent of the partnership subject to the partnership contract. This is regulated by a number of juristic rules, the most significant of which are:

a) Agency as to the work

Each partner carries out work in the partnership on behalf of himself and as an agent for his partner. This is governed by the general rules of agency contract in Islamic jurisprudence. Some of these rules are related to the principal and others are related to the agent and some are related to the things which are the subject of agency. All these matters should be made clear in the Musharaka contract.⁽⁹⁾

b) Scope of the work

This relates to the specification of the scope of each partner's work in the partnership in relation to the latter's objectives and activities. The partner should perform the agreed work without negligence or misconduct. Partnership work includes management of the business (e.g., planning, policy making, development of executive programs, following-up, supervision, performance appraisal and decision-making).

(9) Ibn Qudamah, "*Al-Mughni*", [5: 88 and after], Kitab Al-Wakalah; Sayyid Sabiq, "*Fiqh Al-Sunnah*", [3: 226], (Agency Chapter).

A partner who undertakes work outside his agreed scope of duties is entitled to employ workers to perform the said work, and if he performs such work himself, he shall be entitled to remuneration similar to that paid for similar work. However, it is considered permissible by some Fuqaha that one partner may delegate full authority to another to carry out the business of the partnership if this is the most satisfactory arrangement for the partnership.

c) Appointment of workers

The partners may appoint workers to perform the tasks which are not within the scope of their individual work, and the cost of such work will be borne by the partnership. However, if a partner employs a worker to do some of the tasks which were originally assigned to him, the resulting costs will be borne by him since the partnership contract is based on both funds and work, and the earned profits are the outcome of both elements.⁽¹⁰⁾ Appointment of workers is conditional upon a genuine requirement for their services and that they should receive remuneration in accordance with this.

d) Borrowing, lending, grants and charitable donations

The partner may not borrow money on account of the partnership, lend money to a third party from the funds of the partnership, donate or grant money⁽¹¹⁾ except after the consent of other partners.

1/3/3 Rules of profit

a) General rules of profit⁽¹²⁾

1. Profit should be quantifiable. If it is not, this will undermine the contractual basis of the partnership through leading

(10) Al-Zayla'i, *"Tabayin Al-Haqa'iq Sharh Kanz Al-Daqa'iq"*, [5: 30].

(11) Ibn Qudamah, *"Al-Mughni"*, [5: 22].

(12) Ibn Rushd, *"Bidayat Al-Mujtahid Wa Nihayat Al-Muqtasid"*, op. cit. [2: 253]; Al-Kasani, *"Bada'i' Al-Sana'i"*, [7: 3537]; Ibn Qudamah, *"Al-Mughni"*, [5: 22].

to differences and disputes at the time of profit allocation or liquidation of the partnership. If the partners say that the “profit will be between us”, profit will in this case be allocated according to the share of each of them in the capital.

2. Each partner’s profit must be a proportionate share of the whole partnership profit. No predetermined amount may be assigned to one of the partners, as in this case profit sharing will not take place and the legal basis of the partnership will be undermined.

It is permissible for a partner to propose that if profits exceed a certain amount, such excess or a percentage of it will be credited to him. It is stated in «*Al-Bahr Al-Zakhkhar Al-Jami’ Limadhahib ‘Ulama’ Al-Amsar*» that “If one of them (partners) says that I will have ten if we gain more than that then this will be valid and the condition will be binding as there is no exigency of revocation”.⁽¹³⁾

b) Rules of allocating profits among partners

Fuqaha differ on the issue of allocating profits among the partners. Hereunder is a brief outline of their opinions:

First: Profit should be divided among the partners in proportion to their contributed capital, whether the amount of work done by the partners is equal or not. This is the opinion of Malikis and Shafis and their argument is based on the grounds that profit is the return on capital, hence it must be proportional thereto. Preferential treatment in profit sharing combined with equality of capital contribution leads to a return on an amount that has not been committed.

Second: Profit may vary between the partners if it is so provided for in the contract. This is the opinion of Hanafis and Hanbalis, and their argument is based on the pro-

(13) Refer to: Ali Al-Khafif, “*Companies in Islamic Jurisprudence*”, (pp. 29 and 30); “*Al-Bahr Al-Zakhkhar Al-Gami’ Limadhahib ‘Ulama’ Al-Amsar*”, [4: 82].

position that profit is the fruit of the interaction of funds and work. This is because one of the partners may be more experienced, tactful and discrete than the other, and hence it is permissible for him to require for himself an additional share of profit in return for his extra work contribution. The Hanafis and Hanbalis support this argument based on the saying of Ali Ibn Abu Talib (may Allah be pleased with him): "Profit should be according to what they (partners) stipulated, and the loss should be proportionate to both funds." This opinion assists in considering the role of experience, tactfulness, courtesy and efficiency in achieving profit.⁽¹⁴⁾

Based on the second opinion the net realized profits can be divided into two parts:

- a) Profit is to be allocated according to the efforts of partners in doing the work.
- b) Profit is it is to be allocated according to the share of each partner in the capital.

It is also permissible to allocate a common share of profit to a third party whenever the partners so agree; e.g., a share for the poor and the needy or to charitable organizations. It is also permissible to allocate part of profits as a reserve to support the future position of the partnership.

1/3/4 Rules applicable in case of loss

Fuqaha agree that loss should be divided between the partners in proportion to their respective shares in the capital. Fuqaha call this "Wadhi'ah" (loss). They support this opinion by the following saying of Ali Ibn Abu Talib (may Allah be pleased with him): "Profit should be according to what they (partners)

(14) Refer to: Ibn Rushd, "*Bidayat Al-Mujtahid Wa Nihayat Al-Muqtasid*", [2: 253]; Al-Khatib, "*Mughni Al-Muhtaj Sharh Al-Minhaj*", [2: 215], (Dar Ihya' Al-Turath Al-Arabi, Beirut); Ibn Qudamah, "*Al-Mughni*", [5: 30 and 31]; Mahmud Ibn Ahmad Al-'Ayni "*Al-Binayah Fi Sharh Al-Hidayah*", [6: 108].

stipulated, and the loss should be proportionate to both funds". Ibn Qudamah says: "We know not of any difference in this matter among the scholars".⁽¹⁵⁾ In the case of on-going concerns, it is permissible to defer the allocation of loss in order to be compensated by the profits of subsequent periods.

1/3/5 Rules of Musharaka termination

In general, the partnership shall be terminated if one of the partners terminates the contract, or dies, if his legal competency ceases or if the partnership capital is lost.

The majority of Fuqaha, except for Malikis, are of the opinion that as partnership is one of the permissible forms of contract, each of the partners is entitled to terminate it whenever he wishes, as is the case with agency contracts.

The partnership is based on agency and probity. Each of the partners is a proxy for the others and a principal at the same time. He acts in respect of his share as a principal and in respect of his partners' shares as a proxy; i.e., as an agent. In principle, agency is one of the unanimously permissible contracts and no party is forced to proceed with it against his will. The partnership, as well, should start with an agency relationship between the partners, and this relationship provides the basis for its continuity. If the agency relationship is severed by termination on the part of one of the partners, the legal basis upon which they acted in respect of each other's funds will be eliminated.⁽¹⁶⁾

In the case of death, one of the heirs, if he is of sound mind, may replace the deceased provided that the other heirs and the other partners agree to that. This shall also be applicable in case one of the partners loses competency.

(15) Al-'Ayni, *"Al-Binayah Fi Sharh Al-Hidayah"*, op. cit., [6: 108]; Ibn Qudamah, *"Al-Mughni"*, [5: 37], The Case of : Wadi'ah Should Be Proportionate to the Amount of Fund.

(16) Ali Al-Khafif, *"Companies in Islamic Jurisprudence"*, op. cit., (P. 548).

Appendix (C)

Reasons for the Standard

The Executive Committee for Planning and Follow-up (the Committee) has commissioned a number of consultants to conduct field studies to identify the objectives and standards of financial accounting and the role of governmental and private bodies in preparing accounting standards in countries in which Islamic banks operate. These field studies included the identification of standards that were badly needed and should be given priority by the Financial Accounting Standards Board. The survey revealed the need for early preparation of each of the following standards:

- a) Murabaha and Murabaha to the Purchase Orderer.
- b) Musharaka Financing.
- c) Mudaraba Financing.

While preparing the previous Financial Accounting Statement No. (1): Objectives of Financial Accounting for Islamic Banks and Financial Institutions (Statement of Objectives), and Financial Accounting Statement No. (2) : Concept of Financial Accounting for Islamic Banks and Financial Institutions (Statement of Concepts), the consultants were asked to propose nine standards which were considered important and deserved to be given priority in preparation. The consultants were also asked to arrange the proposed standards in order of priority.

The selection of the above three standards was based on the decision of the Standards Board in its third meeting held in Tehran on 13 Jumada I, 1413 A.H., corresponding to 8 November 1993 A.D., to give priority to the standards relating to financial instruments. The responses to the field study questionnaire which was conducted by the Accounting and Auditing Organization, showed that the average percentage of transactions in which Musharaka financing is used was 15%. The questionnaire and the financial reports of some Islamic banks also revealed that there were

differences between Islamic banks as to the measurement and recognition of Musharaka financing transactions as well as differences in their methods of presentation and disclosure. Such differences in the accounting practices and disclosure have several effects. It may be difficult to compare profits realized by one Islamic bank with those realized by another. This is likely to render the information produced by an Islamic bank less useful to the users of its financial statements. Such differences may also affect the distribution of the results of joint finance transactions in terms of profit or loss between holders of unrestricted investment accounts and owner's equity on one hand, and the allocation of profit or loss between holders of unrestricted investment accounts on the other hand.

However, standardization of the accounting treatment to recognize and disclose profits conforms with the provisions of the Statement of Objectives; such as determination of the rights and obligations of all concerned parties, including those rights resulting from incomplete transactions and other events in accordance with the principles of Shari'a and its concepts of fairness, charity and compliance with Islamic business ethics; and to provide useful information to users of financial reports of Islamic banks to enable them to make legitimate decisions in their dealing with Islamic banks.

Appendix (D)

Basis for Conclusions

The former Executive Committee for Planning and Follow-up and the present Accounting Standards Committee have reviewed in their meetings a number of alternatives and in particular the proposed alternatives in the preliminary study⁽¹⁷⁾ to be adopted in the accounting treatments of Musharaka financing. The Accounting Standards Committee recommended the adoption of the alternatives which were found to be in compliance with the provisions of the Statement of Objectives and the Statement of Concepts.

Recognition and Measurement of the Islamic Bank's Share in Musharaka Capital at the Time of Contracting

The Musharaka capital is governed by a group of principles, the most significant of which are: The share of each partner should be known, specified and agreed as to its amount at the time of contracting, the share of the capital of each partner should be available at the time of contracting. This cannot be in the form of a debt on account in order to avoid deception, misunderstanding and inability to make use of the capital. If the capital is in the form of real or intangible assets, Shari'a principles require the valuation of the intangible assets by agreement of the partners, and the Islamic bank's share in the Musharaka shall be measured at fair value at the time of contracting. The valuation can be conducted by experts or by the partners as agreed by the two parties.

There are two reasons for not using historical cost to measure non-monetary assets which represent the Islamic bank's share in the Musharaka. These are:

(17) Husayn H. Shihatah, "Study of the Juristic and Accounting Aspects of Islamic Musharaka Standard as Performed by Islamic Banks", Accounting and Auditing Organization for Islamic Finance Institutions, 1415 A.H.-1994 A.D.

First: The use of the value agreed upon (fair value) by the two parties achieves one of the financial accounting objectives provided for in the Statement of Objectives. (para. 36)

Second: The use of the fair value leads to the application of the representational faithfulness concept provided for in the Statement of Concepts. (para. 112)

Measurement of the Islamic Bank's Share in Musharaka Capital After Contracting, at the End of the Financial Period

The Islamic bank's share after contracting is measured at its historical cost because Shari'a rules of Musharaka requires the determination of capital and its maintenance up to the time of final settlement in order to determine profit. The latter is defined as the amount earned in excess of the initial Musharaka capital. This conforms with the accounting measurement attribute provided for in the Statement of Concepts. (para. 98)

Recognition of the Islamic Bank's Share in the Profit or Loss of Musharaka

The standard distinguished between Musharaka financing transactions (constant or diminishing ownership) which end during a financial period, and those which continue for more than one financial period. In the first case, the profits or losses are recognized after liquidation. This is in conformity with the Shari'a principle stating: No profit shall be deemed due except after maintaining the capital; i.e., after liquidation which reveals an excess (profit) over the initial capital or shortage (loss) therefrom.

In the second case, if the Musharaka financing transactions continue for more than one financial period, the Islamic bank's share of profits for a financial period resulting from partial or final settlement shall be recognized to the extent that the profits are being distributed; recognition of the Islamic bank's share of losses for any period is made to the extent that such losses are being deducted from its share of the Musharaka capital. This is in conformity with the periodicity concept (Statement of Concepts, para. 74) which enables the preparation of financial reports in such a way as to achieve the objective set out in the Statement of Objectives (para. 33): Determining the rights and obligations of all concerned parties.

Appendix (E)

Definitions

Musharaka

A form of partnership between the Islamic bank and its clients whereby each party contributes to the capital of partnership in equal or varying degrees to establish a new project or share in an existing one, and whereby each of the parties becomes an owner of the capital on a permanent or declining basis and shall have his due share of profits. However, losses are shared in proportion to the contributed capital. It is not permissible to stipulate otherwise.

Constant Musharaka

It is a Musharaka in which the partners' shares in the capital remain constant throughout the period as specified in the contract.

Diminishing Musharaka

It is a Musharaka in which the Islamic bank agrees to transfer gradually to the other partner its (the Islamic bank's) share in the Musharaka, so that the Islamic bank's share declines and the other partner's share increases until the latter becomes the sole proprietor of the venture.

Participation

It is a Musharaka in which the Islamic bank owns shares or units representing an equity stake in another firm's capital.

Mudaraba

It is a partnership in profit between capital and work. It is conducted between investment account holders as owners of capital and the Islamic bank as a Mudarib. The Islamic bank announces its willingness to accept the funds of investment amount holders, the sharing of profits being as agreed upon between the two parties, and the losses being borne by the owner

of funds except if they were due to misconduct, negligence or violation of the conditions agreed upon by the Islamic bank. In the latter cases such losses would be borne by the Islamic bank. A Mudaraba contract may also be concluded between the Islamic bank, as a provider of capital on behalf of itself or on behalf of investment accountholders, and business owners and other craftsmen, including farmers, traders etc. A Mudaraba cannot include market operations undertaken for purely speculative purposes, which are a form of gambling.

