

Financial Accounting Standard No. (3)

Mudaraba Financing



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Preface

This standard aims at setting out accounting rules for recognizing, measuring and disclosing the transactions of Mudaraba 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 treatments of Mudaraba 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 Mudaraba financing transactions carried out by the Islamic bank as a provider of funds and the transactions related to the capital provided by the Islamic bank to be used in a Mudaraba, from the time of its inception to the time of its completion. This shall apply whether the Islamic bank finances the Mudaraba 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 Mudaraba 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 address the following:

- a) The accounting treatment of Mudaraba transactions in the Mudarib (client) books as well as the Mudaraba books.
- b) The Islamic bank's receipt of unrestricted investment accounts funds which are characterized as Mudaraba from a Shari'a perspective.
- c) The Islamic bank's receipt of restricted investment account funds whether within its capacity as Mudarib or agent.
- d) Zakah of Mudaraba fund. (para. 2)

2. Accounting Treatment of Mudaraba Financing

2/1 Recognition of Mudaraba capital at time of contracting

2/1/1 Mudaraba financing capital (cash or kind) shall be recognized when it is paid to the Mudarib or placed under his disposition. (para. 3)

- 2/1/2 If it is agreed that the capital of a Mudaraba is to be paid in instalments, then each instalment shall be recognized at the time of its payment. (para. 4)
- 2/1/3 If the conclusion of a Mudaraba contract is contingent on the occurrence of an event in the future or is delayed to a future time, and the payment of the Mudaraba capital is conditional upon the occurrence of that event or the falling due of that time, then the Mudaraba capital shall be recognized only when it is paid to the Mudarib. (para. 5)
- 2/1/4 Mudaraba financing transactions shall be presented in the Islamic bank's financial statements under the heading of "Mudaraba Financing". Mudaraba capital provided in the form of non-monetary assets shall be reported as "non-monetary Mudaraba assets". (para. 6)
- 2/2 Measurement of Mudaraba capital at the time of contracting
 - 2/2/1 Mudaraba capital provided in cash by the Islamic bank shall be measured by the amount paid or the amount placed under the disposition of the mudarib. (para. 7)
 - 2/2/2 Mudaraba capital provided by the Islamic bank 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 upon between the Islamic bank and the client), 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. 8)
 - 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 Mudaraba capital unless otherwise agreed by both parties. (para. 9)
- 2/3 Measurement of Mudaraba capital after contracting at the end of a financial period

- 2/3/1 Mudaraba capital shall be measured after contracting as stated in item 2/2. However, any repayment of the Mudaraba capital, if any, made to the Islamic bank shall be deducted from the Mudaraba capital. (para. 10)
- 2/3/2 If a portion of the Mudaraba capital is lost prior to the inception of work because of damage or other causes without any misconduct or negligence on the part of the Mudarib, such loss shall be deducted from the Mudaraba capital and shall be treated as a loss to the Islamic bank. However, if the loss occurs after inception of work, it shall not affect the measurement of Mudaraba capital. (para. 11)
- 2/3/3 If the whole Mudaraba capital is lost without any misconduct or negligence on the part of the Mudarib, the Mudaraba shall be terminated and the account thereof shall be settled and the loss shall be treated as a loss to the Islamic bank. (para. 12)
- 2/3/4 If the Mudaraba is terminated or liquidated and the Mudaraba capital (taking account of any profits or losses) is not paid to the Islamic bank when a settlement of account is made, the Mudaraba capital (taking account of any profits or losses) shall be recognized as a receivable due from the Mudarib. (para. 13)
- 2/4 Recognition of the Islamic bank's share in Mudaraba profits or losses
- 2/4/1 Profits or losses in respect of the Islamic bank's share in Mudaraba financing transactions that commence and end during a single financial period shall be recognized at the time of liquidation. (para. 14)
- 2/4/2 In the case of Mudaraba financing 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 Mudarib, 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 account for that period to the extent

that such losses are being deducted from the Mudaraba capital. (para. 15)

2/4/3 As implied by 2/3/4, if the Mudarib does not pay the Islamic bank its due share of profits after liquidation or settlement of account is made, the due share of profits shall be recognized as a receivable due from the Mudarib. (para. 16)

2/4/4 Losses resulting from liquidation shall be recognized at the time of liquidation by reducing the Mudaraba capital. (para. 17)

2/4/5 The Mudarib shall bear the losses incurred due to misconduct or negligence on his part. Such loss shall be recognized as a receivable due from the Mudarib. (para. 18)

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 decline in the value of Mudaraba assets. (para. 19)

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 shall be observed. (para. 20)

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. 21)

Adoption of the Standard

The Standard of Mudaraba 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 | |
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| 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 these 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 Mudaraba 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 by the Committee 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 Al-Mukarramah 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 during the period of 3–4 Rabi' I, 1415 A.H., corresponding to 10–11 August 1994 A.D., the Committee discussed the draft of the juristic and accounting 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 upon by the Committee.

In its meeting held in Makkah on 7–8 Ramadan 1415 A.H., corresponding to 6–7 February 1995 A.D., the Shari'a Committee discussed the juristic aspect and approved it subject to certain revisions being made.

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 approved it in its meeting held in Bahrain on 1–2 Safar 1416 A.H., corresponding to 29–30 June 1995 A.D., after making some changes in the draft.

The Accounting and Auditing Standards Board met during the period of 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 both the written comments received prior to the listening session as well as the oral comments expressed in the sessions.

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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 Mudaraba Financing Transactions

1. Terms and Elements of Mudaraba

- 1/1 There are two contracting parties: The provider of the funds and the Mudarib. Both parties shall be eligible to act as principal and agent.
- 1/2 The wording – “Offer and Acceptance” – by which both contracting parties express their willingness to conclude a contract shall conform to the following:
 - 1/2/1 The wording should explicitly or implicitly indicate the purpose of the contract.
 - 1/2/2 Acceptance of the offer is contingent on its taking place during the time which both parties are negotiating agreement to the contract. However, acceptance is not valid if one party refuses the terms of the offer or leaves the place where the negotiation of the contract is being made before the deal is concluded.
 - 1/2/3 Acceptance should be of the same conditions as the Offer.

Contracting is permissible by verbal utterance or in writing of the contract and signing it. It is also permissible through correspondence or by the use of modern communication means; e.g., fax or computer. This was approved by the Islamic Fiqh Academy of the Islamic Conference Organization.
- 1/3 Capital: This is the amount of money given by the provider of funds to the Mudarib with the purpose of investing it in the Mudaraba activity. The following conditions shall be satisfied:

1/3/1 Capital should be known as to amount and type (i.e., currency).

1/3/2 Capital should be in cash. However, it is considered permissible by some jurists that the capital of a Mudaraba be in trading assets (e.g., inventory). At the time of contracting, the value of such assets or their historical cost shall be considered as the Mudaraba capital.

It is considered permissible by Hanbalis to provide non-monetary assets (e.g., planes, ships) for Mudaraba capital. The Mudarib invests these assets and shares the returns from investing them with the provider of funds. The Mudarib should return the assets to the provider of funds at the end of the contracting period.

1/3/3 Capital cannot be in the form of debt (due from a third party or the Mudarib). Rather, capital should be readily available for use in cash or kind.

1/3/4 The Mudaraba capital should be paid to the Mudarib. Fuqaha differ on what constitutes payment. Some Fuqaha are of the view that payment should be made by transferring the funds from the provider of funds to the Mudarib, while other Fuqaha are of the view that payment means enabling the Mudarib to have disposition of the capital. However, contracting can be made in respect of the whole capital and the payment thereof to the Mudarib may be made in several instalments.

1/4 Profit is the amount earned in excess of capital. Profit is the end objective of Mudaraba. The following conditions as to profit shall be satisfied:

1/4/1 It should be for both parties, and no one party should have possession thereof without the other.

1/4/2 The proportional profit share of each party should be known at the time of contracting and it must be as a percentage of profit. The share of the Mudarib should be explicitly stated at the time of contracting. However, it should be known that

it is permissible to adjust the percentage of profit allocation between the two parties at a subsequent point in time.

1/4/3 The provider of funds bears all losses incurred from the Mudaraba, and the Mudarib shall not bear any portion thereof unless it arises from his misconduct or negligence.

1/5 Work represents the contribution provided by the Mudarib in return for the capital provided by the provider of funds. Work in this context relates to the management of the Mudaraba. The following conditions shall apply to such work:

1/5/1 Work is the exclusive right of the Mudarib without interference from the provider of funds. However, Hanbalis permit the participation of the provider of funds in the work.

1/5/2 The provider of funds should not restrict the Mudarib's action in such a way as to prevent him from achieving the objective of Mudaraba, i.e., profit.

1/5/3 The Mudarib should not violate Shari'a rules in his actions related to the Mudaraba, and should abide by the applicable current practice of the activity.

1/5/4 The Mudarib should abide by the conditions set by the provider of funds provided such conditions do not contradict those of the Mudaraba contract.

2. Mudaraba Rules

2/1 Limiting a Mudaraba to a certain period

Some Fuqaha permit the limiting of a Mudaraba to a certain period, while others do not permit it on the grounds that a Mudaraba contract is not permanently binding; i.e., each party has the right to nullify the contract whenever he wants.

2/2 Making the contract conditional on a future matter or event

This is permissible by some Fuqaha provided the implementation of the contract should not start unless the matter occurs or the future event takes place.

2/3 Guarantee in Mudaraba

This refers to the responsibility of the Mudarib to return the capital to the owner of funds in all cases. This is not permissible due to the fact that the Mudarib's possession of the fund is made as a trust, and the trustworthy person does not guarantee the fund except in the case of his trespass or omission. Nevertheless, some Fuqaha permit the owner of funds to ask for guarantees from the Mudarib against his trespass or omission. This is called betrayal guarantee. It is also permissible by some scholar of the Malikis school that a third party, who is out of the Mudaraba, may provide a guarantee. This was approved by the Islamic Fiqh Academy, but with certain conditions.

2/4 Rulings pertaining to work in Mudaraba

2/4/1 Type of activity. Shafis limit Mudaraba only to trade. However, other Fuqaha permit all types of profit oriented activities; e.g., trading, industrial, agricultural or services.

2/4/2 The limits of the Mudarib actions as to the Mudaraba funds:

- a) Actions which the Mudarib has the right to perform by virtue of the contract. These are the main and subsidiary work of the activity.
- b) Actions which the Mudarib has the right to perform by virtue of a general power of attorney. These are the actions that have no relation to the main activity, but assist in the investment process; e.g., commingling of the Mudaraba funds with the Mudarib's own funds.
- c) Actions which the Mudarib does not have the right to perform except by an explicit permission from the provider of the funds. For example, actions which are not conducive to earning a return on the funds; the creation of new obligations on the provider of funds, such as borrowing on the Mudaraba fund account.

2/4/3 Actions of the provider of funds in Mudaraba

- a) Actions related to decision taking; e.g. selling and purchasing. Such work may not be stipulated in the contract according to

the opinion of the majority of Fuqaha. However, even if the provider of funds carries out such work without stipulation, some Fuqaha permit it because he performs it while being under the mandate of the Mudarib.

- b) Purchasing of services from the provider of the funds; e.g., warehousing and transportation services. This is considered permissible by some Fuqaha.
- c) Dealing by the provider of funds, together with the Mudarib, using Mudaraba funds; e.g., selling or purchasing. This is considered permissible by some Fuqaha.
- d) Supervisory activity in respect of the Mudaraba funds in either the field or the office is permissible without any qualification.

2/5 Rulings pertaining to profit

2/5/1 Realization of profit

It is the time at which it can be established that profit is achieved in a Mudaraba. According to the Islamic Fiqh Academy, "Profits are due when realized, and owned by declaration or revaluation and become payable only upon distribution".⁽²⁾

2/5/2 Entitlement to profit

Hanafis, and some Shafis, say that profit should be recognized on a realization basis, whereas the Malikis, some Hanbalis, believe that profit should be recognized only when distributed between the two parties; i.e., on a cash basis.

2/5/3 Distribution of profit

Distribution of profit is conditional upon its realization, on agreement as to the basis of allocation and on returning the capital to the provider of the funds. Nevertheless, if both parties agreed to distribute profit without returning the capital;

(1) Islamic Fiqh Academy Resolution No. (5) para. 7, issued in respect of Muqaradah bonds and investment certificates in the fourth session of the Academy held in Jeddah during the period of 18–23 Jumada II, 1408 AH., corresponding to 6–11 February 1988 A.D.

i.e., during the life of the Mudaraba, then that is permissible according to majority of Fuqaha. However, Fuqaha have differed on the permanence of the possession of the distributed profit for both parties; i.e., the extent to which future losses can be made good from the distributed profits. In this case, the Mudarib would be asked to meet such losses out of the profit that had been distributed to him, and the amount distributed to the provider of the funds should be treated as a deduction from the capital.

2/6 Rulings pertaining to losses

- 2/6/1 As was said earlier, losses are borne only by the provider of the funds, and the Mudarib does not bear any portion thereof unless the loss was due to his misconduct or negligence. Fuqaha are in agreement on this.
- 2/6/2 Net losses at the time of winding up a Mudaraba are considered as a decrease in the Mudaraba capital, and the Mudarib shall return the remainder of the capital after deducting the loss. All Fuqaha are in agreement on this.
- 2/6/3 Periodic losses incurred in the course of a continuous Mudaraba shall be set off against previously earned profits that have not been distributed between both parties, if any. All Fuqaha are in agreement on this.
- 2/6/4 In a continuous Mudaraba, periodic losses that cannot be set off against previously earned and undistributed profits shall be held in suspense until profits are realized thereafter and set off against them. Such profits shall not be distributed until the losses are made good. If no profits are earned thereafter or if the earned profits do not cover these losses until the end of the contract, the losses shall then be treated as stated in 2/6/2. All Fuqaha are in agreement on this.
- 2/6/5 Periodic losses incurred in the due course of a continuous Mudaraba and preceded by earned profits that had been distributed shall be compensated therefrom according to the principle of non-permanence of the distributed profit.

2/6/6 Loss of the Mudaraba fund. If all of the Mudaraba fund is lost before or after the inception of activity, it shall be treated as an ordinary loss and borne by the provider of funds unless the loss incurred was due to misconduct or negligence by the Mudarib.

2/7 Rulings pertaining to violation on the part of the Mudarib

If the Mudarib violates the terms or purposes of the contract or the restrictions placed on him by the provider of the funds, he is guilty of misconduct and his status as a holder of the funds on trust changes into that of a guarantor; i.e., the nature of the possession of the funds changes from a Mudaraba to a debt due from the Mudarib. If the Mudarib disposes of the funds despite the violation and he gains profit, some Fuqaha say that all such profit should belong to the provider of the funds, while others say that all of it should belong to the Mudarib. Yet, another group says that such profit should be shared by the two parties.

2/8 Rulings pertaining to revocation of a Mudaraba

If a Mudaraba is revoked due to non-fulfilment of one of its terms and conditions, then the fund remains on trust in the possession of the former Mudarib because he becomes an employee and his actions in respect of the revoked Mudaraba fund may be valid and effective. If profit is realized from such actions, some Fuqaha argue that all of the profit should belong to the provider of funds and the former Mudarib should receive pay equivalent to that for similar activities, while other Fuqaha believe that the former Mudarib should receive the pay for equivalent work or the share of profit stated in the contract, whichever is lower. Yet, other Fuqaha are of the opinion that the Mudarib receives a percentage of the profit equivalent to what is earned in similar activities.

2/9 Rulings pertaining to termination of a Mudaraba

A Mudaraba is terminated either by agreement between both parties or by reason of force majeure, such as loss of all funds or the death of one of the two parties. Some of the rulings are as follows:

- 2/9/1 The Mudarib should return the capital to the provider of the funds. However, if the Mudarib does not, he will be considered to be in default, the funds will become guaranteed by him and the Mudaraba fund will be converted from a Mudaraba into a debt due from the Mudarib.
- 2/9/2 In case the Mudaraba is terminated and part or all of the funds are in goods which have not yet been sold, it is permissible that the two parties agree on the immediate sale of such assets, divide the assets between them or that one of them takes the assets to himself and gives the other his fair share of their value in cash. However, if the two parties differ as to selling the goods immediately or waiting until the lapse of a certain period, then if there is expectation of profit the opinion of the Mudarib will prevail; otherwise, the opinion of the provider of funds will prevail.

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 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 (Objectives Statement), and Financial Accounting Statement No. (2) : Concept of Financial Accounting for Islamic Banks and Financial Institutions (Concepts Statement), 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.

Mudaraba is considered to be the corner stone of Islamic banking whether in terms of the Islamic bank's relationship with investment accountholders or

in its relationship with those who request Mudaraba financing. Nevertheless, the field study revealed that Islamic banks do not deal much in Mudaraba due to the fact that it is not possible for the bank to interfere in the Mudarib's work in a way that would enable the Islamic bank to ensure the safe application of funds delivered thereto. To deal with this matter, reliable information should be made available on the actions related to Mudaraba funds. Hence, the preparation of a Mudaraba standard based on sound controls could help in making such information available. It is expected that this standard, which reflects the Islamic bank's role as provider of funds, would greatly affect the preparation of a future standard reflecting the role of the Islamic bank as a Mudarib.

The responses to the field study questionnaire conducted by the Accounting and Auditing Organization for Islamic Financial Institutions on some Islamic banks revealed that there were differences within Islamic banks in the measurement and recognition of Mudaraba financing transactions. The responses also revealed differences in the methods of presentation and disclosure. Such differences in accounting treatments and disclosure thereof have several effects. It may be difficult to compare the profits realized by one Islamic bank with those of another. This is likely to render the information produced by the Islamic bank less useful to users of its financial statements. Such differences may also affect the allocation of the results of joint financial 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 interested 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 values; 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 alternatives proposed in the preliminary study⁽³⁾ to be adopted in the accounting treatments of Mudaraba 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.

The juristic nature of Mudaraba is determined by the existence of two parties. One party provides the funds and the other is concerned with the work. Islamic banks use Mudaraba in their relationship with investment accountholders and in their relationship with those requesting Mudaraba financing. In the latter case, the Islamic bank performs a dual role in providing third parties with Mudaraba financing: as a Mudarib with the funds of investment accountholders and as an agent for shareholders. However, the accounting treatment in the Islamic bank's books as a Mudarib with the funds of investment accountholders differs from the accounting treatment of a Mudarib or of a provider of funds for those who request finance. This difference represents the basis on which the scope of this standard was determined; i.e., it is confined to the Islamic bank's role as a provider of funds through investing part of the available resources by means of Mudaraba financing.

Recognition and Measurement of Mudaraba Capital at Time of Contracting

It is a Shari'a requirement that capital should be known in terms of quantity and quality as this represents the basis of the value in which Mudaraba financing is presented in the Islamic bank's books.

(1) Muhammad Abdul-Halim Umar, "*Study of the Juristic and Accounting Aspects of the Mudaraba Standard*", Accounting and Auditing Organization for Islamic Finance Institutions, 1415 A.H.. – 1994 A.D.

It is also stipulated that capital should be in cash. In an opinion suitable to our present age, capital may be in kind (trading assets) and its value at the time of contracting as agreed between both parties shall be the Mudaraba capital. This represents the basis for determining the amount of Mudaraba capital at the time of contracting. The capital may also be in the form of non-monetary assets prepared for utilization and the fair value thereof at the time of contracting is considered the Mudaraba capital as this would be more reliable.

It is also a Shari'a requirement that capital should be paid to the Mudarib taking into consideration the opinion which says that payment is realized by enabling the Mudarib to dispose of the funds without requiring that his physical acquisition thereof has occurred. This represents the basis for keeping the Mudaraba amount in a Mudaraba funds and enabling the Mudarib to draw therefrom without recourse to the Islamic bank for approval.

There are two reasons for not using the historical cost basis to measure the non-monetary assets submitted by the Islamic bank as Mudaraba capital. These are:

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

Second: The use of the value agreed upon by the parties to the contract to value the non-monetary assets leads to the application of the representational faithfulness concept provided for in the Statement of Concepts. (para. 112)

Measurement of Mudaraba Capital After Contracting

The use of the historical basis to measure the Mudaraba capital provided by the Islamic bank after contracting (i.e., the avoidance of subsequent revaluation) is one of the requirements of Shari'a rules of Mudaraba in terms of specifying the capital and its maintenance up to the time of settlement of account in order to identify the profit. Profit is the amount earned in excess of the initial Mudaraba capital. This also conforms with the accounting measurement attribute provided for in the Statement of Concepts. (para. 98)

Recognition of the Islamic Bank's Share in Mudaraba Profits or Losses

If the Mudaraba financing transactions continue for more than one financial period, profits for a period resulting from partial or final settlement shall be recognized to the extent that the profits are being distributed, while losses for a period shall be recognized to the extent that such losses are being deducted from the Mudaraba capital. This is in accordance with the periodicity concept (Statement of Concepts, para. 74) which enables the preparation of financial reports in a way to achieve the objective of determining the rights and obligations of all interested parties, provided for in the Statement of Objectives. (para. 33)

This is consistent with the preponderant opinion of Fuqaha regarding the permanence of possession of profit that is periodically distributed to the provider of the fund and the Mudarib after a settlement of account is made. This represents the basis on which the Islamic bank's share of profits is presented in its income statement because these profits would be considered by the Islamic bank as realized profits and their possession thereof is ascertained.

It is a Shari'a condition that loss be borne by the provider of funds, particularly in the case where the Mudarib is not committing a misconduct or negligence. This represents the basis for the Islamic bank's recognition of the net Mudaraba loss at the end of the period in the income statement and the reduction of Mudaraba capital by the amount of loss.

Periodic losses that occur during the course of the Mudaraba are also set off against profits which have not been allocated. In case the whole or part of the Mudaraba fund is lost before being put to use, then it shall be considered as a loss of capital. This is the basis on which the Islamic bank as provider of funds recognizes losses in the same period in which they occur and the Mudaraba capital is reduced accordingly by the amount of the loss. This is because in this case the loss has occurred beyond the scope of Mudaraba and hence it is considered as a loss of the entrusted funds and its recognition cannot be delayed as is the case with ordinary Mudaraba losses. However, after the Mudaraba fund is put to use, the loss of part of the Mudaraba capital although borne by

the provider of funds (the Islamic bank), does not change the amount at which the original Mudaraba capital had been measured. This is because this loss has occurred during the course of the Mudaraba; i.e., after the original capital had been determined and put to use, and accordingly the Mudaraba capital should remain as it is through the period of the Mudaraba and the loss would have to be made good from future profits before any distribution of profits could be made.

In case the Mudarib is in default and has not returned the capital to the Islamic bank at the end of the contract, he will become a guarantor of the funds. This is the basis for converting the Mudaraba financing account, which is not paid to the Islamic bank at the end of the period, into a receivable account.

Appendix (E)

Definitions

Mudaraba

It is a partnership in profit between capital and work. It may be conducted between investment accountholders as providers of funds 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 provider 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 funds, on behalf of itself or on behalf of investment accountholders, and business owners and other craftsmen, including farmers, traders etc. Mudaraba differs from what is known as speculation which includes an element of gambling in buying and selling transactions. (It is to the former that this standard applies).

Unrestricted Investment Accounts⁽⁴⁾

With this type of account, the investment accountholder authorizes the Islamic bank to invest the accountholder's funds in a manner which the Islamic bank deems appropriate without laying down any restrictions as to where, how and for what purpose the funds should be invested. Under this arrangement the Islamic bank can commingle the investment accountholder's funds with its own funds or with other funds the Islamic bank has the right to use (e.g., current accounts). The investment accountholders and the Islamic bank generally share the returns on the invested funds. (Statement of Concepts, para. 12)

(4) Unrestricted participating investment bonds and any other accounts that are of a similar nature are equivalent to unrestricted investment accounts.

Restricted Investment Accounts⁽⁵⁾

With this type of account, the investment accountholder imposes certain restrictions as to where, how and for what purpose his funds are to be invested. Further, the Islamic bank may be required not to commingle its own funds with the restricted investment account funds for purposes of investment. In addition, there may be other restrictions which investment accountholders may impose. For example, investment accountholders may require the Islamic bank not to invest their funds in instalment sales transactions or without guarantor or collateral, or require that the Islamic bank itself should carry out the investment itself rather than through a third party (Statement of Concepts, para. 13).



(5) Restricted participating investment bonds and restricted participating investment units (investment funds) and any other accounts of a similar nature are equivalent to the restricted investment accounts.