Shari'ah Standard No. (8)

Murabahah*

(Revised Standard)

* This standard was previously issued by the title "Shari'ah Rules for Investment and Financing Instruments No. (1) Murabahah to the Purchase Orderer. It is reissued as a Shari'ah standard based on the resolution of the Shari'ah Board to reformat all Shari'ah Rules in the form of Shari'ah Standards.

Contents

IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

Preface

The purpose of this standard is to explain the Shari'ah basis and rules for a Murabahah transaction, the stages of this transaction beginning from the promise to transferring ownership of the goods to the customer, and the Shari'ah requirements that need to be observed by Islamic financial Institutions.(2)

(2) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

Statement of the Standard

1. Scope of the Standard

This standard covers the Murabahah transaction and its various stages, the issues relating to guarantees before concluding a Murabahah deal such as promise, *Hamish Jiddiyyah* (security deposit) and issues relating to guarantees for recovery of the debt created by the Murabahah transaction.

This standard does not cover deferred payment sales that take place on a basis other than that of Murabahah. It also does not cover other trust and bargaining sales.

2. Procedures Prior to the Contract of Murabahah

2/1 The customer's expression of his wish to acquire an item through the Institution

2/1/1 The Institution may purchase the item only in response to its customer's wish and application, as long as this practice is compatible with the Shari'ah precepts for the contract of sale.

2/1/2 With due consideration to item 2/2/3, it is permissible for the customer to request the Institution to purchase the item from a particular source of supply. However, the Institution is entitled to decline to carry out the transaction if the customer refuses offers from other sources of supply that are more suitable for the Institution.

2/1/3 The customer's wish to acquire the item does not constitute a promise or commitment except when it has been expressed in due form. It is permissible to prepare a single set of documentation to be signed by the customer and to include both the customer's stated wish that the Institution should buy the item from the supplier and a promise to buy the item from the Institution. It is permissible for the customer to prepare such

a document, or it may be a standard application form prepared by the Institution to be signed by the customer.

2/1/4 The customer may obtain statement of prices from the supplier whether they are addressed to the customer by name [specific offer], or with no reference to any named customer [general offer]. In the latter case, the statement is considered as an invitation to negotiate, and not as an offer of sale. It is preferable that the invoice should be addressed to the Institution so as to include an offer of sale from the supplier effective up to the end of a specified period. The contract of sale is deemed concluded once acceptance comes from the Institution.

2/2 The position of the Institution in respect to the application of the customer for Murabahah

2/2/1 When there is acceptance by the customer of an offer from the supplier that is either addressed to him personally, or that has no addressee, then the sale is concluded with the customer and so it is not permissible for the Institution to carry out Murabahah on the same item.

2/2/2 It is essential to exclude any prior contractual relationship between the customer who is the purchase orderer and the original supplier of the item ordered, if any, regarding the supply of the item. It is a requirement of Murabahah that the transaction between the two parties must genuinely, not fictitiously, exclude any prior contractual relationship.

It is not permissible to assign a contract that has been executed between the customer and the supplier of the ordered item to the Institution.

2/2/3 The Institution must ensure that the party from whom the item is bought is a third party other than customer or his agent. For example, it is not permitted for a customer to sell an ordered item to the Institution and then repurchase it through a Murabahah transaction. Nor may the party that is supplying the item be wholly, or by way of majority [more than 50%],

owned by the customer. If a sale transaction takes place and later on it is discovered that it was carried out through such practices, this would render the transaction void as it is tantamount to 'Inah.

2/2/4 If the supplier (owner) of the item has a blood relationship or marital relationship with the customer, then the Institution shall verify, before entering into Murabahah, that the sale is not fictitious and not a stratagem for the sale of 'Inah.

2/2/5 It is not permissible for the Institution and the customer to agree to form a Musharakah in a project or a specified deal together with a promise from one of them to buy the other's share in Musharakah by means of Murabahah on either spot or deferred payment terms. However, it is permissible for one partner to promise to purchase the other's share in Musharakah at market price or at a price to be agreed upon at the time of sale provided a new contract is drawn up. This sale may be on spot or on deferred payment terms.

2/2/6 It is not permitted to carry out a Murabahah on deferred payment terms where the asset involved is gold, silver or currencies.

2/2/7 It is also impermissible to issue negotiable Sukuk where the underlying asset consists of Murabahah receivables or other receivables only.

2/2/8 Likewise, it is not permitted to renew a Murabahah contract on the same commodity that was the subject matter of a previous Murabahah contract with the same customer, i.e. to refinance the transaction.

2/3 The promise from the customer

2/3/1 It is not permissible that the document of promise to purchase (signed by the customer) should include a bilateral promise which is binding on both parties (the Institution and the customer).

2/3/2 The customer's promise to purchase, and the related contractual framework, are not integral to a Murabahah transaction, but are intended to provide assurance that the customer will complete the transaction after the item has been acquired by the Institution. If the Institution has other opportunities to sell the item, then it may not need such a promise or contractual framework.

2/3/3 A bilateral promise between the customer and the Institution is permissible only if there is an option to cancel the promise which may be exercised either by both promisors or by either one of them.

2/3/4 It is permissible for the Institution and the customer, after the latter has given a promise but before the execution of the Murabahah, to agree to revise the terms of the promise whether with respect to the deferment of payment, the mark-up or other terms. The terms of the promise cannot be revised except by mutual consent by both parties.

2/3/5 It is permissible for the Institution to purchase the item from a supplier on a "sale or return" basis, i.e., with the option to return it within a specified period. If the customer then does not purchase the item, the Institution is able to return it to the supplier within the specified period on the basis of the conditional option that is established in Shari'ah. The option between the Institution and the supplier does not expire by the mere presentation of the item to the customer, but it expires by virtue of the actual sale to the customer. It is advisable to stipulate in a stipulated option to revoke (*khiyar al-Shart*) that the mere offer by the purchaser for the sale of the item to a third party does not invalidate the option.

2/4 Commissions and expenses

2/4/1 It is not permissible for the Institution to receive a commitment fee from the customer.

2/4/2 It is not permissible for the Institution to receive a fee for providing a credit facility.

2/4/3 The expenses of preparing the documents of the contract between the Institutions and the customer are to be borne evenly by the two parties (the Institution and the customer), provided they do not agree that the expenses are to be borne wholly by one party, and provided those expenses are proportional to the actual amount of work involved, so that they do not implicitly include a commitment fee or a facility fee.

2/4/4 If the Murabahah is carried out by means of syndicated financing, the Institution which acts as the arranger of the syndicate is entitled to an arrangement fee to be paid by the participants in the syndicate.

2/4/5 It is permissible for the Institution to receive a fee for a feasibility study that it undertakes in case such study is requested by the customer and for the benefit thereof and the customer agrees to pay the fee thereof. The customer is entitled to a copy of the study if he so requires.

2/5 Guarantees related to the commencement of the transaction

2/5/1 It is permissible for the Institution to obtain from the customer (the purchase orderer) a guarantee (performance deed) regarding the good performance by the supplier of his contractual obligations towards the Institution in his personal capacity and not in his capacity as purchase orderer or in his capacity as an agent of the Institution. Hence, if the Murabahah contract is not executed, his guarantee would still be valid. This guarantee is required only in cases where the customer has suggested a particular source of supply for the item that is the subject matter of the Murabahah contract.

As a consequence of this guarantee, the customer shall make good any damage suffered by the Institution due to failure of the supplier to provide good performance of his contractual obligations. These obligations concern meeting the specification

of the item to be supplied and the exercise of diligence in executing the contract, non-observance of which may result in the loss of the Institution's time and efforts or property, or in a legal dispute and damage claims.

2/5/2 It is not permitted to impose on a customer who is the purchase orderer a guarantee regarding hazards that may affect the item such as damage and destruction during a period of shipment or storage.

2/5/3 It is permissible for the Institution, in the case of a binding promise by the customer, to take a sum of money as *Hamish Jiddiyyah* (security deposit). This is to be paid by the customer at the request of the Institution, both as an indication of the financial capacity of the customer and to ensure the compensation of any damage to the Institution arising from a breach by the customer of his binding promise. Having taken this *Hamish Jiddiyyah*, the Institution need not to demand compensation for damage as this may be charged against the *Hamish Jiddiyyah*. The *Hamish Jiddiyyah* is not considered as 'Arboun (Earnest Money). The amount of money deposited by the customer as security for his commitment can be either held, if the customer permits the Institution to invest it, as an investment trust on the basis of Mudarabah between the customer and the Institution, or held in a current account at the discretion of the customer.

2/5/4 In the case of the customer's breach of his binding promise, the Institution is not permitted to retain *Hamish Jiddiyyah* as such. Instead, the Institution's rights are limited to deducting the amount of the actual damage incurred as a result of the breach, namely the difference between the cost of the item borne the Institution and the price at which the item is sold to a third party. The actual damage to the Institution may not include the loss of its mark-up in the Murabahah transaction, that is, its opportunity loss.

2/5/5 When the customer has fulfilled his promise and executed the contract of Murabahah, the Institution must refund *Hamish Jiddiyyah* to the customer. The Institution is not entitled to receive any amount out of *Hamish Jiddiyyah* except in the case of breach of promise as laid down in item 2/5/3. It is permissible for the Institution to agree with the customer that the amount of *Hamish Jiddiyyah* will be deducted from the price payable by the customer pursuant to the contract of Murabahah.

2/5/6 It is permissible for the Institution to take 'Arboun (Earnest Money) upon conclusion of the Murabahah sale with the customer. This may not be done during the contractual stage at which the customer has given his promise to purchase. In the event that the customer revokes the contract in an 'Arboun-based transaction, it is preferable that the Institution, after deducting the actual damage it incurs, refunds the remaining amount of 'Arboun to the customer. The damage in this context means the difference between the cost of the item borne the Institution and the price at which the item is sold to a third party.

3. Acquisition of Title to, and Possession of, the Asset by the Institution or Its Agent

3/1 The acquisition of the asset or good by the Institution prior to its sale by means of Murabahah

3/1/1 The Institution shall not sell any item in a Murabahah transaction before it acquires such item. Hence, it is not valid for the Institution to conclude a Murabahah sale with the customer before the Institution concludes a urchase contract with the supplier of the item the subject matter of the Murabahah and before it acquires actual or constructive possession of such items, which can be achieved when the supplier gives the Institution control over the item or the documents that represent possession thereof [see items 3/2/1-3/2/4]. Likewise, the Murabahah is considered void in case the contract with the supplier is void, because

in this case the Institution would fail to acquire complete title to the item.

3/1/2 It is permitted that the contract between the Institution and the supplier be completed by means of a meeting of the two parties to discuss the details, at which point the contract may be executed. Likewise, it is permitted that the contract be completed through exchanging of the notices of offer and acceptance, either in writing or by any form of modern communication customarily practiced according to known principles.

3/1/3 The original principle is that the Institution itself purchases the item directly from the supplier. However, it is permissible for the Institution to carry out the purchase by authorizing an agent, other than the purchase orderer, to execute the purchase; and the customer (the purchase orderer) should not be appointed to act as an agent except in case of a dire need. Furthermore, the agent must not sell the item to himself. Rather, the Institution must first acquire title of the item and then sell it to the agent. In such a case, the provisions of item 3/1/5 should be observed.

3/1/4 In cases when the customer is authorized to purchase the item as the Institution's agent, it is obligatory to adopt procedures which would ensure that certain conditions are observed. These conditions include:

a) the Institution itself must pay the supplier, and not pay the price of the item into the account of the customer as agent, whenever possible.

b) the Institution should obtain from the supplier the documents that confirm that a sale has taken place.

3/1/5 It is obligatory to separate the two liabilities of risk attaching to the purchased item, namely the liability of the Institution and the liability of the customer as agent of the Institution. This is achieved by having an interval in time between the

performance of the agency contract and the execution of the contract of Murabahah, as indicated in the customer's notice of performance of the agency contract to acquire the item and offer to purchase the item by means of Murabahah [see Appendix (a)], followed by the institution's notice of its acceptance of the customer's offer to purchase and the execution of the Murabahah sale contract [see Appendix (b)].

3/1/6 The original principle is that all documents and contracts concerned with the execution of the sale of the item must be in the name of the Institution and not in that of the customer, unless the latter acts as the Institution's agent in acquiring the item.

3/1/7 It is permissible, at the time when the Institution appoints someone as its agent for the acquisition of the item, that the two parties agree to authorize the agent to carry out the acquisition of the item as agent, without disclosing the existence of the agency agreement. In this case, the agent will act as principal in dealing with other parties, and will undertake the purchase directly in his name but on behalf of the Institution as principal. However, it is preferable that the agent's role be disclosed.

3/2 The Institution's taking possession of the asset or good, prior to its sale by Murabahah

3/2/1 It is obligatory that the Institution's actual or constructive possession of the item be ascertained before its sale to the customer on the basis of Murabahah.

3/2/2 The condition that possession of the item must be taken by the Institution (before its onward sale to the customer) has a specific purpose: that the Institution must assume the risk of the item it intends to sell. This means that the item must move from the responsibility of the supplier to the responsibility of the Institution. Similarly, it is obligatory that the point when the risk of the item is passed on by the Institution to the customer

be clearly identified, with reference to the stages in which the item is transferred from one party to another.

3/2/3 The forms of taking delivery or possession of items differ according to their nature and different trade customs. Taking possession may be actual in the case of the physical delivery or transportation to the acquirer or its agent, but may also take place constructively by placing of the item at the acquirer's disposal so as to enable him to deal with it at his will, even though no physical delivery has taken place. Taking possession of an item of real property may also take place by means of the property being vacated and its being placed at the acquirer's disposal; if the latter is not able to have disposal of the purchased item, then the vacation of the property is not considered as conveying possession. In the case of moveable assets, possession will take place in accordance with the nature of the asset.

3/2/4 The receipt of a bill of lading by the Institution or its agent, when purchasing goods on the international market, is considered as constructive possession. The same would apply to the Institution's receipt of certificates of storage issued by warehouses following appropriate and reliable formalities.

3/2/5 The original principle is that the Institution itself must receive the item from the premises of the supplier or from a location that is specified in the delivery conditions. The responsibility for the risk attached to the item is transferred to the Institution upon its taking possession of the item. However, it is permissible for the Institution to authorize another party to take delivery of the item on its behalf.

3/2/6 As the Institution is the owner of the subject matter of Murabahah its insurance lies with the Institution before selling it to the customer. Any amount recovered from insurance at this stage will belong to the Institution exclusively and the customer has no claim to it even if the recovered amount exceeds the purchase price. The Institution is entitled to include

the expenses of insurance in the Murabahah cost price to be subsequently added to the price of Murabahah. Insurance must be on the basis of Takaful whenever possible.

3/2/7 Agency in carrying out the procedures of obtaining insurance cover for the item at the stage of the Institution's acquisition of ownership of the asset is permitted. However, it is obligatory that the Institution should bear the cost of insurance.

4. Conclusion of a Murabahah Contract

4/1 It is not permitted for the Institution to consider that the contract of Murabahah is automatically concluded by its mere taking possession of the asset. Likewise, the Institution may not force a customer who is the purchase orderer to take delivery of the asset and pay the Murabahah selling price, if the customer refuses to conclude the Murabahah transaction.

4/2 The Institution is entitled to receive compensation for any actual damage it has incurred as a result of the customer's breach of a binding promise. The compensation consists of the customer reimbursing the Institution for any loss due to a difference between the price received by the Institution in selling the asset to a third party and the original cost price paid by the Institution to the supplier.

4/3 When the Institution has purchased an asset for a deferred price, with the intention that it will be sold on a Murabahah basis, then the Institution is obliged to disclose to the customer that the asset is purchased by the Institution on deferred payment basis. The Institution has the obligation to disclose to the customer, when concluding the contract of sale, the details of any expenses that it would include in determining the cost. The Institution is also entitled to include any expenses relating to the item if this is acceptable to the customer. However, if the Institution failed to disclose any expenses, it is not entitled to include them unless they are customarily considered as normal expenses, such as transportation expenses, storage expenses, fees for letters of credit and insurance premiums.

4/4 The Institution is not entitled to include in the base cost of the item, for the purpose of calculating the Murabahah price, any amounts other than the direct expenses that are paid to a third party. It is not permissible, for example, for the Institution to add to the cost of the item payments made to its own staff for their work, and the like.

4/5 If the Institution has, even after the drawing up of the Murabahah contract, received a discount for the same item that was sold on Murabahah basis from the supplier of the item, then the customer should benefit from that discount by a reduction of the total Murabahah selling price in proportion to the discount.

4/6 It is an obligation that both the price of the item and the Institution's profit on the Murabahah transaction be fixed and known to both parties on the signature of the contract of sale. It is not permitted under any circumstances to subject the determination of the price or the profit to unknown variations or variations that are determinable in the future, such as by concluding the sale and making the profit dependent on the rate of LIBOR that will prevail in the future. There is no objection to referring to any other known indicators during the promise stage as a comfort indicator to determine the rate of profit, provided that the determination of the Institution's profit at the time of concluding the Murabahah is based on a certain percentage of the cost and is not tied up with LIBOR or a time factor.

4/7 The Institution's profit mark-up in Murabahah must be known, and the mere mention of the total selling price is not sufficient. It is permissible that the profit be determined based on a lump sum amount or a certain percentage of the cost price only or of the cost price plus the expenses. This determination is completed by the agreement and mutual consent of the two parties.

4/8 It is permissible to agree on the payment of the price of the item under Murabahah either by short or long term instalments, and the selling price of the asset becomes a debt that the customer is obligated to pay at the time agreed upon. It is not permitted subsequently to demand any extra payment either in consideration of extra time

given for payment or for delay in payment that may be for a reason or no reason.

4/9 It is permissible for the Institution to stipulate in the contract of Murabahah a condition that the Institution is free from responsibility for all or some of the defects of the asset, but not from destruction caused before the possession of the customer or diminution of quantity sold; this is known as *Bay' al-Bara`ah* (sale on 'as is' basis). In the case of stipulating such a condition, it is preferable that the Institution should assign to the customer the right of recourse to the supplier to obtain compensation for any defects that are established, which would otherwise be recoverable by the Institution from the supplier.

4/10 The Institution shall be responsible for pre-existing hidden defects which appear after the conclusion of the contract, unless it stipulates otherwise according to item 10/4. However, it shall not be responsible for any new defects (recent defects) that arise after the conclusion of the contract and taking delivery by the customer.

4/11 The Institution is entitled to include, as a condition of the contract, that in case of the customer's refusal, after the execution of the Murabahah contract, to take delivery of the asset at the prescribed time, the Institution could revoke the contract or sell the asset to a third party on behalf of the customer and for his account. The Institution could then recover from the selling price the amount due to it from the customer under the contract, and would have recourse to the customer for the balance if that price were not sufficient to cover the amount due to the customer.

5. Guarantees and Treatment of Murabahah Receivables

5/1 It is permissible for the Institution to stipulate to the customer that instalments may become due before their originally agreed due dates in case of the customer's refusal or delay in paying any instalment without any valid reason after the lapse of the time specified in the notice to be sent by the Institution to the customer within a reasonable period of time following the due date.

5/2 The Institution should ask the customer to provide permissible security in the contract of Murabahah. Among other things, the Institution may receive a third party guarantee or the mortgagee of the investment account of the customer or the mortgagee of any item of real or moveable property, or the mortgagee of the subject matter of the Murabahah contract as a fiduciary mortgagee (or a registered charge), either without taking possession of the mortgageed asset, or by taking possession of the mortgageed asset and then releasing the mortgagee progressively according to the percentage of the total payment received.

5/3 It is permissible for the Institution to require the customer to provide cheques or promissory notes before the execution of the contract of Murabahah, as a guarantee of the indebtedness that will be created after the execution of the contract. This is possible on the written condition that the Institution is not entitled to use these cheques or documents except on their due dates. The requirement to provide cheques as security is not permissible in countries where they could be presented for payment before their due date.

5/4 It is not permissible to stipulate that the ownership of the item will not be transferred to the customer until the full payment of the selling price. However, it is permissible to postpone the registration of the asset in the customer's name as a guarantee of the full payment of the selling price. The Institution may receive authority from the customer to sell the asset in case the customer delays payment of the selling price, in which case the Institution should issue a counter-deed to the customer to establish the latter's right to ownership. If the Institution sells the asset as a result of the customer's failure to make a payment of the selling price on its due date, it must confine itself to recovering the amount due to it and must return the balance to the customer.

5/5 In the case of the Institution receiving a mortgagee from the customer, the Institution is entitled to stipulate that the customer should make an assignment to the Institution to enable it to sell the mortgageed

asset for the purpose of recovering the amount due from the customer without recourse to the judiciary.

5/6 It is permissible that the contract of Murabahah consists of an undertaking from the customer to pay an amount of money or a percentage of the debt, on the basis of undertaking to donate it in the event of a delay on his part in paying instalments on their due date. The Shari'ah Supervisory Board of the Institution must have full knowledge that any such amount is indeed spent on charitable causes, and not for the benefit of the Institution itself.

5/7 It is not permissible to extend the date of payment of the debt in exchange for an additional payment in case of rescheduling, irrespectively of whether the debtor is solvent or insolvent.

5/8 When there is default in payment by the customer with regard to instalments of the selling price that are due, the amount due is just the amount of the unpaid selling price. It is not permissible for the Institution to impose any additional payment on the customer for the Institution's benefit. This provision is, however, subject to item 5/6 .

5/9 It is permissible for the Institution to give up part of the selling price if the customer pays early, provided this was not part of the contractual agreement.

5/10 If the customer wishes to pay in a currency different from Murabahah currency, it is permissible, with the agreement of the Institution at the time of payment on condition that the payable debt is paid in full or the amount agreed to be paid in different currency is paid in full and no part of the currency exchange amount remains due. This currency exchange may not be stipulated in the contract of Murabahah.

6. Date of Issuance of the Standard

This Standard was issued on 4 Rabi' I, 1423 A.H., corresponding to 16 May 2002 A.D.

Adoption of the Standard

The Shari'ah standard for Murabahah was adopted by the Shari'ah Board in its meeting No. (4) held on 25-27 Safar 1421 A.H., corresponding to 29-31 May 2000 A.D.

In its meeting No. (8) held in Mecca on 28 Safar - 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D., the Shari'ah Board readopted a resolution to reformat the Shari'ah rules for Murabahah in the form of a Shari'ah standard.

Appendix (A)
Notice from Institution's Customer of Its Performance of Purchasing Asset or Good As Agent for Institution, and of Its Offer to Purchase Item from Institution According to Contract of Murabahah

Notice from the institution's customer of its performance of the purchase of the asset or good as agent for the institution:

From: (The Institution's customer as agent) .....

To: (The Institution).....

In the performance of my contract of agency with you, I hereby inform you that I have purchased the item described below on your behalf and for your benefit. This item is in my possession on your behalf.

In accordance with my promise to you, I hereby agree to purchase this item from you for a total price of ….., namely the cost price of ….. plus the mark-up of …...

The payment of this price will be in accordance with the following schedule of instalments:

- ……..

- …….

- ……..

Please send the acceptance in accordance with this offer.

Appendix (B)
Notice of Acceptance by Institution of Customer's Offer to Purchase Asset or Good to Be Acquired, and of selling item by Institution to Customer

Notice of the acceptance by the Institution of the customer's offer to purchase the asset or good to be acquired:

From: (The Institution).....

To: (The customer as the Institution's agent).....

In response to your notice dated ….., containing your offer to purchase the item described below which is owned by us, we hereby confirm to you our sale of the item to you at a total price of ….. comprising the cost price of ….. plus the mark-up of ….., in accordance with the conditions explained in the general agreement to a contract of Murabahah.

Please send the acceptance in accordance with this offer.

Appendix (C)
Brief History of the Preparation of the Standard

In its meeting No. (1) held on 11 Dhul-Hajjah 1419 A.H., corresponding to 27 February 1999 A.D., the Shari'ah Board decided to give priority to the preparation of a Standard setting out the Shari'ah rules for Murabahah.

On Tuesday 13 Dhul-Hajjah 1419 A.H., corresponding to 30 March 1999 A.D., the Fatwa and Arbitration Committee recommended to the Shari'ah Board the commissioning of a Shari'ah consultant to prepare a juristic study and an exposure draft of the Shari'ah Rules for Murabahah.

In its meeting held on 13-14 Rajab 1420 A.H., corresponding to 22-23 October 1999 A.D., the Fatwa and Arbitration Committee discussed the exposure draft of the Shari'ah Rules for Murabahah, and asked the consultant to make the amendments in light of the comments made by the members.

The revised exposure draft of the Shari'ah Rules was presented to the Shari'ah Board in its meeting No. (2) held in Mecca on 10-15 Ramadan 1420 A.H., corresponding to 18-22 December 1999 A.D. The Shari'ah Board made further amendments to the exposure draft of the Shari'ah Rules and decided that it should be distributed to specialists and interested parties in order to obtain their comments in order to discuss them in a public hearing.

A public hearing was held in Bahrain on 29–30 Dhul-Hajjah 1421 A.H., corresponding to 4-5 April 2000 A.D. The public hearing was attended by more than 30 participants representing central banks, institutions, accounting firms, Shari'ah scholars, academics and others who are interested in this field. The members responded to the written comments that were

sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Studies Committee and the Fatwa and Arbitration Committee held a joint meeting on 21-23 Muharram 1421 A.H., corresponding to 26-28 April 2000 A.D., to discuss the comments made about the exposure draft of the Shari'ah Rules. The joint meeting made the necessary amendments, which it deemed necessary in light of the discussions that took place in the public hearing.

The Shari'ah Board in its meeting No. (4) held on 25–27 Safar 1421 A.H., corresponding to 29–31 May 2000 A.D., in Al-Madinah Al-Munawwarah discussed the amendments made by the Shari'ah Studies Committee and the Fatwa and Arbitration Committee, and made the necessary amendments, which it deemed necessary. The standard was adopted with the name of "Shari'ah Rules for the Murabahah". Some paragraphs were adopted by the unanimous vote of the members of the Shari'ah Board, while the other paragraphs were adopted by the majority vote of the members, as recorded in the minutes of the Shari'ah Board.

The Shari'ah Board decided in its meeting No. (7) held in Makkah Al-Mukarramah on 9-13 Ramadan 1422 A.H., corresponding 24-28 November 2001 A.D., to pass a resolution to reformat all Shari'ah rules in a form of standards and a committee was formed for this purpose.

In its meeting No. (8) held in Al-Madinah Al-Munawwarah on 28 Safar - 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D., the Shari'ah Board adopted the reformatting of the Shari'ah Rules for Investment and Financing No. (1) on Murabahah with the name of Shari'ah Standard No. (8) on Murabahah.

The Shari'ah Standards Review Committee reviewed the standard in its meeting held in Rabi' II, 1433 A.H., corresponding to March 2012 A.D., in the State of Qatar, and proposed after deliberation a set of amendments (additions, deletions, and rephrasing) as deemed necessary, and then submitted the proposed amendments to the Shari'ah Board for approval as it deemed necessary.

In its meeting No. (39) held in the Kingdom of Bahrain on 13-15 Muharram 1435 A.H., corresponding to 6-8 November 2014 A.D., the Shari'ah Board discussed the proposed amendments submitted by the Shari'ah Standards Review Committee. After deliberation, the Shari'ah Board approved the necessary amendments, and the standard was adopted in its current amended version.

Appendix (D)
The Shari'ah Basis for the Standard

Preface on the Permissibility of Murabahah

Definition of Murabahah

Murabahah is selling a commodity as per the purchasing price with a defined and agreed profit mark-up. This mark-up may be a percentage of the selling price or a lump sum. This transaction may be concluded either without a prior promise to buy, in which case it is called an ordinary Murabahah, or with a prior promise to buy submitted by a person interested in acquiring goods through the Institution, in which case it is called a "banking Murabahah" i.e. Murabahah to the purchase orderer. This transaction is one of the trust-based contracts that depends on transparency as to the actual purchasing price or cost price in addition to common expenses.

Permissibility of Murabahah

The authorities for the permissibility of Murabahah are authorities on the permissibility of sale. Among them is the saying of Allah, the exalted: ***{"...Allah has permitted trade..."}***.(3) Some scholars has also cited to support the permissibility of Murabahah the saying of Allah, the Exalted: ***{"It is no crime for you to seek the bounty of your Lord,"}***(4) arguing that the bounty mentioned here means profit. The Murabahah is also analogous to a form of sale called *Tawliyyah* (which means to sell as per the purchasing price without making profit). This is because the Prophet (peace be upon him) purchased a she-camel from Abu Bakr to use it as a transportation to immigrate to Medina. Abu Bakr wanted to give it to the Prophet (peace be upon him) free of charge, but the Prophet refused

(3) [Al-Baqarah (The Cow): 275].
(4) [Al-Baqarah (The Cow): 198].

saying: *"I will preferably take it at the acquisition price"*. The majority of scholars agreed, in principle, on the permissibility of Murabahah.

Promise from the Purchase Orderer

- The basis for the permissibility of responding to the application of the customer that the Institution buys the commodity from a particular supplier is because such a demand will not affect the acquisition of the commodity by the Institution, especially in view of the fact that this demand is not binding. The Institution is entitled to acquire the commodity from another supplier provided the commodity complies with the desired specification. The customer may be forced to fulfil his obligation on the basis of general sources of the Qur`an and Sunnah that require fulfilment of obligation and undertaking. The International Fiqh Academy has issued a resolution endorsing a unilateral binding promise.(5) The same was adopted in a fatwa for Kuwait Finance House,(6) Qatar Islamic Bank,(7) and others.
- The basis for allowing price quotations be submitted in the name of customer is because such an act has no contractual effect if there is no acceptance by the customer. The basis why it is preferred that the quotation be submitted in the name of the Institution, is to avoid confusion and this is what was endorsed by the Fatwas of Qatar Islamic Bank,(8) and Kuwait Finance House.(9)
- The basis for not allowing a Murabahah deal when the customer accepts the deal directly from the supplier is because, by this, a sale contract has taken place between the customer and the supplier in which case the commodity enters into ownership of the customer. This ruling will not be affected whether or not the customer has paid the price. This is because payment is not a condition for the permissibility and conclusion of a contract as payment of the price is but a consequence of a contract and is not principal requirement or a condition for regarding a contract valid.

(5) International Fiqh Academy Resolution No. 40-41 (2/5 and 3/5).
(6) Fatwa No. (49).
(7) Fatwa No. (8).
(8) Fatwa No. (35).
(9) Fatwa No. (87).

- The basis for the requirement that there must not be any contractual commitment between the customer and the supplier is to safeguard against the contract being a mere interest-based financing. Therefore, the lack of any commitment between the customer and the supplier is a basic condition for the permissibility of executing a Murabahah by the Institution.
- The basis for the requirement that the customer must not have any (business) connection with the supplier is to avoid involving in a 'Inah (sell and buy back) transaction that is prohibited by Shari'ah.
- The basis for the permissibility that the supplier may be a relative of the customer or a husband or wife to the customer is because both parties have independent legal liability unless it has come to be that they are involved in a 'Inah transaction, in which case the transaction is prohibited. This is to defeat a potential intentional arrangement to evade formalities of the transaction. The Fatwa of Kuwait Finance House supports this.(10)
- The basis for not allowing a partner to promise to buy the shares of another partner on a Murabahah basis is because this will lead to the buyer guaranteeing the share of other partner, which is Riba.
- The basis for not allowing dealings in gold, silver and currencies on deferred Murabahah basis is the saying of the Prophet, peace be upon him, in respect to exchange of gold with silver that such exchange take place *"hand to hand"*;(11) i.e., without delay in delivery, and the rules of currencies are subsumed under the ruling for gold and silver. This ruling is endorsed by the resolution of the International Fiqh Academy.(12)
- The basis for the prohibition of Murabahah tradable securities or refinancing of a Murabahah transaction is because these fall under the heading of sale of debt that is prohibited by Shari'ah.
- The basis for not allowing a bilateral binding promise is because it amounts to a contract prior to acquisition of the item to be sold. The International Fiqh Academy has issued a resolution in this respect.(13)
- The basis for the permissibility of the agreement to amend the terms of the promise is because a promise is not a contract and as such the amendment

(10) Fatwa No. (55).
(11) The Hadith has been related by Muslim in his *"Sahih"*.
(12) International Fiqh Academy Resolution No. 63 (1/7).
(13) International Fiqh Academy Resolution No. 41(3/5).

of the profit margin and the duration will not amount to rescheduling of debt which is prohibited by Shari'ah.

- The basis for using options when buying on Murabahah is the case of Hiban Ibn Munqidh when the Prophet (peace be upon him), said to him: *"If you buy, a condition that there is no cheating and that you have a three day period for any of the goods bought. If you are satisfied, then keep it and if you are not satisfied, return it to the buyer."*(14) The ruling on the application of option in Murabahah is endorsed by a resolution issued during the second Fiqh Forum organised by Kuwait Finance House.
- The basis for the impermissibility of a commitment fee is because such a fee is in exchange for the right to contract, which is a mere intention and wish that is not a subject of exchange.
- The basis for the impermissibility of a facility commission is because it is not allowed to receive commission in the event of giving out a loan facility itself. It is therefore a logical conclusion to disallow commission for a mere readiness to finance the customer on a deferred payment basis.
- The basis for allowing that the expenses of preparing the document of contracts between the Institution and the customer be borne by the two parties is because both parties will equally benefit from this, and moreover there is no any impermissible act involved. The basis for the permissibility that these expenses may be borne by one of the parties is because this is a form of condition that is permissible.
- The basis for the permissibility of the customer guaranteeing the good performance of the supplier is because this guarantee secures rights and does not adversely affect any rules of the Murabahah transaction.
- The basis for not allowing that the customer guarantee the risk of transportation of the goods is because the safety of the goods is the responsibility of the owner and the customer is not the owner. Hence, the owner must bear the risk since the right to profit is associated with bearing risk.
- The basis for the permissibility of *Hamish Jiddiyyah* (security deposit) is because it is a form of guarantee for any financial damage that may occur.
- The basis for the permissibility of obtaining the earnest money to secure performance is the practice of Umar Ibn Al-Khattab (may Allah be pleased

(14) The Hadith has been related by Ibn Majah, *"Sunan Ibn Majah"* [2: 789].

with him) in the presence of some companions of the Prophet, peace be upon him,[15] which has been permitted by Imam Ahmad. A resolution has been issued in connection with the permissibility of 'Arboun (Earnest Money) by the International Islamic Fiqh Academy.[16]

Acquisition of Title to, and Possession of, the Asset by the Institution or its Agent

- The basis for the prohibition of selling a commodity before taking possession is the saying of the Prophet (peace be upon him): *"Do not sell what you own not"*[17] and the Hadith in which the Prophet (peace be upon him) prohibits a person from selling what he does not own.[18] The basis for preferring that the Institution appoint an agent other than the purchase orderer in case of the need to do so is to avoid a fictitious transaction that shows on paper that the acquisition is made on behalf of the Institution. This is necessary in order that the Institution appear as the real purchaser and in order to demarcate the liabilities of the parties, the liability of the Institution and the liability of the purchase orderer after the sale contract.
- The basis for the requirement that the Institution must pay the supplier directly is to avoid the risk of the contract degenerating into mere interest-based financing.
- The basis for the requirement that the liabilities of the parties -in case the Institution acquires the goods through agency- is to demarcate the two liabilities.
- The basis for the requirement that documents must be directed to the Institution is because the purchase is taking place on behalf of the institution.
- The basis for the requirement that the agent must explain to the supplier his agency status is to control the transaction and to determine the party to be referred to for the execution of the contract.

(15) The source of the Hadith has been stated earlier.
(16) Resolution No. 72 (3/8) in respect of 'Arboun (Earnest Money).
(17) The Hadith has been related by Al-Tirmidhi *"Sunan al-Tirmidhi"* [3: 534].
(18) The Hadith has been related by Al-Tabrani in *"Al-Mu'jam Al-Awsat"* [5: 66], Dar Al-Haramayn, Cairo, 1415 A.H.

- The basis for the requirement of possession before a sale contract is to ensure that the Institution becomes liable for the risk of destruction of the commodity before it is entitled to sell it.
- The basis for separating an agency contract from a Murabahah transaction is to be sure that there is no any intentional arrangement to connect the two contracts.
- The basis for the rule that constructive possession is sufficient to meet the requirement of possession and that possession is according to the nature of the items is because the Shari'ah did not state a particular form for possession. Rather this is left to the customary practices. Again, the purpose of possession is to enable one to have control over something. Therefore, any procedure that serves this objective would be regarded as possession.
- The basis for the requirement that the contract of agency be separate from the contract of sale on a Murabahah basis is because of the risk that the contracts may be connected to each other.
- The basis for the rule that the Institution bear the expenses of insurance is because these expenses follow ownership of the goods.

Conclusion of a Murabahah Contract

- The basis for the rule that the Institution is entitled to compensation in case of breach of a binding promise by the customer to buy the goods is because of the damage that may be inflicted on the Institution due to the act of the customer. This is because the customer has caused the Institution to enter into a deal that it would not have concluded in the absence of the promise. The International Islamic Fiqh Academy has issued a resolution in this respect.(19)
- The basis for the rule that the Institution's rights are limited, in case of breach of promise, to the difference between the cost of the item to the Institution and its selling price to a third party is because the lawful right in a guarantee is limited to the amount that compensates for the damage suffered and because the Institution's right to recover loss of its mark-up is irrational since there is no mark-up unless there is actually a Murabahah transaction and in this case there is no such transaction.

(19) International Islamic Fiqh Academy's resolution No. 40-41 (2/5 and 3/5).

- The basis for the requirement of transparency as to the cost price is because Murabahah is a trust related contract that requires disclosure of the amount and the currency of the cost price because a price in a deferred payment sale is higher.
- The basis for allowing normal expenses to be included in computing the selling price of the commodity is because these expenses are paid to a third party.
- The basis for entitlement of the buyer to benefit from the discount acquired by the Institution is because Murabahah is a mark-up sale. Therefore, if the previous purchasing price decreases then the cost price is the amount that remains after the discount and this price is the cost price for the purpose of the Murabahah.
- The basis for the requirement that the price and the profit in Murabahah must be determined is to avoid uncertainty and lack of knowledge.
- The basis for the requirement that the profit must be separately disclosed from the cost price and that it is not allowed to be calculated as a single amount for the customer is because Murabahah is a sale with a profit margin. Therefore, it is necessary this profit be disclosed separately to ensure that the customer will agree to it.
- The basis for the permissibility of instalment payment is because Murabahah is one of the sale contracts that are subject to spot payment, deferred payment or instalment payment. The basis for the impermissibility of requesting an additional sum of money for delay in payment is because this is the prohibited Riba.
- The basis for the permissibility of stipulating a defect exclusion item is because a buyer is entitled to require guaranteeing hidden defects which are related to the sold commodity by the seller. However, the buyer may relinquish this right by agreeing to a defect exclusion item, as stated by a number of scholars.(20)
- The basis for the permissibility of stipulating that the contract would be terminated for default in payment is because the original princi-

(20) See Al-Kasani, *"Bada`i' Al-Sana`i'"* [5: 276]; Al-Mawwaq, *"Al-Taj Wa Al-Iklil"* [4: 439]; Al-Shirazi, *"Al-Muhadhdhab"* [1: 284]; Ibn Qudamah, *"Al-Mughni"* [4: 129]; and Al-Buhuti, *"Kashshaf Al-Qina'"* [3: 228].

ple in respect to stipulations is validity and permissibility. In addition, this item does not render permissible an impermissible act or prohibit a permissible act. Hence, this item falls under the Hadith that says: *"Muslims are bound by the conditions they made, except a condition that renders permissible an impermissible act or prohibits a permissible act.*(21)

Guarantees in Murabahah and Treatment of Murabahah Receivables

- The basis for the condition that all instalments will become due if there is delay in payment is the Hadith of the Prophet, peace be upon him: Muslims are bound by the conditions they made, and because payment on a deferred basis is the right of the buyer, and the buyer may choose to pay before time and relinquish the deferral of the date of payment entirely or make payment of all instalments contingent on default on payment of one instalment.
- The basis for demanding collateral to secure payment is because such a requirement does not affect the contract; rather, it consolidates performance and such guarantees are relevant to contracts involving credit.
- The basis for not allowing a stipulation that delays transfer of ownership is because such a stipulation is against the effect of a sale contract, which is immediate transfer of ownership. The basis for allowing the Institution to hold up registering the commodity in the name of the customer until payment is realised is that such an action does not affect the transfer of ownership to the buyer.
- The basis for the permissibility of stipulating a condition, whereby the debtor in case of default is obliged to donate a sum of money in addition to the amount of the debt to be spent by the Institution on charitable causes, is because this has been considered as an instance of the commitment to make a donation, which is well established in the Maliki school of law. This

(21) This Hadith has been reported by number of the companions. It has been related by Ahmad in his *"Musnad"* [1: 312]. Ibn Majah through a good chain of transmission in his *"Sunan"* [2: 783], Mustafa Al-Babi Al-Halabi edition, Cairo, 1372 A.H./1952 A.D.; Al-Hakim in his *"Mustadrak"*, Hyderabad edition, India, 1355 A.H.; Al-Bayhaqi in his *"Sunan"* [6: 70 and 156] and [1: 133], Hyderabad edition, India, 1355 A.H.; and Al-Daraqutni in his *"Sunan"* [4: 228] and [3: 77], Dar Al-Mahasin Lil-Tiba'ah edition, Cairo, 1372 A.H./1952 A.D.

is the opinion of Abu Abdullah Ibn Nafi' and Muhammad Ibn Ibrahim Ibn Dinar, among the Maliki jurists.[22]

- The basis for the prohibition of additional payment over the principal debt in consideration for extension of time is because such action is a pre-Islamic form of Riba.
- The basis for the permissibility of discount or rebate for earlier payment is because discount for early payment is a form of settlement between the creditor and the debtor to pay less than the amount of the debt. This is among the settlement that are endorsed by Shari'ah as stated in the case of Ubay Ibn Ka'b (may Allah be pleased with him) and his debtor where the Prophet (peace be upon him) suggested to him in words: *"write off a portion of your debt."*[23] The International Islamic Fiqh Academy has issued a resolution in support of this rule.[24]
- The basis of the permissibility of payment of debt in another currency is that this would entail the settlement of the debt by discharging it. This does not involve any prohibited transaction pertaining to debts either with regard to sale or purchase.

As for some of the forms mentioned in the standard, there are texts to support them, inter alia, the Hadith reported on the authority of Ibn Umar (may Allah be pleased with him) who said: "I have met the Prophet (peace be upon him) at the house of Hafsah (may Allah be pleased with her), and I said to him: 'O Prophet of Allah, I would like to ask you: 'I sell a camel in Al-Baqi' for a price quoted in dinar but I take dirham, and I sell for a price quoted in dirham but I take dinars, I take this from this and I give this from this.' The Prophet (peace be upon him) replied: *'There is no objection to your taking the other currency based on the price of the day, provided you do not leave each other with something remaining owed as a debt between you'."*[25] Some of the forms in the standard are a kind of set-off and this is permissible.

(22) See the book entitled: *"Tahrir Al-Kalam Fi Masa`il Al-Iltizam"* by Al-Hattab. This rule has been endorsed by the resolutions and recommendations of the Fourth Fiqh Forum organized by the Kuwait Finance House.

(23) The Hadith has been related by Al-Bukhari: *"Sahih Al-Bukhari"* [1: 179] and [2: 965].

(24) The International Islamic Fiqh Academy Resolution No. 64 (7/2).

(25) Related by Abu Dawud, Al-Tirmidhi, Al-Nassa`i, Ibn Majah and Al-Hakim, who deemed it a sound Hadith. Al-Dhahabi agreed with Al-Hakim. It was also narrated without a chain of narrators, quoting only Ibn Umar: *"Al-Talkhis Al-Habir"* [3: 26].

Appendix (E)
Definitions

Murabahah

It is the sale of a commodity by an institution to its customer (the purchase orderer) as per the purchasing price/cost with a defined and agreed profit mark-up (as set out in the promise/*Wa'd*), in which case it is called a banking Murabahah. The banking Murabahah involves deferred payment terms, but such deferred payment is not one of the essential conditions of such transaction, as there is also a Murabahah arranged with no deferral of payment. In this case, the seller only receives a mark-up that only includes the profit for a spot sale and not the extra charge it would, otherwise, receive for deferral of payment.

Commitment Fee

A commitment fee is the percentage or amount which the Institution takes from the customer to start processing the transaction even though a sale contract may not be concluded).

'Arboun

The term 'Arboun means an amount of money that the customer as purchase orderer pays to the Institution after concluding the Murabahah sale, with the provision that if the sale is completed during a prescribed period, the amount will be counted as part of the price. If the customer fails to execute the Murabahah sale, then the Institution may retain the whole amount.

Syndicated Financing

A syndicated financing is a partnership relationship for financing a particular project which two or more parties has interest to finance. They will distribute the profit or revenue as per agreement. In other words, syndicated financing is the acceptance of a number of companies (financial Institutions) to enter into a joint investment transaction through one of the permissible investment instruments with an understanding that one of the

parties assumes leadership of the deal. During the period of the transaction, the transaction would enjoy an independent liability separated from their companies.

Credit Facility

A credit facility is an upper limit for a customer's Murabahah transactions. This credit facility may be restricted to a specified type of item, or to a specified period of time.

Shari'ah Standard No. (9)

Ijarah and Ijarah Muntahia Bittamleek*

(Revised Standard)

* This standard was previously issued by the title "Shari'ah Rules for Investment and Financing Instruments No. (2) Ijarah and Ijarah Muntahia Bittamleek. It was reissued as a Shari'ah standard based on the resolution of the Shari'ah Board to reformat all Shari'ah Rules in the form of Shari'ah Standards.

Contents

IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

Preface

This standard outlines the basis of the Shari'ah rulings on Ijarah and Ijarah Muntahia Bittamleek, beginning with the rules relating to the promise to lease, if any, and concluding with the rules of repossession of the leased property in an operating Ijarah by the lessor or transferring its ownership in case of Ijarah Muntahia Bittamleek, within or by the end of the lease term. The Standard also aims to outline the Shari'ah requirements that must be observed by Islamic financial Institutions (Institution/Institutions)[(2)] with respect to Ijarah transactions.

(2) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

Statement of the Standard

1. Scope of the Standard

This standard covers operating leases of properties or Ijarah Muntahia Bittamleek, whether the Institution is the lessor or the lessee.

This standard does not cover *Sukuk al-Ijarah*, as they are covered by Shari'ah Standard on Investment Sukuk, nor the employment of persons (labour contract), as it is covered by a separate standard.

2. Promise to Lease (an Asset)

2/1 In principle, an Ijarah contract is executed for an asset owned by the lessor or an usufruct owned by the sub-lessor. However, it is for a customer to request an Institution to acquire the asset or to acquire the usufruct of an existing asset which the customer wishes to take on lease.

2/2 In principle, Ijarah may be effected directly on the asset without any requirement of a preceding master agreement. However, it is permissible to have a master agreement drawn up coveringa number of Ijarah transactions between the Institution and the customer, setting out the general terms and conditions of agreement between the two parties. In this case, there may either be a separate lease contract for each transaction, in a specific written document signed by the two parties, or alternatively the two parties may exchange notices of offer and acceptance by referring to the terms and conditions contained in the master agreement.

2/3 It is permissible for the Institution to require the customer who has promised to lease to pay a sum of money to the Institution to ensure the customer's seriousness in accepting a lease on the asset and the subsequent obligations, provided no amount is to be deducted from

this sum except in proportion to the actual damage suffered by the Institution in case the customer does not fulfil his promise. Thus, if the customer, in case of Ijarah associated with a promise to transfer ownership, breaches his promise, the promisor shall be charged either the difference between the cost of the asset intended to be leased and the total lease rentals for the asset which is leased on the basis of Ijarah Muntahia Bittamleek to a third party, or, in case of operating Ijarah, the promisor breaching his promise shall be charged the difference between the cost of acquisition and the total selling price if sold to a third party by the Institution (promisee). Otherwise; i.e., in case it is not sold, the promisee shall not be entitled to receive any compensation.

2/4 The amount of money deposited by the customer as security for his commitment can be either held on trust in the custody of the Institution in which case the latter cannot invest it, or it may be held on an investment trust basis in which case the customer permits the Institution to invest it on the basis of Mudarabah between the customer and the Institution. It is permissible to agree with the customer, upon the execution of the contract of lease, that this amount shall be treated as an advance payment of the instalments of the lease rental.

3. Acquisition of the Asset to Be Leased, or Its Usufruct, by the Institution

3/1 For the permissibility of an Ijarah contract concerning a specified asset, the lease contract should be preceded by acquisition of either the asset to be leased or the usufruct of that asset.

3/1/1 If the asset or the usufruct thereof is owned by the Institution, which should in principle be the case, an Ijarah contract may be executed as soon as agreement is reached by the two parties.

3/1/2 However, if the asset is to be acquired by the customer [see item 3/2 below], or by a third party, the Ijarah contract shall not be executed unless and until the Institution has acquired that asset.

Ownership is possible under a sale contract, even if the title is not registered in the purchaser's name (the Institution), and the purchaser has the right to obtain a counter-deed to establish the actual transfer of his ownership of the asset. [see item 3/5 below]

3/2 An asset may be acquired by a party and then leased to that party. In this case, the Ijarah transaction should not be stipulated as a condition of the purchase contract by which the Institution acquires the asset.

3/3 A lessee of an asset may enter into a sub-lease contract with a party other than the owner for a rental that is either the same, lower or higher, payable either currently or on a deferred basis, unless the owner stipulates that the lessee should not assign or sublet the property to third parties, or should not do so without his approval.

3/4 The lessee may lease the asset back to its owner in the first lease period for a rental that is lower, same or higher than what he is paying, if the two rentals are paid on a spot basis. However, this is not permissible if it should lead to contract of 'Inah, by varying the rent or the duration. For example, it is not permissible, if the first rental is one hundred dinars payable on a spot basis, for the lessee to sublet it to the lessor for one hundred and ten dinars payable on a deferred basis, or if the first rental is one hundred and ten dinars payable on a deferred basis, for the second to be for one hundred dinars payable instantly, or if the two rentals are of the same amount, but the payment of the first rental is deferred for one month and the second rental is deferred for two months.

3/5 An Ijarah contract may be executed for an asset undertaken by the lessor to be delivered to the lessee according to accurate specifications, even if the asset so described is not owned by the lessor. In this case, an agreement is reached to make the described asset available during the duration of the contract, giving the lessor the opportunity to acquire or to produce it. It is not a requirement of this lease that the rental should be paid in advance as long as the lease is not executed according to the contract of Salam (or Salaf). Should the lessee receive

an asset that does not conform to the description, then he is entitled to reject it and demand an asset that conforms to the description.

3/6 An Institution's customer may jointly acquire an asset that he wishes to lease with the Institution, and then lease the Institution's share of the asset from the Institution. In this case, the rental specified as receivable by the Institution should only be in proportion to its share in the ownership of the asset, since the lessee is a co-owner of the asset and therefore has to pay rent only on the share that he does not own.

3/7 An Institution may appoint one of its customers to act as its agent in acquiring on its behalf an asset that is desired by that customer such as equipment, machinery, etc., whose description and price are fixed with a view to the Institution's leasing such asset or assets to the customer after it has acquired their ownership through either actual or constructive possession. Although this type of agency (for the purchase of the assets) is permissible, it is always preferred that the agent is someone other than the customer (prospective lessee) as far as possible.

4. Concluding an Ijarah Contract and the Forms of Ijarah

4/1 Signature of the contract and the consequences thereof

4/1/1 The lease contract is a binding contract which neither party may terminate or alter without the other's consent [see items 5/2/2, 7/2/1, and 7/2/2]. However, an Ijarah contract may be terminated in accordance with item 7/2/1.

4/1/2 The duration of an Ijarah contract must be specified in the contract. The period of Ijarah should commence on the date of execution of the contract, unless the two parties agree on a specified future commencement date, resulting in a future Ijarah, that is, an Ijarah contract to be executed at a future date.

4/1/3 If the lessor fails to deliver the asset to the lessee on the date specified in the Ijarah contract, no rental is due for the period

between the date specified in the contract and the date of actual delivery, and the rental should be reduced accordingly, unless it is agreed that the lease be extended by an equivalent period after its original expiry date.

4/1/4 'Arboun (Earnest Money) may be taken in respect of lease at the execution of the contract of lease, with the lessee having the right to terminate the contract during a specified period of time, and 'Arboun is treated as an advance payment of the rental. If the Ijarah contract is not executed for a reason attributable to the lessee, the lessor may retain the 'Arboun. However, it is preferable for the Institution to forgo any amount in excess of the actual damage it has suffered. [see para. 3/2]

4/2 Forms of the Ijarah contract

4/2/1 Ijarah contracts may be executed in respect of the same asset for different periods for several lessees, provided that two contracts are not executed in respect of the same asset for the same period. Such an arrangement is called "successive leases", because each Ijarah is considered as being successive to the previous one and not concurrent with it on the basis of its being a future Ijarah. [see item 4/1/2 above]

4/2/2 If the lessor signs an Ijarah contract for a particular asset for a specified period of time, he cannot sign another Ijarah contract with another lessee for the duration of the existing Ijarah period or for any remaining period thereof. [see item 7/1/2 below]

4/2/3 An Ijarah contract may be signed with several lessees being entitled to the same specified usufruct of a particular asset and duration of rent, without specifying a particular period of time for a particular person. In this case, each lessee may benefit from the property during the time assigned to him in accordance with specified rules. This case is one form of Muhaya`ah (time-sharing) in benefiting from the usufruct.

4/2/4 A lessee may invite others to share with him in the usufruct he owns. In this case, they become co-owners in the usufruct of the leased property. This can only be done before entering into a sub-lease. If the property is sub-leased after the co-owners having owned the usufruct each co-owner is entitled to a share in the sub-lease rental pro rata to his share in the usufruct.

5. Subject Matter of Ijarah

5/1 Rules governing benefit and leased property

5/1/1 The leased asset must be capable of being used while preserving the asset, and the benefit from an Ijarah must be permissible by Shari'ah. For example, a house or a chattel may not be leased for the purpose of an impermissible act by the lessee, such as leasing premises to be used as headquarters by an Institution dealing in interest or to a shopkeeper for selling or storing prohibited goods, or leasing a vehicle to transport prohibited merchandise.

5/1/2 The subject matter of Ijarah may be a share in an undivided asset held in common with the lessee, whether the lessee is a partner with the lessor or not. In this case the lessee may benefit from the leased share in the same way in which the lessor used to benefit from it, i.e., by usufruct division based on Muhāya'ah i.e. by identifying a particular time (time-sharing) or a particular part of the property, used alternately by the co-owners, or any other means with consent of the other partner.

5/1/3 An Ijarah contract may be executed for a house or a chattel, even with a non-Muslim, if the use to be made of it is permissible, such as a house for residential purposes, a car for transport, or a computer to store data, unless the lessor knows in advance, or has reason to presume, that the use of the asset to be leased will be for an impermissible purpose.

5/1/4 The lessee must use the leased asset in a suitable manner or in conformity with common practice, and comply with conditions which are acceptable in Shari'ah. He must also avoid causing

damage to the leased asset by misuse through misconduct or negligence.

5/1/5 The lessor must accept responsibility for any defects of the leased asset which impair the intended use of the asset, and may not exclude his liability for any impairment that the leased asset may sustain, either by his own doing or as a result of events outside his control, which affect the benefits intended to be available under the Ijarah contract.

5/1/6 If the benefit from the leased asset is impaired wholly or partially as a result of the lessee's misconduct, while the property remains under lease, the lessee is obliged to restore or repair the usufruct, and rent for the time during which the benefit is lost is not to be waived.

5/1/7 The lessor may not stipulate that the lessee will undertake the major maintenance of the asset that is required to keep it in the condition necessary to provide the contractual benefits under the lease. The lessor may delegate to the lessee the task of carrying out such maintenance at the lessor's cost. The lessee should carry out operating or periodical (ordinary) maintenance.

5/1/8 The leased asset is the responsibility of the lessor throughout the duration of the Ijarah, unless the lessee commits misconduct or negligence. The lessor may take out permissible insurance on it whenever possible, and such insurance expenses must be borne by the lessor. The lessor may take this into account implicitly when the lease rental is to be fixed. However, he may not, after the contract is signed, charge the lessee any cost in excess of the cost anticipated at the time of fixing the rent. The lessor may also delegate to the lessee the task of taking out insurance at the lessor's expense.

5/2 Rules governing lease rentals

5/2/1 The lease rental may be in cash or in kind (goods) or benefit (service). The rental must be specified, either as a lump sum

covering the duration of the Ijarah contract, or by instalments for parts of the duration. It may also be for a fixed or variable amount, according to whatever designated method the two parties agree upon. [see item 5/2/3 below]

5/2/2 The rental is made obligatory by the contract and the lessor's entitlement to the rental runs from the time when the lessee starts to benefit from the asset or once the lessor makes the usufruct of the asset available to the lessee, and the entitlement to the rental does not necessarily commence on the date of signing the Ijarah contract. The rental may be paid entirely in advance or in instalments during a period equivalent, or more or less, to the duration of the Ijarah. However, if the asset is made available only after a period longer than what customary practices deem proper, then no payment shall be obligatory.

5/2/3 In case the rental is subject to changes (floating rental), it is necessary that the amount of the rental of the first period of the Ijarah contract be specified in lump sum. It is then permissible that the rentals for subsequent periods be determined according to a certain benchmark. Such benchmark must be based on a clear formula which is not subject to dispute, because it becomes the determining factor for the rentals of the remaining periods. This benchmark should be subject to a ceiling, on both maximum and minimum levels.

5/2/4 It may be agreed that the rental should consist of two specified parts: one to be paid or transferred to the lessor and the other to be held by the lessee to cover any expenses or costs approved by the lessor, such as the cost of major maintenance, insurance, etc. The excess of the second part of the rental shall be treated as an advance to the lessor on account, while the lessor shall bear any shortage.

5/2/5 The amendment of future rentals is permissible by the agreement of both parties, i.e. the periods for which the lessee has not yet received any benefit. The rentals of any previous periods which

have not yet been paid become a debt owed to the lessor by the lessee, and therefore cannot be increased.

6. Guarantees and Treatment of Ijarah Receivables

6/1 Permissible security, of all kinds, may be taken to secure the rental payments or as a security against misuse or negligence on the part of the lessee, such as a charge over assets, guarantees or an assignment of rights over assets of the lessee held by third parties, even if such rights are a permissible life or property insurance indemnity in favour of the lessee.

6/2 The two parties may agree that the rental be paid fully in advance. It is also permissible to make the rent payable in instalments, in which case the lessor may stipulate that the lessee should immediately pay the remaining instalments if he, after receiving a specified period of due notice, delays, without a valid reason, payment of one instalment or more, provided that the asset shall be made available for the lessee to use for the remaining period of time. Any stipulated upfront rental or accelerated -because of delay of payment- rental is subject to settlement at the end of the Ijarah period or, if the Ijarah contract is terminated earlier, at the time of such termination. Any extension of time by the lessor after the stipulated time for prompt payment is considered as a consent to deferral of payment throughout the extension period and not a right of the lessee, subject always to item 5/2/2 above.

6/3 No increase in the rental due may be stipulated by the lessor in case of delay in payment by the lessee.

6/4 It may be provided in the contract of Ijarah or Ijarah Muntahia Bittamleek that a lessee who delays payment for no good reason undertakes to donate a certain amount or percentage of the rental due in case of late payment. Such donation should be paid to charitable causes under the co-ordination of the Institution's Shari'ah Supervisory Board.

6/5 In case of foreclosure of the security provided by the lessee, the lessor may deduct from such amounts only what is due in respect

of rental for previous periods, and not all rental instalments, including instalments which have not yet fallen due and in respect of periods for which the lessee has not had the benefit of the leased asset. The lessor may also deduct from the security all legitimate compensations necessitated by the lessee's breach of contract.

7. Changes to the Ijarah Contract

7/1 Selling of or damage to the leased asset

7/1/1 If the lessor sells the leased asset to the lessee, the Ijarah contract is terminated due to the transfer of the ownership of the leased asset and ownership of usufruct to the lessee.

7/1/2 The lessor may sell the leased asset to a third party other than the lessee, and the title to the asset together with the rights and obligations of the lessor under the Ijarah contract is thereby transferred to the new owner, because the asset and the rights and obligations attached to it become the right of the third party. The lessee's consent is not necessary when the lessor decides to sell the asset to a third party. If the purchaser does not know about the Ijarah contract, he may terminate the sale contract, but if he knows about it and consents to it, he takes the place of the previous owner in his entitlement to the rental for the remaining period.

7/1/3 In case of total destruction of the leased asset, the Ijarah contract is terminated if it is concluded on an identified asset. In such a case, it may not be stipulated that the rest of the instalments should be paid.

7/1/4 The leased asset in the possession of the lessee is held by the lessee in a fiduciary capacity on behalf of the lessor. The lessee will not be held liable for any damage or destruction of the leased asset unless such damage or destruction is a result of misconduct or negligence on the part of the lessee. In this case, he is obliged to replace the asset if it is replaceable; otherwise, he is liable for the amount of the damage to be determined by valuation.

7/1/5 In case of the partial destruction of the leased asset in a manner that impairs the benefits expected from the leased asset, the lessee may terminate the Ijarah contract. Both he and the lessor may also agree to amend the rental in case of partial destruction of the leased property, if the lessee waives his right to termination. The lessor in this case is not entitled to rent for the period during which the lessee was not able to benefit from the asset unless the lessor makes it up (by agreement with the lessee) with a like benefit after the expiry of the period specified in the contract. [see para. 5/1/6]

7/1/6 In an *Ijarah Mawsufah fi al-Dhimmah* (contract for an unidentified asset undertaken by the lessor to be delivered according to the agreed specifications), the owner in cases of total and partial destruction must offer an alternative asset having a specification similar to that of the destroyed asset, unless otherwise agreed at the time. The Ijarah shall continue for the remaining time of the contract. If it is not possible to provide a substitute asset, the contract will be terminated. [see item 3/5]

7/1/7 If the lessee stops using the leased asset or returns it to the owner without the owner's consent, the rental will continue to be due in respect of the remaining period of the Ijarah, and the lessor may not lease the property to another lessee for this period, but must keep it at the disposal of the current lessee unless the lessee relinquishes to the lessor the remaining period of time, in which case the lease expires. [see item 7/2/1 below]

7/2 Termination, expiry and renewal of the Ijarah contract

7/2/1 It is permissible to terminate the lease contract by mutual consent but it is not permissible for one party to terminate it except in case of force majeure or there is a defect in the leased asset that materially impairs its use. Termination is also possible when one party secures an option to terminate the contract in which case the party who holds the option may exercise it during the specified period.

7/2/2 The lessor may stipulate that the Ijarah contract be terminated if the lessee does not pay the rent or fails to pay it on time.

7/2/3 An Ijarah contract does not terminate with the death of either party thereto. However, the heirs of the lessee may terminate the Ijarah contract if they can prove that the contract has become, as a result of the death of their legator, too onerous for their resources and in excess of their needs.

7/2/4 An Ijarah contract expires with the total destruction of the leased asset in the case of leasing a specific asset or with the inability to enjoy the usufruct owing to the loss of the benefit that the asset was intended to provide.

7/2/5 The two parties may terminate the Ijarah contract before it begins to run.

7/2/6 The lease expires upon the expiry of its term, but it may remain operative for a good cause, such as the late arrival to the place intended in the lease of transportation vehicles, and in the case of a late harvesting period for land leased for crop cultivation. The lease then continues with the rental based on the prevailing market value. An Ijarah may be renewed for another term, and such renewal may be made before the expiry of the original term or automatically by adding a provision in the new contract for such renewal when the new term starts, unless either party serves a notice on the other of its desire not to renew the contract.

8. Transfer of the Ownership in the Leased Property in Ijarah Muntahia Bittamleek

8/1 In Ijarah Muntahia Bittamleek, the method of transferring the title in the leased asset to the lessee must be evidenced in a document separate from the Ijarah contract document, using one of the following methods:

a) By means of a promise to sell for a token or other consideration, or by accelerating the payment of the remaining amount of rental, or by paying the market value of the leased property.

b) A promise to give it as a gift (for no consideration).

c) A promise to give it as a gift, contingent upon the payment of the remaining instalments.

In all these cases, the separate document evidencing a promise of gift, promise of sale or a promise of gift contingent on a particular event, should be independent of the contract of Ijarah Muntahia Bittamleek and cannot be taken as an integral part of the contract of Ijarah.

8/2 A promise to transfer the ownership by way of one of the methods specified in item 8/1 above is a binding promise by the lessor. However, a binding promise is binding on one party only, while the other party must have the option not to proceed. This is to avoid a bilateral promise by the two parties which is Shari'ah impermissible because it resembles a concluded contract.

8/3 In all cases of transfer of ownership by way of gift or sale, it is necessary, when the promise is fulfilled, that a new contract be drawn up, since the ownership to the property is not automatically transferred by virtue of the original promise document that was drawn up earlier.

8/4 In case the Ijarah contract is combined, through a separate document, with a gift contingent upon the condition that the remaining rent instalments be paid, the ownership to the leased property is transferred to the lessee if the condition is fulfilled, without the need for any other procedure to be adopted or a document to be signed. However, if the lessee's payment is short of even one instalment, the ownership to the property is not transferred to him, since the condition has not been fulfilled.

8/5 If the leased asset was purchased from the lessee before it was leased back to the lessee on the basis of Ijarah Muntahia Bittamleek, a (reasonable) period of time, between the lease contract and the time of the sale of the asset to the lessee, must have expired, to avoid the contract of 'Inah. This period must be long enough so that the leased property or its value could have changed. This shall

also apply to the case of early ownership of the asset where a sale contract is concluded during the Ijarah. [see para. 7/1]

8/6 Subject to item 8/8 below, the rules governing Ijarah must apply to the Ijarah Muntahia Bittamleek, i.e. when a promise is made by the lessor to transfer the ownership in the leased asset to the lessee. None of these rules should be breached under the pretext that the leased asset was bought by the lessor on the basis of a promise by the lessee that he would acquire it or that ownership of it would devolve upon him, or that he would pay rentals in excess of those payable in respect of a similar property which are similar in amount to the instalments of an instalment sale, or that local laws and conventional banking practices consider such a transaction as an instalment sale with a deferred transfer of the ownership.

8/7 Transfer of the ownership in the leased property cannot be made by executing, along with the Ijarah, a sale contract that will become effective on a future date.

8/8 If the leased asset is destroyed or if the continuity of the lease contract becomes impossible up to the expiry period without the cause being attributable to the lessee in either case, then the rental is adjusted based on the prevailing market value. That is, the difference between the prevailing rate of rental and the rental specified in the contract must be refunded to the lessee if the latter rental is higher than the former. This is to avoid loss to the lessee, who agreed to a higher rental payment compared to the prevailing rate of rental in consideration of the lessor's promise to pass the title to him upon the expiry of the lease term.

9. Date of Issuance of the Standard

This Standard was issued on 4 Rabi' I, 1423 A.H., corresponding to 16 May 2002 A.D.

Adoption of the Standard

The Shari'ah standard for Ijarah and Ijarah Muntahia Bittamleek was adopted by the Shari'ah Board in its meeting No. (4) held on 25-27 Safar 1421 A.H., corresponding to 29-31 May 2000 A.D.

In its meeting No. (8) held in Mecca on 28 Safar - 4 Rabi' I, 1423 A.H. corresponding to 11-16 May 2002 A.D., the Shari'ah Board readopted a resolution to reformat the Shari'ah rules for Ijarah and Ijarah Muntahia Bittamleek in the form of a Shari'ah standard.

Appendix (A)
Brief History of the Preparation of the Standard

In its meeting No. (1) held on 11 Dhul-Hajjah 1419 A.H., corresponding to 27 February 1999 A.D., the Shari'ah Board decided to give priority to the preparation of the Shari'ah rules for Ijarah and Ijarah Muntahia Bittamleek.

On Tuesday 13 Dhul-Hajjah 1419 A.H., corresponding to 30 March 1999 A.D., the Fatwa and Arbitration Committee decided to commission a Shari'ah consultant to prepare a juristic study and an exposure draft on the Shari'ah Rules for Ijarah and Ijarah Muntahia Bittamleek.

In its meeting held on 13-14 Rajab 1420 A.H., corresponding to 22-23 October 1999 A.D., the Fatwa and Arbitration Committee discussed the exposure draft of the Shari'ah Rules for Ijarah and Ijarah Muntahia Bitamleek, and asked the consultant to make the amendments in light of the comments made by the members.

The revised exposure draft of the Shari'ah Rules was presented to the Shari'ah Board in its meeting No. (3) held in Mecca on 10-15 Ramadan 1420 A.H., corresponding to 18-22 December 1999 A.D. The Shari'ah Board made further amendments to the exposure draft of the Shari'ah Rules and decided that it should be distributed to specialists and interested parties in order to obtain their comments in order to discuss them in a public hearing.

A public hearing was held in Bahrain on 29–30 Dhul-Hajjah 1421 A.H., corresponding to 4-5 April 2000 A.D. The public hearing was attended by more than 30 participants representing central Institutions, accounting firms, Shari'ah scholars, academics and others who are interested in this field. The members responded to the written comments that were sent prior

to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Standards Committee and the Fatwa and Arbitration Committee held a joint meeting on 21-23 Muharram 1421 A.H., corresponding to 26-28 April 2000 A.D., to discuss the comments made about the Shari'ah Rules. The committee made the amendments which it considered necessary in light of the discussions that took place in the public hearing.

The Shari'ah Board in its meeting No. (4) held on 25–27 Safar 1421 A.H. corresponding to 29–31 May 2000 A.D., in Al-Madinah Al-Munawwarah discussed the amendments made by the Shari'ah Studies Committee and the Fatwa and Arbitration Committee, and made the amendments which it considered necessary. Some paragraphs of the standard were adopted in the name of Shari'ah Rules for Ijarah and Ijarah Muntahia Bittamleek by the unanimous vote of the members of the Shari'ah Board, while the other paragraphs were adopted by the majority vote of the members, as recorded in the minutes of the Shari'ah Board.

In its meeting No. (7) held on 9-13 Ramadan 1422 A.H. corresponding to 24-28 November 2001 A.D., in Makkah Al-Mukarramah, the Shari'ah Board decided to convert all Shari'ah rules for Investments and Financing to Standards and a committee was formed for this purpose.

In its meeting No. (8) held in Al-Madinah Al-Munawwarah on 28 Safar - 4 Rabi' I, 1423 A.H. corresponding to 11-16 May 2002 A.D., the Shari'ah Board adopted the reformatting of Shari'ah Rules for Ijarah and Ijarah Muntahia Bittamleek in the name of Shari'ah Standard No. (9) on Ijarah and Ijarah Muntahia Bittamleek. The committee did not make any changes to the substance.

The Shari'ah Standards Review Committee reviewed the standard in its meeting held in Rabi' II, 1433 A.H. corresponding to March 2012 A.D., in the State of Qatar, and proposed after deliberation a set of amendments (additions, deletions, and rephrasing) as deemed necessary, and then submitted the proposed amendments to the Shari'ah Board for approval as it deemed necessary.

In its meeting No. (39) held in the Kingdom of Bahrain on 13-15 Muharram 1435 A.H., corresponding to 6-8 November 2014 A.D., the Shari'ah Board discussed the proposed amendments submitted by the Shari'ah Standards Review Committee. After deliberation, the Shari'ah Board approved necessary amendments, and the standard was adopted in its current amended version.

Appendix (B)
The Shari'ah Basis for the Standard

Permissibility of Ijarah and Ijarah Muntahia Bittamleek

- Ijarah derives permissibility from the Qur`an, the Sunnah, consensus of Fuqaha and Ijtihad (reasoning).
- On the level of the Qur`an, Allah, the Almighty, says: ***{"said one of them 'O my father engage him on wages"}***,(3) and ***{"if you had wished, surely you could have exacted some recompense for it"}***.(4)
- The authority for the permissibility of Ijarah in the Sunnah is the saying of the Prophet (peace be upon him): *"Whoever hired a worker must inform him of his wages"*,(5) and his saying: *"Give a worker his wages before his sweat (body odour) is dried"*.(6)
- The permissibility of Ijarah also generated consensus among the legal community. The Ijarah is also acceptable by reasoning because it is a convenient means for people to acquire right to use assets that they do not own since not all people may be able to own tangible assets.
- The Ijarah Muntahia Bittamleek, on the other hand, is not different in its rules from an ordinary Ijarah, except that it is associated with a promise by the lessor to transfer ownership at the end of the Ijarah term. The permissibility of this form of Ijarah is confirmed by the resolution of International Islamic Fiqh Academy which explained the impermissible and the permissible forms of Ijarah Muntahia Bittamleek.(7)
- It must be noted that the permissible Ijarah Muntahia Bittamleek is different from hire-purchase as commonly practised by the conventional

(3) [Al-Qasas (The Narrative): 26].
(4) [Al-Kahf (The Cave): 77].
(5) This Hadith has been related by Ibn Majah in his *"Sunan"* [2: 817]; and Al-Haythami in *"Majam' Al-Zawa'id"* [4: 98].
(6) This Hadith has been reported by Ibn Majah in his *"Sunan"* [2: 817]; and Al-Tabrani in *"Al-Mu'jam Al-awsat"*; and Al-Haithami in *"Majam' Al-Zawa'id"* [4: 98].
(7) Resolution of the International Islamic Fiqh Academy No. 110 (4/12).

banks in the following respects. In hire-purchase, the terms and provisions of sale and leasing are applied to the subject matter at the same time, and subsequently the ownership of the subject matter is transferred to the lessee (buyer), once he pays the last instalment without the need for a separate contract for the transfer of ownership. In the permissible Ijarah Muntahia Bittamleek, on the other hand, the provisions governing Ijarah are applied to the leased asset until the end of the Ijarah term, after which the lessee obtains ownership of the asset in the manner explained in this Standard.

- It must be noted also that the Ijarah contract intended in this Standard is the lease of tangible assets (chattels or property), which is a contract giving a legal title to legitimate and identified usufruct for a defined period of time in exchange for a legitimate and determined consideration.

Promise to Lease an Asset

The basis for allowing the Institution to demand payment of money by a party who has promised to take the property as lessee is the need to confirm the commitment of the promissor. This is because a binding promise has financial implications if the promissor retracts the promise. The request for payment of a commitment fee is to cater for financial damage that the Institution may have incurred as a result of the promissor taking back the promise or defaulting in payment. The unified Shari'ah Supervisory Board of Al Baraka issued a Fatwa in respect to *Hamish Jiddiyyah* (security deposit) in Murabahah.[8] This ruling is also applicable to Ijarah.

Acquisition of the Asset to be Leased, or Its Usufruct, by the Institution

- The basis for not allowing the leasing of an asset that is not owned by the lessor is the Hadith that prohibits one from selling what he does not own,[9] and Ijarah proper is a sale of usufruct. The basis for allowing the leasing back of an asset to the person from whom the asset was acquired is because such a transaction does not involve any 'Inah sale.
- The basis for not allowing a simultaneous combination of Ijarah and sale is because making purchase contracts contingent upon leasing contracts is impermissible by an explicit text in the view of a number

(8) International Islamic Fiqh Academy Resolution No. 110 (4/12).
(9) Fatwa of Unified Shari'ah Board of Al Baraka No. (9/10).

of jurists. This is prohibited by a well-known Hadith which prohibits two sales in one sale.(10)

- The basis for the permissibility of sub-leasing when the lessor has allowed it is because the lessee has ownership of the usufruct by virtue of the Ijarah contract, in which case he is entitled to transfer such usufruct for consideration as he deems fit. The basis for impermissibility of sub-leasing when the lessor has not allowed it is because the ownership of usufruct by the lessee is limited in which case the lessee is obliged to consider any limitations on this ownership.
- The basis for the permissibility of leasing a property on the basis of specifications even if the lessor does not own it is that this will not lead to dispute, in which case it is similar to a Salam contract. However, in this case the lessor should not request advance payment of the rentals according to one of the views of the Shafi'is and Hanbalis.
- The basis for preferring that the agent who purchases on behalf of the Institution be someone other than the customer (lessee) is to avoid fictitious transactions and to demonstrate the genuine role of the Institution in making the usufruct of the asset available to the lessee.

Contract of Ijarah

- The basis for the binding nature of an Ijarah contract is because Ijarah is one of the contracts for transferring ownership that depends on an exchange of counter-values. The Shari'ah principle is that these contracts are binding because of the Saying of Allah, the Almighty: ***{"... Fulfil (your) obligations..."}***.(11) The basis for allowing cancellation of an Ijarah contract due to contingencies is because without the right to cancel the Ijarah contract the lessee would waste money by paying rent for unneeded usufruct due to an event of which he did not contribute to the occurrence.
- The basis for requiring a designated term for the lease is because without such a designated term there would be an uncertainty that might lead to dispute. The basis for allowing an Ijarah contract take effect based on

(10) The Hadith has been related by Abu Dawud in his *"Sunan"* [3: 283].

(11) The Hadith has been related by Ahmad, Al-Nasa'i and Al-Tirmidhi. Al-Tirmidhi autheticated the Hadith: see, *"Nayl Al-Awtar"* [5: 248].

future events is because Ijarah is, unlike a sale contract, a contract that involves time and for this it is relevant that it be contingent on future events.

- The basis for the permissibility of obtaining 'Arboun (Earnest Money) to secure performance is the practice of Umar Ibn Al-Khattab (may Allah be pleased with him) in the presence of some companions of the Prophet (peace be upon him). This practice is also permitted by Imam Ahmad. A resolution has been issued in connection with the permissibility of 'Arboun (Earnest Money) by the International Islamic Fiqh Academy.(12)
- The basis for the impermissibility of re-leasing after the lease of the asset is that under the first contract, the usufruct of the asset no longer belongs to the owner, and a new contract may not be signed with another lessee before the contract with the first lessee is terminated. Hence, this form of Ijarah is not suitable as an investment instrument, because it constitutes an impermissible sale of the rent receivable pursuant to providing new lessees with an asset already leased out to the existing lessee. The form just described is different from the transfer, by the owner, of the ownership of the leased assets to an investor, so that the latter takes his place, wholly or partially, with regard to the ownership of all or some parts of the assets, as well as in the ownership of the usufruct of, and entitlement to his share of the rent from, those assets. Al Baraka Forum has issued a resolution disallowing multiple leases of the same asset after the first Ijarah contract.(13)
- The basis for allowing successive leases on the same specified usufruct of a particular asset without specifying a particular period for a particular person is because the usufruct -in line with the term assigned to each party- can accommodate the parties. The justification for not allowing a specific term for each person is that each party will know the term to which he is entitled in his turn and because their applications are considered in order. This rule was supported by a resolution of Al Baraka Forum.(14)

(12) [Al-Ma`idah (The Table): 1].
(13) Resolution No. 72 (3/8) in respect of 'Arboun (Earnest Money).
(14) Resolution No. (13/4).

- The basis for the requirement that incorporating co-lessees must take place before any sub-lease contract is signed is because sub-leasing the property means the sub-lessor no longer owns the usufruct, and thus he would be leasing out a benefit of the usufruct that he does not own, which is not permissible in Shari'ah as stated earlier. The jurists have considered a bankrupt lessor -a person who leases things he does not own- among those who must be restricted in using their property.

Subject Matter of Ijarah

- The basis for the requirement that the leased asset must be capable of being used while preserving the asset is that the subject of a lease is usufruct and not the asset, as leasing is not possible for things that perish by use. The basis for the requirement that benefit from Ijarah must be permissible is that leasing an asset that will be used in impermissible way makes the lessor an accomplice in doing evil and this is prohibited as per the saying of Allah, the Almighty: ***{"Help you one another in Al-Birr and At-Taqwa (virtue, righteousness and piety)"}***.(15)
- The basis for the impermissibility of stipulating a defect exclusion clause in respect to the leased asset is that such a condition defeats the purpose of the contract, which is exchange of usufruct for rentals. If the usufruct is partially or wholly impaired, the receipt of the rentals by the lessor becomes a form of unjust enrichment. The resolution of the International Islamic Fiqh Academy has declared that the lessor must accept responsibility for any destruction or impairment of the leased asset insofar as these events are not sustained as a result of misconduct or negligence on the part of the lessee.(16) The Fatwa of the unified Shari'ah Supervisory Board of Al Baraka states that the lessor is not entitled to exclude his liability in respect of defects in the leased asset.(17)
- The reason why the lessor may not stipulate that the lessee will undertake the major maintenance of the leased asset is that this condition defeats the purpose of an Ijarah contract. Again, it is the duty of the lessor to ensure that the usufruct is intact, and this is not possible unless the asset is maintained and kept safe so that the lessor may be entitled

(15) Resolution No. (10/1).
(16) [Al-Ma`idah (The Table): 2].
(17) International Islamic Fiqh Academy Resolution No. 13 (1/3).

to the rentals in consideration for the usufruct. The unified Shari'ah Supervisory Board of Al Baraka issued a fatwa supporting this.(18)

- The reason why insurance expenses must be borne by the lessor is that the owner of the asset is responsible for insuring it, and the lessor is the owner. This is supported by the resolution issued by the International Islamic Fiqh Academy.(19)
- The basis for the permissibility of using a certain benchmark or price index to determine rentals of subsequent periods after the expiration of the first period of an Ijarah contract is that the rentals will subsequently be known. This is similar to the principle of *Ujrat al-Mithl* (prevailing market rate of rental) and does not lead to dispute. Again, using a benchmark to determine the rentals is to the benefit of all parties since there is possibility of rental fluctuation that may be in favour of either the lessee or the lessor in view of the fact that the contract remains binding on both parties throughout its term. This rule is supported by a Fatwa issued during Al Baraka's 11th Forum.
- The basis for the permissibility of restructuring the rentals for the future periods is that such an act is deemed to create a new contract for a new term for which the rentals are not yet due. Hence, the rentals are not regarded as a debt, in which case the prohibition of rescheduling rentals in return for higher payment is not applicable to this. However, increasing previously agreed rentals in exchange for a deferred period of payment is a form of Riba.

Guarantees and Treatment of Ijarah Receivables

- The basis for the permissibility of obtaining guarantees for payment is that this is not contrary to the purpose of an Ijarah contract. Rather guarantees are relevant to credit transactions because they secure performance.
- The basis for the permissibility of a payment acceleration clause is the saying of the Prophet (peace be upon him): *"Muslims are bound by the conditions they made"*, and because payment on a deferred basis is the right of the lessee (the debtor as to rentals), and the lessee may, based

(18) Fatwa of the Unified Shari'ah Board of Al Baraka No. (1/97).
(19) Fatwa of the Unified Shari'ah Board of Al Baraka No (9/9).

on agreement, choose to pay before time and relinquish the deferral of the date of payment entirely. The lessee may also agree to a stipulation that bases acceleration of payment on the event of default in payment.

- The basis of the prohibition of increasing the amount of lease receivables in exchange for a deferral of payment is because this is a form of Riba.
- The basis for the permissibility of stipulating that a solvent debtor should undertake to make a payment to charity in case of default is that this is similar to an undertaking to make a donation that is approved by the Maliki scholars, notably Abdullah Ibn Nafi' and Muhammad Ibn Ibrahim Ibn Dinar.[20]

Changes to the Ijarah Contract

- The basis for allowing the lessor to sell the leased asset to a third party without the consent of the lessee is that the lessor owns the asset and is acting within the limits of his ownership without affecting the right of the lessee that is materialised in the usufruct. If the Ijarah expires, enabling the buyer to take possession of the asset is sufficient to discharge the seller from any responsibility as to delivery in which case the buyer will own the asset excluding the right of the lessee to the usufruct which is attached to the asset even if the ownership is transferred. The Shari'ah Supervisory Board of Al Rajhi Banking and Investment Corp.,[21] and the Shari'ah Supervisory Board of the Jordan Islamic Bank[22] have issued a resolution in support of this ruling.
- The basis for the termination of the lease contract due to a total destruction of the leased asset is that the rent is in consideration of the benefit of the leased asset and if the latter is destroyed, there is no justification for the payment of the rental.
- The basis for the entitlement of the lessor to the rentals even though the lessee returns the leased asset to the owner or stops using it is that Ijarah is a binding contract that cannot be terminated unilaterally by the lessee.

(20) International Islamic Fiqh Academy Resolution No. 13 (1/3).

(21) See: Al-Hattab, *"Tahrir Al-Kalam Fi Masa`il Al-Iltizam"* (pp. 170). This view appeared in the Fatwas of Kuwait Finance House.

(22) Resolution of the Shari'ah Board of Al Rajhi Banking and Investment Corp. No. (11).

- The basis for the permissibility of terminating the lease contract in case of intervening contingencies or force majeure is that there is a pressing need which calls for this. This is because if the contract were to be binding in spite of such contingencies, then a person with a valid excuse may incur loss that was not a result of a contract. The Shari'ah Supervisory Board of the Kuwait Finance House[23] and the unified Shari'ah Supervisory Board of Al Baraka[24] have issued a supporting Fatwa in this regard.
- The basis for the permissibility that the lessor may stipulate that an Ijarah contract be terminated due to non-payment of rental by the lessee is that contractual stipulations are primarily valid and enforceable. This stipulation does not legalise impermissible acts or invalidate permissible acts. Therefore, the permissibility of this stipulation comes under the prophetic Hadith stating: *"Muslims are bound by the conditions they made except a condition that legalises impermissible act or invalidates permissible act"*.[25]
- The basis of the rule that Ijarah does not terminate with the death of either party thereto is that the subject-matter of the contract is the asset and as long as the asset is available the Ijarah contract remains unaffected. The basis for the right of the lessee's heirs to terminate the Ijarah if they can prove that the contract has become too onerous for their resources is to avoid inflicting damage on the heirs. This exceptional ruling is taken from the Maliki School of law since it serves the interests of the lessee. The heirs of the lessor may not terminate the Ijarah in the event of the death of the lessor because there is no potential damage to them, as they will receive the rentals for the remainder of the term of the contract.

Transfer of the Ownership in the Leased Asset in Ijarah Muntahia Bittamleek

- The basis of the rule that the documents of the lessor's promise to sell and the methods of transfer of ownership be separated from the Ijarah contract is to ensure that the obligations and liabilities are not

(23) Fatwas of the Shari'ah Board of Jordan Islamic Bank No. (18).
(24) Fatwa No. (233) and (253).
(25) Fatwa No. (9/9) of the Unified Shari'ah Board.

linked to each other. The International Islamic Fiqh Academy has issued a resolution in this regard.(26)

- The basis for the rule that the promise of a client to take an asset acquired by the Institution on lease is binding is that the Institution has acquired the asset in order to lease it to the client due to the promise. Therefore, the rule that the promise to take the asset on lease is binding will protect the promisee.
- The basis for not allowing bilateral promises is that the resemblance of these promises to a contract, i.e. a contract is effected before taking ownership of the subject matter of the contract. The International Islamic Fiqh Academy has issued a resolution in this regard.(27)
- The basis for the permissibility of a gift contingent upon the expiry of the Ijarah term is that a conditional gift is valid. The Prophet (peace be upon him) sent a gift to Negus (the former emperor of Ethiopia) on condition that he was alive at the time of the arrival of the messenger.(28) The basis for the permissibility of leasing an asset to the person from whom it is purchased by way of Ijarah Muntahia Bittamleek on condition that the parties observe the lapse of a period of time is that this prevents the contract from becoming a 'Inah transaction. This is because the physical changes to the asset or changes in the value of the asset during this period give it the economic characteristics of a different asset.
- The basis for the requirement that all the rules prescribed for an ordinary lease are applicable to Ijarah Muntahia Bittamleek is that a mere promise to transfer ownership does exclude the contract from becoming an Ijarah contract or from the applicable rules. This requirement is necessary in order to prevent a linking of contracts (the sale contract and lease

(26) This Hadith has been related by a number of companions. It was also related by Ahmad in his *"Sunan"* [1: 312]; Ibn Majah in his *"Sunan"* through a good chain of transmission [2: 783], Mustafa Al-Babi Al-Halabi edition, Cairo, 1372 A.H./1952 A.D.; Al-Hakim in *"Mustarak"*, Edition of Hyderabad, India, 1355 A.H.; Al-Bayhaqi in his *"Sunan"* [6: 70 and 156] and [1: 133], Edition of Hyderabad, India, 1355H; and Al-Daraqutni in his *"Sunan"* [4: 228] and [3: 77], Dar Al-Mahasin Lil-Tiba'ah edition, Cairo, 1372 A.H./1952 A.D.

(27) Intenatioanl Islamic fiqh Academy Resolution No. 13 (1/3).

(28) The Hadith has been related by Ibn Hibban: *"Sahih Ibn Hibban"* [11: 516]; and Ahmad in his *"Musnad"* [6: 404].

contract). The International Islamic Fiqh Academy has issued a resolution in support of this ruling.[29]

- The basis for the rule that ownership cannot be made in contingent on a future date is that a sale contract cannot be dependent on a future date, as the term 'sale' means that its effect (transfer of ownership) immediately takes place.
- The basis for allowing recourse to the prevailing market rate of rental when the transfer of ownership becomes impossible without any cause attributable to the lessee is to protect the lessee against any loss as the lessee has paid more than the prevailing rate of rental in order to acquire title to the asset. If this acquisition of title becomes impossible, then the rental must be adjusted retrospectively to the prevailing market rate. This ruling is analogous to the principle that the price must be discounted when a sold crop has suffered damages due natural calamities.

(29) See Note (25).

Appendix (C)
Definitions

Ijarah

The term Ijarah as used in this standard means leasing of property pursuant to a contract under which a specified permissible benefit in the form of a usufruct is obtained for a specified period in return for a specified permissible consideration.

Ijarah Muntahia Bittamleek

One of the forms of Ijarah used by Islamic financial Institutions is Ijarah Muntahia Bittamleek. This is a form of leasing contract which includes a promise by the lessor to transfer the ownership in the leased property to the lessee, either at the end of the term of the Ijarah period or by stages during the term of the contract, such transfer of the ownership being executed through one of the means specified in the Standard.

Shari'ah Standard No. (10)

Salam and Parallel Salam

(Revised Standard)

Contents

IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

Preface

The aim of the standard is to explain the rules for and limitations of Salam and Parallel Salam in respect to concluding a Salam contract, the subject matter of Salam and changes to the contract, whether in the event of ability to deliver or otherwise. The standard also explains rulings in respect to issuing Salam Sukuk.

Statement of the Standard

1. Scope of the Standard

This standard covers Salam and Parallel Salam transactions, whether the Institution is the buyer or the seller, and issuing Salam Sukuk. This standard does not cover Istisna'a (manufacturing or supplier contract) because the latter is covered by a separate standard.

2. Contract of Salam

2/1 General framework for Salam contracts

2/1/1 It is permissible to initiate through negotiations several Salam contracts (with different parties). Each operation will end at its due date. It is also permissible to draw up a general framework or a master agreement that consists of an understanding to conclude successive Salam contracts, each of which will take place at an appropriate time. In this latter case, the transaction involved shall be concluded on the basis of a memorandum of understanding in which the contracting parties determine the framework of the contract and the intention of the parties to buy and sell. The parties shall also determine the quantity and specifications of the goods, the manner of their delivery, the basis for determining the price, and the manner of payment. The types of guarantees and other prospective arrangements shall also be specified in the memorandum. The execution of each Salam contract may then take place separately at the appropriate date.

2/1/2 If the Salam contract is concluded on the basis of what was initially agreed in the memorandum of understanding, the contents of the memorandum become part and parcel of the contract. This will hold true unless the parties agreed when the

contract was concluded to exempt themselves from some of the obligations referred to in the memorandum of understanding.

2/2 Form of a Salam contract

A contract of Salam may be concluded using the word Salam, or Salaf, or sale, or any term that indicates sale of a prescribed commodity for deferred delivery in exchange for immediate payment of the price.

3. Subject Matter of Salam

3/1 Capital of Salam contract and its conditions

3/1/1 It is permissible for the capital of Salam to be in the form of fungible goods (such as wheat and other cereals) in which case the parties must make sure that they do not fall into Riba. The capital may also be items of material value (such as livestock). It is also permissible for it to be in the form of the general usufruct of a particular asset, such as living in a house or having the use of an aircraft or a ship for a certain period. In such a case, when a party is granted access to the usufruct through delivery of the asset, this is regarded as immediate receipt (possession) of the Salam capital.

3/1/2 The capital of Salam should be made known to the two parties in a manner that removes all uncertainty and eliminates the possibility of dispute. In principle, the capital of Salam should be in the form of cash. In this case, the currency of payment, the amount and the manner of payment shall be clearly defined. If the capital of Salam is in the form of fungibles,[1] then the kind, type, specifications and quantity of these shall be clearly defined.

3/1/3 The capital in a Salam contract must be paid immediately at the place where the contract is concluded. However, as an exception to this ruling, payment may be delayed for two or three days at

(1) Fungibles are goods that share common features such that they do not differ significantly. Any fungibles can be replaced by any other in the event of destruction, without need to assess the value of the item destroyed or the one replacing it.

most. Even if such a short delay has been stipulated earlier, this will not affect the Salam contract provided that the period of delay is not equal to or greater than the delivery period for al-Muslam Fihi.

3/1/4 It is not permitted that a debt be recognised as the capital of Salam, such as using as the capital of Salam loans or debts owed by the seller to the Institution as a result of previous transactions.

3/2 Al-Muslam Fihi and its conditions

3/2/1 Salam contracts are permitted for fungible goods, like those that may be weighed, measured or counted, the articles of which do not differ in any significant manner, provided that no Riba ensues.

3/2/2 Among the items for which variations in numbers make no difference are the products of companies that manufacture goods in approximate units that are identified by trademarks, standardised specifications and are regularly and commonly available at any time. However, this rule must be read together with item 3/2/8.

3/2/3 Salam is not permitted for anything specific like "this car". Nor is it permitted for anything for which the seller may not be held responsible, like land, buildings or trees; or for articles whose values change according to subjective assessment, like jewellery and antiques. Also, it is not permissible to stipulate that al-Muslam Fihi must be from a specific piece of land. However, on the delivery date the seller may present the buyer with whatever items are available (and meet the contract specifications), irrespective of whether such items are from his own fields or factories or elsewhere.

3/2/4 It is not permissible for al-Muslam Fihi to be an amount of currency, gold or silver, if the capital of the Salam contract was paid in the form of currency, gold or silver.

3/2/5 Al-Muslam Fihi must be the kind of article for which a specification may be drawn up so that the seller may be held responsible for its conformity to the specification. It will be sufficient if the specification is explained in a manner that removes uncertainty, except for minor discrepancies that are customarily ignored, considered acceptable, and not usually regarded as grounds for dispute.

3/2/6 It is a requirement that al-Muslam Fihi be clearly known to the contracting parties in a manner that eliminates any possibility of uncertainty or ambiguity. The reference for determining descriptions that are used to specify and identify al-Muslam Fihi is customary practice and the experience of experts.

3/2/7 It is a requirement that the parties know the quantity of al-Muslam Fihi. The quantity of each item is determined according to its condition and nature with regard to weight, measurement, volume and number.

3/2/8 It is a requirement that al-Muslam Fihi be commonly available under normal circumstances at the place where it should be on the delivery date, so that the commodity will be accessible to the seller in order to discharge his obligation by delivering it to the buyer.

3/2/9 It is a requirement that the date of delivery for al-Muslam Fihi be known in a manner that eliminates any uncertainty or ambiguity which may lead to a dispute. There is no Shari'ah objection to the contracting parties setting various dates on which the delivery of al-Muslam Fihi may take place, in instalments, provided the capital of Salam was paid at the time the contract was originally concluded.

3/2/10 In principle, the parties may designate the place at which al-Muslam Fihi is to be delivered. If the parties to the contract do not determine the place of delivery, then the place at which the contract was concluded will be regarded as the place of delivery unless it turns out to be impossible to make delivery

to such a place. In that case, the place of delivery should be determined according to customary practice.

3/3 Security for al-Muslam Fihi

Al-Muslam Fihi may be secured by a mortgagee or a guarantee or any other permissible means of securing payment.

4. Changes to al-Muslam Fihi

4/1 Selling al-Muslam Fihi before taking possession

It is not permitted for the buyer to sell al-Muslam Fihi before taking possession of it.

4/2 Replacement of al-Muslam Fihi

It is permissible for the buyer to exchange al-Muslam Fihi for other goods, except currency, after the delivery date falls due, as long as such a substitution was not stipulated in the contract. This rule applies whether or not the substitute is similar in kind to al-Muslam Fihi. This is provided that the substitute is suitable for being exchanged as al-Muslam Fihi for the capital of the Salam contract, and that the market value of the substitute should not be greater than the market value of al-Muslam Fihi at the time of delivery.

4/3 Cancellation (Iqalah) of a Salam contract

It is permissible, when both parties agree, to cancel the entire Salam contract in return for repayment in full of the amount of the capital of Salam. Partial cancellation, that is, cancellation of the delivery of part of al-Muslam Fihi, in return for repayment of a corresponding part of the capital of Salam, is also permissible.

5. Delivery of al-Muslam Fihi

5/1 The seller is under an obligation to deliver al-Muslam Fihi to the buyer on the due date in accordance with the terms of the contract, such as agreed specifications and quantity. The buyer, on the other hand, must accept the goods if they meet the specifications explained in the contract. If the buyer refuses to accept al-Muslam Fihi, he shall be compelled to do so.

5/2 If the seller offers delivered goods of a quality that is superior to that required by the contractual specifications, the buyer must accept the goods, provided that the seller shall not seek a higher price for the better quality. This may be considered one of the ways in which a contract is ethically fulfilled. However, this will apply only if the (inferior) description specified in the contract is not itself deemed vital.

5/3 If the quality of the delivered goods is inferior to that required by the contractual specifications, the buyer is entitled either to reject or to accept the goods in that condition. If he accepts the goods, his action is considered as ethical acceptance. It is also permissible for the two parties to agree to a settlement on terms for acceptance of the goods even at a discounted price.

5/4 It is not permitted for a seller to deliver al-Muslam Fihi in the form of a commodity different from the one agreed upon if the commodity is considered to belong to the same genus as al-Muslam Fihi (e.g., al-Muslam Fihi is corn and the commodity that the seller wants to deliver is wheat). However, the delivery of al-Muslam Fihi in the form of a different type of commodity from that agreed upon may take place only on the basis of the conditions for the replacement of al-Muslam Fihi by other goods. [see item 4/2]

5/5 Delivery of al-Muslam Fihi may take place before the due date, on condition that the goods conform to the agreed specifications and quantities. If the buyer has a valid reason for rejecting the goods, then he will not be compelled to accept them. Otherwise, the buyer will be forced to accept the goods.

5/6 If the seller fails to perform his obligation, owing to insolvency, he should be granted an extension of time for delivery.

5/7 It is not permitted to stipulate a penalty clause in respect of delay in the delivery of al-Muslam Fihi.

5/8 In case all or part of al-Muslam Fihi is not available to the seller on the due date, the buyer shall have the following options:

5/8/1 To wait until al-Muslam Fihi is available.

5/8/2 To cancel the contract and recover the paid capital.

It is also permissible for the parties to agree to replacement of al-Muslam Fihi by other goods. [see item 4/2]

6. Parallel Salam

6/1 It is permissible for the seller to enter into a separate, independent Salam contract with a third party in order to acquire goods of a similar specification to those specified in the first Salam contract, so that the first Salam obligation will be discharged by delivering these goods. Hence, the seller in the first Salam contract becomes the buyer in the second Salam contract.

6/2 It is permissible for the buyer to conclude a separate parallel Salam with a third party for the purpose of selling, on the basis of Salam, a commodity whose description corresponds to the description of the commodity to be acquired through the first Salam contract. In this situation, the buyer in the first Salam contract becomes the seller in the second Salam contract.

6/3 In both the two situations mentioned in items 6/1 and 6/2, it is not permissible for the parties to link the obligations under the two Salam contracts together so that the execution of the obligations of one contract is contingent on the outcome of the other. Hence, it is necessary that both the obligations and the rights under the two contracts stand alone in all respects. Therefore, if one party breaches his obligation under the first Salam contract, the other party (the injured party) has no right to relate this damage or loss to the party with whom he concluded a Parallel Salam. Consequently, he has no right on the basis of his loss or damage under the first Salam contract to terminate the second Salam contract or to delay in performing it.

6/4 All the rules of Salam as explained in items 1-5 above are applicable to Parallel Salam as well.

7. Salam Sukuk Issues

It is not permitted to issue tradable Sukuk based on the debt from a Salam contract. [see item (4/1)]

8. Date of Issuance of the Standard

This Shari'ah Standard was issued on 29 Safar 1422 A.H., corresponding to 23 May 2001 A.D.

Adoption of the Standard

The Shari'ah Standard on Salam and Parallel Salam was adopted by the Shari'ah Board in its meeting No. (6) held on 25-29 Safar 1422 A.H., corresponding to 19-23 May 2001 A.D.

In its meeting No. (8) held in Mecca on 28 Safar - 4 Rabi' I 1423 A.H., corresponding to 11-16 May 2002 A.D., the Shari'ah Board readopted a resolution to reformat the Shari'ah Rules for Salam and Parallel Salam in the form of a Shari'ah Standard.

Appendix (A)
Brief History of the Preparation of the Standard

In its meeting No. (5) held in Makkah Al-Mukarramah on 8-12 Ramadan 1421 A.H., corresponding to 4-8 December 2001 A.D., the Shari'ah Board decided to give priority to the preparation of the a Shari'ah rules for Salam and Parallel Salam.

On Monday 11 Shawwal 1420 A.H., corresponding to 17 January 2000 A.D., the Fatwa and Arbitration Committee decided to commission a Shari'ah consultant to prepare a juristic study and an exposure draft on the Shari'ah Rules for Salam and Parallel Salam.

In its meeting held in Bahrain on 21-23 Muharram 1421 A.H., corresponding to 26-28 April 2000 A.D., the Fatwa and Arbitration Committee discussed the exposure draft of the Shari'ah rules for Salam and Parallel Salam and asked the consultant to make the amendments in light of the comments made by the members.

In its meeting No. (4) held in Abu Dhabi, United Arab Emirates, on 14 Sha'ban 1421 A.H., corresponding to 10 November 2000 A.D., the Fatwa and Arbitration Committee discussed the exposure draft and made some relevant amendments.

The revised exposure draft of the Shari'ah rules was presented to the Shari'ah Board in its meeting No. (5) held in Makkah Al-Mukarramah on 8-12 Ramadan 1421 A.H., corresponding to 4-8 December 2000 A.D. The Shari'ah Board made further amendments to the exposure draft of the standard and decided that it should be distributed to specialists and interested parties in order to obtain their comments to discuss them in a public hearing.

A public hearing was held in Bahrain on 4-5 Dhul-Hajjah 1421 A.H., corresponding to 27-28 February 2001 A.D. The public hearing was attended by more than 30 participants representing central banks, institutions, accounting firms, Shari'ah scholars, academics and others interested in this field. Members of the Shari'ah Studies Committee responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Fatwa and Arbitration Committee held its meeting No. (5) in Bahrain on 15 Dhul-Hajjah 1421 A.H., corresponding to 10 March 2001 A.D., to discuss the comments made about the exposure draft. The committee made the necessary amendments in light of both the written comments that were received and oral comments that took place in the public hearing.

The Shari'ah Board in its meeting No. (6) held in Al-Madinah Al-Munawwarah on 25-29 Safar 1422 A.H., corresponding to 19-23 May 2001 A.D., discussed the amendments made by the Fatwa and Arbitration Committee, and made the necessary amendments. The standard was adopted in the name of Shari'ah rules for Salam and Parallel Salam. Some paragraphs were adopted by the unanimous vote of the members of the Shari'ah Board while the other paragraphs were adopted by the majority vote of the members, as recorded in the minutes of the Shari'ah Board.

The Shari'ah Board decided in its meeting No. (7) held in Makkah Al-Mukarramah on 9-13 Ramadan 1422 A.H., corresponding 24-28 November 2001 A.D., to reformat all Shari'ah rules in a form of standards and a committee was formed for this purpose.

In its meeting No. (8) held in Al-Madinah Al-Munawwarah on 28 Safar - 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D., the Shari'ah Board adopted the reformatted version of the Shari'ah rules for Investment and Financing No. (3) on Salam and Parallel Salam with the title of Shari'ah Standard No. (9) on Salam and Parallel Salam, without any substantial changes in the content.

The Shari'ah Standards Review Committee reviewed the standard in its meeting held in Rabi' II, 1433 A.H., corresponding to March 2012 A.D.,

in the State of Qatar, and proposed after deliberation a set of amendments (additions, deletions, and rephrasing) as deemed necessary, and then submitted the proposed amendments to the Shari'ah Board for approval as it deemed necessary.

In its meeting No. (39) held in the Kingdom of Bahrain on 13-15 Muharram 1435 A.H., corresponding to 6-8 November 2014 A.D., the Shari'ah Board discussed the proposed amendments submitted by the Shari'ah Standards Review Committee. After deliberation, the Shari'ah Board approved necessary amendments, and the standard was adopted in its current amended version.

Appendix (B)
The Shari'ah Basis for the Standard

Permissibility of Salam

A contract of Salam derives its permissibility from the Qur`an, the Sunnah and Ijma' (consensus of Fuqaha). On the level of the Qur`an, Allah, the Almighty, says: ***{"O ye who believe! When you deal with each other, in transactions involving future obligations in a fixed period time, reduce them to writing"}***.(2) Ibn Abbas said: "I declare that a Salaf (Salam) contract in which the commodity is guaranteed for future delivery has been permitted by Allah" and then he read: ***{"O ye who believe! When you deal with each other, in transactions involving future obligations in a fixed period time, reduce them to writing"}***. It is reported that Ibn Abbas said: "This verse is a revelation for the particular purpose of making Salam permissible."(3)

On the level of Sunnah, Ibn Abbas is reported to have said: *"The Prophet (peace be upon him) has came to Medina and found that people were selling dates for deferred delivery after a duration of one or two years on a Salam basis. The Prophet (peace be upon him) said: 'Whoever pays for dates on a deferred delivery basis (Salam) should do so on the basis of a specified scale and weight'"*. In another text of the Hadith the Prophet (peace be upon him) said: *"Whoever pays on a deferred delivery basis should do so on the basis of a specified scale, weight and date of delivery"*.(4)

The scholars are unanimous on the permissibility of a Salam contract. Ibn Mundhir said that the scholars agreed that a Salam contract -i.e, a contract

(2) [Al-Baqarah (The Cow): 282].

(3) See: Ibn Al-Jawzi, *"Zad Al-Masir Fi 'Ilm Al-Tafsir"* [1: 336]; and Ibn Kathir, *"Tafsir Al-Qur`an Al-'Azim"* [1: 496].

(4) The Hadith has been related by Al-Bukhari, Muslim and others. See: *"Sahih Al-Bukhari"* [2: 781], Damascus: Dar Al-Qalam edition; and *"Sahih Muslim"* [3: 1226], Beirut: Dar Al-Fikr edition.

in which a person sells to his fellow man a specific and determined thing by weight or measure for a future defined date of delivery—is permissible.(5)

Wisdom of Making Salam Permissible

The wisdom of making Salam permissible lies in the fact that Salam facilitates a type of financing for people in need of it. In particular, farmers, market gardeners and merchants, among others, need working capital for their businesses and for their living expenses in order to operate. Hence, Salam is made permissible so that these businesses may benefit from it. The buyer may benefit from its permissibility as well, by acquiring the commodity at a price below the market price.

Similarly, a contract of Salam responds to the needs of a large number of business enterprises at different levels, ranging from small and medium-sized enterprises to conglomerates that are involved in agricultural and industrial production or trade and the like. In order for these businesses to be productive, they need working capital in the form of either cash or assets. Hence, Salam has provided an investment opportunity in the form of financing of the working capital for trade. It also covers the demands of those in need of liquidity, as long as they are able to fulfill the orders they receive in return at the due date.

Although the contract of Salam is commonly used by agricultural businesses, its permissibility is not, however, confined to these fields. It can also be used in other investment opportunities, such as industry or trade.

The contract of Salam also meets immediate needs for liquidity. This is because it gives the seller flexibility in using the sale proceeds (before the commodity is delivered), and the opportunity to arrange for the counter-value (al-Muslam Fihi) and its delivery to the buyer at the date of delivery.

Subject Matter of a Salam Contract

- The basis for the permissibility of presenting usufruct as capital in a Salam contract is the view of the Maliki scholars. This is regarded as immediate receipt of the capital based on the Shari'ah maxim that says:

(5) Ibn Al-Mundhir, *"Al-Ijma"* (P. 54); and Ibn Qudamah; *"Al-Mughni"* [6: 385], Cairo: Matba'at Hajar edition.

"Taking possession of part of a thing is like taking possession of the whole thing".(6) Hence, this is not a sale of debt (because the buyer has received control over the usufruct).(7)

- The basis for the requirement that the capital of Salam must be known to the two parties is that a Salam contract is one of the exchange contracts in which the consideration need to be known so as to remove any uncertainty.(8)
- The basis for the requirement that the capital must be paid at the conclusion of a Salam contract is the saying of the Prophet (peace be upon him): *"Whoever pays on a deferred delivery basis should do so on the basis of specifying the scale"*.(9) The *Taslif* or *Islaf* means payment in advance. Salam was so named because the capital must be paid in advance. If payment is delayed, the transaction is not called Salam.(10) Again, any delay in payment of the capital and dispersal of the parties renders the transaction a sale of debt for debt(11) which is prohibited, and the scholars agreed on its prohibition. Ibn Rushd said: "As for sale of debt for debt, Muslim scholars are unanimous regarding its prohibition".(12)
- The basis for it not being permitted that a debt be capital in Salam is because this would render the transaction a form of sale of debt and this is prohibited by the Shari'ah.
- The basis for the impermissibility of Salam where the subject matter is a specific and identified thing is the Hadith stating that *"A man came*

(6) Al-Dardir, *"Al-Sharh Al-Saghir"* [4: 347].
(7) Al-Buhuti, *"Sharh Muntaha Al-Iradat"* [2: 37].
(8) Al-Qadi Abdul-Wahhab, *"Al-Ma'unah"* [2: 987]; Ibn Juzay, *"Al-Qawanin Al-Fiqhiyyah"* (P. 202); Al-Kasani, *"Bada`i' Al-Sana`i'"* [5: 301]; Ibn Qudamah, *"Al-Mughni"* [6: 411]; and Al-Shirazi, *"Al-Muhadhdhab"* [1: 300].
(9) The Hadith has been related by Al-Bukhari, Muslim and others: *"Sahih Al-Bukhari"* [2: 781], Damascus: Dar Al-Qalam edition; and *"Sahih Muslim"* [3: 1226], Beirut: Dar Al-Fikr edition.
(10) Ibn Qudamah, *"Al-Mughni"*, [6: 408]
(11) See: Al-Kasani, *"Bada`i' Al-Sana`i'"* [5: 202]; Ibn Rushd (the grandson) *"Bidayat Al-Mujtahid Wa Nihayat Al-Muqtasid"* [2: 205], Beirut, Dar Al-Qalam edition; Al-Qadi Abdul-Wahhab, *"Al-Ma'unah"* [2: 988]; and Al-Zayla'i, *"Tabyin Al-Haqa'iq Sharh Kanz Al-Daqa'iq"* [4: 117].
(12) Ibn Rushd, *"Bidayat Al-Mujtahid"* [2: 150].

to the Prophet (peace be upon him) and said; 'The kin of so and so from the Jews had embraced Islam. However, they are hungry and I am afraid they may become apostates'. The Prophet (peace be upon him) asked the people around him; 'Who has something (money)?' One Jew said; 'I have so and so (he mentioned a sum of money), may be he said; 'I have three hundred dinars and I will pay such and such price for the products of the farm of the kin of so and so'. The Prophet (peace be upon him) said: '(buy) With such and such price to be delivered after such and such period, but not for the products of the kin of so and so'".(13) Again, if a Salam contract is concluded for providing products from a specific farm, there might not be products from this farm at the time of delivery, and this leads to Gharar (uncertainty).

- The basis for the requirement that the subject-matter of Salam be commonly available under normal circumstances where it is required is to remove uncertainty and to ensure that the seller will be able to deliver it at the date of delivery.

Changes to a Salam Contract

- The basis for the impermissibility of selling the subject-matter of Salam before taking possession of it is because such an action is a form of sale of debts which is not permissible.
- The basis for the impermissibility of substituting the subject-matter of Salam with a commodity, the price of which is higher than the prevalent market value of the subject-matter of Salam at the date of delivery is to deter the buyer from making a compound profit on one deal.
- The basis for the permissibility of the termination of a Salam by agreement (Iqalah) is because the Prophet (peace be upon him) has encouraged Iqalah in general and Salam is not an exception from this concession. Salam is also a form of sale and since sale contracts admit Iqalah, so too does a Salam contract. Again, Iqalah is actually

(13) The Hadith has been related by Ibn Majah and Abu Dawud. See: *"Sunan Ibn Majah"* [2: 765-766]; and *"Sunan Abu Dawud"* [3: 744]. Al-Shawkani said: "There is an unknown narrator in the chain of transmission of this Hadith. This is because Abu Dawud narrated it through Muhammad Ibn Kathir from Sufyan from Abu Ishaq from a Najrani man from Ibn Umar. Therefore, the Hadith is not of a strong authority. See: *"Nayl Al-Awtar"* [5: 345-346].

permitted for the sale of tangible goods in consideration of the need of contracting parties to be able to deal with regret and a desire to withdraw from the contract. In the case of Salam, the possibility that the parties may regret concluding the transactions is greater than in the sale of tangible goods because Salam is a low cost form of sale for which permissibility of Iqalah is easily applicable in Salam.(14)

Delivery of al-Muslam Fihi

The basis for not allowing penalty clauses in Salam is because al-Muslam Fihi is considered to be a debt; and it is not permitted to stipulate payment in excess of the principal amount of debts.

Parallel Salam

- The basis for the permissibility of Parallel Salam is that it represents two Salam deals that are separable from each other despite the fact that the descriptions of the subject-matter in the two contracts are similar. However, the contract does not lead to two sales in one, which is impermissible.
- The basis for the impermissibility of tradeable Salam Sukuk is because trading with such Sukuk is a form of sale of debt which is prohibited.

(14) See: Al-Kasani, *"Bada`i' Al-Sana`i'"* [5: 214].

Appendix (C)
Definitions

Salam

A Salam transaction is the purchase of a commodity for deferred delivery in exchange for immediate payment. It is a type of sale in which the price, known as the Salam capital, is paid at the time of contracting while the delivery of the item to be sold, known as al-Muslam Fihi (the subject-matter of a Salam contract), is deferred. The seller and the buyer are known as al-Muslam Ilaihi and al-Muslam or Rab al-Salam respectively. Salam is also known as Salaf (literally; borrowing).

Parallel Salam

If the seller enters into another separate Salam contract with a third party to acquire goods, the specification of which corresponds to that of the commodity specified in the first Salam contract, so that he (the seller) can fulfil his obligation under that contract, then this second contract is called, in contemporary custom, Parallel Salam or *Salam Muwazi*. The following is an example of such a contract. An Institution on one hand buys a specified quantity of cotton from farmers on a Salam basis and, in turn, the buyer in the first Salam contract enters into a new separate Salam contract with textile mills so as to provide them, by means of that new Salam contract, with cotton, the specifications of which are similar to the specifications of the cotton to be acquired under the first Salam contract, without making the execution of the second Salam contract contingent on the execution of the first Salam contract.

Iqalah

Iqalah or cancellation of a contract is a bilateral agreement of the contracting parties to abate and remove the legal effect of a contract.

Mithlis (Fungibles)

Items that are mutually interchangeable, i.e., items whose units are identical (in specifications), and if destructed, are guaranteed by other identical units without consideration to their value.

Financial Accounting Standard No. (4)

Musharaka Financing

Contents

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, *"Tabyin 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 accountholders 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.

Financial Accounting Standard No. (7)

Salam and Parallel Salam

Contents

Preface

This standard aims at setting out accounting rules for recognizing, measuring, presenting and disclosing Salam financing and parallel Salam transactions carried out by the Islamic banks and financial institutions.[1] Attached with the standard are details of the juristic bases for the accounting treatments.

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

Statement of the Standard

1. Scope of Standard

This standard addresses the accounting rules of Salam financing and parallel Salam transactions. This includes the treatment of *Ra`s Al-Mal* paid by the Islamic bank in a Salam transaction or that which it receives in a parallel Salam transaction, the receipt and sale of Al-Muslam Fihi in a Salam transaction or the delivery of its like in a parallel Salam transaction. The standard also includes the treatment of revenues, expenses, gains and losses relating to Salam financing and parallel Salam transactions.

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

2. Accounting Treatments of Salam Financing and Parallel Salam Transactions

2/1 Salam financing shall be recognized when the capital of Salam is paid (whether in cash, kind or benefit) to Al-Muslam Ileihi or when it is made available to him. (para. 2)

2/2 Parallel Salam transactions shall be recognized when the Islamic bank receives the capital of Salam (in cash, kind or benefit). (para. 3)

2/3 At the Time of Contracting

a) Capital is measured by the amount paid. (para. 4)

b) Capital provided in kind or benefit shall be measured at the fair value (the value agreed between the Islamic bank and the client) of the asset or the provided benefit. (para. 5)

2/4 At the end of a financial period

a) Capital is measured at the end of a financial period as in item 2/3. However, if it is probable that Al-Muslam Ileihi will not deliver Al-

Muslam Fihi in full or in part, or it is probable that the value of Al-Muslam Fihi will decline, the Islamic bank shall make a provision of the amount of the estimated deficit. (para. 6)

b) Salam financing transactions shall be presented in the Islamic bank's financial statements under the heading of Salam Financing. (para. 7)

c) Parallel Salam transactions shall be presented in the Islamic bank's financial statements as a liability under the heading Parallel Salam. (para. 8)

2/5 Receipt of Al-Muslam Fihi

2/5/1 Assets constitutive of Al-Muslam Fihi received by the Islamic bank in accordance with the contract are recorded at their historical cost. (para. 9)

2/5/2 In the case of receipt of a similar kind of Al-Muslam Fihi, but of a different quality:

2/5/2/1 If the market value (or the fair value if the market value is not available) of the received Al-Muslam Fihi is equal to the value of contracted Al-Muslam Fihi, the received Al-Muslam Fihi shall be measured and recorded at book value. (para. 10)

2/5/2/2 If the market value (or the fair value if the market value is not available) of the received Al-Muslam Fihi is lower than the book value of the contracted Al-Muslam Fihi, the received Al-Muslam Fihi shall be measured and recorded at market value (or fair value) at the time of delivery and the difference shall be recognized as a loss. (para.11)

2/5/3 In the case of failure of the Islamic bank to receive Al-Muslam Fihi or part thereof at the due date of delivery:

2/5/3/1 In case of complete or partial failure, if the delivery date is extended, the book value of Al-Muslam Fihi shall remain as it is. (para. 12)

2/5/3/2 If the Salam financing contract is completely or partially cancelled and the client does not repay the capital of Salam, the amount shall be recognized as a receivable due from the client. (para. 13)

2/5/4 Failure of the Islamic bank to receive Al-Muslam Fihi due to client's misconduct or negligence:

2/5/4/1 Complete or partial failure

a) If the Salam financing contract is completely or partially cancelled and the client has failed to repay the capital of Salam or the required portion thereof, the amount due shall be recognized as a receivable due from the client. (para. 14)
b) In case the Islamic bank has securities pledged against Al-Muslam Fihi and the proceeds from the sale of the securities are less than its book value, the difference is recognized as a receivable due from the client. Alternatively, if the proceeds are more than the book value then the difference is credited to the client. (para. 15)
c) The client shall be debited with any additional amounts which are established in favour of the Islamic bank. (para. 16)

2/6 Substitution of another kind of goods for Al-Muslam Fihi

Item 2/5/2/2 shall also apply in case another kind of goods is substituted for Al-Muslam Fihi and the market or fair value of the substitute is less than the book value of Al-Muslam Fihi. (para. 17)

2/7 Measurement of the value of Al-Muslam Fihi at the end of a financial period after it is received

At the end of a financial period, assets acquired through Salam financing shall be measured at the lower of historical cost and cash equivalent value, and if the cash equivalent value is lower the difference shall be recognized as loss in the income statement. (para. 18)

2/8 Recognition of the result of delivering of Al-Muslam Fihi in a parallel Salam transaction

Upon delivery of Al-Muslam Fihi by the Islamic bank to the client in a parallel Salam transaction, the difference between the amount paid by the client and the cost of Al-Muslam Fihi shall be recognized as profit or loss. (para. 19)

3. Disclosure Requirements

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. 20)

4. Effective Date

This Standard shall be effective for financial statements for fiscal periods beginning 1 Muharram 1419 A.H. or 1 January 1999 A.D. (para. 21)

Adoption of the Standard

The Standard of Salam and Parallel Salam was adopted by the Accounting and Auditing Standards Board in its meeting No. (13) held on 10-11 Safar 1418 A.H., corresponding to 15-16 June 1997 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. Rashid Akhtar Chughtai	
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

A letter was sent on 30 Jumada I, 1416 A.H., corresponding to 24 October 1995 A.D., to the Islamic financial institutions to seek their opinion on the standards to be given priority. After taking into consideration the replies received from the Islamic financial institutions, the Accounting and Auditing Standards Board (Standards Board) decided in its meeting No. (9) held on 24-25 Rabi' II, 1415 A.H., corresponding to 19-20 September 1995 A.D., in Bahrain, to give priority to the preparation of a standard on Salam and Parallel Salam.

In its meeting No. (3) held on 26 Jumada II, 1416 A.H., corresponding to 18 November 1995 A.D., in Bahrain, the Accounting Standards Committee of the Standards Board decided to commission a consultant to prepare a study on the juristic aspects of the standard, and in its meeting No. (4) held on 14-15 Dhul-Qa'dah 1416 A.H., corresponding to 2-3 April 1996 A.D., in Jordan, the Committee commissioned another consultant to prepare a study on the accounting aspects of the standard. In Rabi' I, 1416 A.H., corresponding to August 1996 A.D., the consultants completed the juristic and accounting studies.

The Accounting Standards Committee discussed the results of both studies and the exposure draft of the standard in its meeting No. (6) held on 17-18 Rabi' II, 1417 A.H., corresponding to 31 August–1 September 1996 A.D., and its meeting No. (7) held on 28-29 Jumada II, 1417 A.H., corresponding to 9-10 November 1996 A.D., held in Bahrain. Both documents were revised in light of the discussions that took place and the comments given by the members.

The exposure draft was submitted to the Shari'a Committee in its meeting No. (5) held on 20-22 Rajab 1417 A.H., corresponding to 1-3 December 1996 A.D., in Bahrain, and the amendments which it deemed necessary were made.

The amended exposure draft was discussed in the Standards Board meeting No. (12) held on 9-11 Ramadan 1417 A.H., corresponding to 18-20 January 1997 A.D., in Jeddah, Saudi Arabia. The Standards Board made further amendments to the exposure draft and decided that it 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.

Two listening sessions were held, one in Bahrain on 14-15 Dhul-Qa'dah 1417 A.H., corresponding to 23-24 March 1997 A.D., and the other in Malaysia on 24-25 Dhul-Qa'dah 1417 A.H., corresponding to 34 April 1997 A.D. The listening sessions were attended by more than 145 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 sessions to both the written comments that were received prior to the listening sessions as well as the oral comments that were expressed in the sessions of the listening sessions.

The Accounting Standards Committee held two meetings on 15 Dhul-Qa'dah 1417 A.H., corresponding to 24 March 1997 A.D., and 23 Dhul-Hajjah 1417 A.H., corresponding to 30 April 1997 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 two listening sessions.

The revised exposure draft was reviewed and approved by the Shari'a Committee in its meeting No. (6) which was held on 1-2 Muharram 1418 A.H., corresponding to 7-8 May 1997 A.D., after making some changes in the draft.

The Accounting and Auditing Standards Board adopted the proposed standard in its meeting No. (13) held on 10-11 Safar 1418 A.H., corresponding to 15-16 June 1997 A.D.

Appendix (B)
Juristic Rules of Salam and Parallel Salam

1. Definition

Salam and Salaf (borrowing) are of the same meaning. Salam is a type of sale and it can be defined as:

"Purchase of a commodity for deferred delivery in exchange for immediate payment according to specified conditions",(2) or "Sale of a commodity for deferred delivery in exchange for immediate payment".

2. Legitimacy

Salam sale has its legitimacy from:

2/1 Qur`an and Sunnah.(3)

2/2 Ijma' (consensus). Ibn Al-Mundhir said: "All authoritative Fuqaha (jurists) unanimously agreed that Salam is considered permissible".(4)

2/3 On the wisdom of its legitimacy, Ibn Qudamah said: "Because people had a need for (Salam) and because farmers, market gardeners and tradesmen needed money for their living expenses and to spend on their businesses to bring them to fruition, and so faced financial need, Salam was made permissible so that they could benefit from it as well as Al-Muslam having the benefit of its permissibility.(5)

(2) Ibn Abidin, *"Radd Al-Muhtar 'Ala Al-Dur Al-Mukhtar"*, [4: 281]; Al-San'ani, *"Ar-Rawd Al-Nadir Sharh Majmu' Al-Fiqh Al-Kabir"*, [3: 225]; Al-Hattab, *"Mawahib Al-Jalil"*, [4: 514]; Ibn Qudamah, *"Al-Mughni"*, [4: 304]; Ahmad Ali Abdullah, *"Juristic Rules of the Contract of Salam and Parallel Salam"*, Accounting and Auditing Organization for Islamic Financial Institutions, 1996, (P. 2).

(3) [Al-Baqarah (The Cow): 282]; Ibn Hajar, *"Bulugh Al-Maram Ma'a Subul As-Salam"*, [3: 47].

(4) *"Al-Mughni"*, [4: 304].

(5) *"Al Mughni"*, [4: 305].

Therefore, Salam draws its legitimacy from the strongest Islamic sources of legislation. It is legitimate as a general rule in conformity with general principles of Shari'a.(6)

3. Capital of Salam

The validity of a Salam contract is dependent on satisfying the following conditions:

3/1 The capital should be known.

The commodity to be supplied should be known as to kind, type, quality and amount. The original rule regarding payment is that it should be in cash. Fuqaha have differed as to the permissibility of payment in the form of trading assets. Some Fuqaha have considered it permissible, and this is the view adopted in preparing this standard. Malikis have also allowed payment to be in the form of a benefit in kind, such as the benefit of living in a house.(7)

3/2 Receipt of Salam payment

3/2/1 The majority of Fuqaha specify that the receipt of the Salam payment should be at the place where the contract is established. This is in consideration of the seller's need and to prevent the introduction of debt into the consideration given by Al-Muslam (buyer). In particular, the Salam payment can not be in the form of cancellation of debt due from Al-Muslam Ileihi. This is a precaution against Riba.(8)

3/2/2 The Malikis have permitted a short delay in making the Salam payment.(9)

4. Al-Muslam Fihi

Validity of the Salam contract is dependent on satisfying the following conditions and terms relating to Al-Muslam Fihi:

---

(6) Ahmad Ali Abdullah, op.cit., (pp. 4-13).

(7) Al-Kasani, *"Bada`i' Al-Sana`i'"*, [7: 3149]; Al-Shirazi, *"Al-Muhadhdhab"*, [1: 300]; *"Al-Mughni"*, [4: 330]; *"Mawahib Al-Jalil"*, [4: 416].

(8) *"Bada`i' Al-Sana`i'"*, [7: 3155]; Muhammad Ibn Yusuf Atfish, *"Sharh Kitab Al-Nil"*, [8: 640].

(9) *"Mawahib Al-Jalil"*, [4: 916].

4/1 It should be subject to specification and can be recognized as a debt.(10)

4/2 It should be subject to identification so as to negate lack of knowledge of its kind (e.g., wheat or cotton), type (e.g., Syrian wheat), and quality of a type (e.g., superior, medium or inferior Syrian wheat). It should also be known as to amount.

4/3 Deferring the delivery of Al-Muslam Fihi

4/3/1 The majority of Fuqaha make it a condition that the delivery of Al-Muslam Fihi should be deferred to a future date. This is also the view adopted in this standard.(11)

4/3/2 The Shafis have permitted prompt delivery of Salam.(12)

4/4 Permissibility of specifying the future date of delivering Al-Muslam Fihi.

Fuqaha have agreed that specifying the future date of delivery is considered permissible; for example, the last day in the month of October 1996. Fuqaha have also agreed that the delivery should not be contingent on an unknown event; for example, the solvency or the arrival of another person. However, Fuqaha have differed on the issue of the lack of specificity that is considered permissible with regard to the delivery date of Al-Muslam Fihi; for example, during the harvesting season or during the time of Hajj (pilgrimage). The majority of Fuqaha have required a greater degree of specificity of the delivery date, but the Malikis considered that a range of possible delivery dates is acceptable and so did the Hanbalis in one of their versions. It is the latter view that has been adopted in this standard.(13)

4/5 The future date of delivery should be fixed to match the time when Al-Muslam Fihi would most likely be commonly available in order to prevent Gharar (uncertainty) and to enable Al-Muslam Ileihi to discharge his obligation. The Hanafis stipulate that the future

(10) *"Bada`i' Al-Sana`i'"*, [7: 4613].
(11) *"Mawahib Al-Jalil"*, and [4: 528]; *"Al-Mughni"*, [4: 321].
(12) *"Al-Muhadhdhab"*, [1: 297].
(13) *"Al-Bada`i'"*, [7: 3175]; and *"Mawahib Al-Jalil"*, [4: 523].

availability of Al-Muslam Fihi should be known at the date of contracting to the date of delivery.(14) However, the opinion of the majority of Fuqaha is the one adopted in this standard.

4/6 Specification of Al-Muslam Fihi is accepted based on the description of Al-Muslam Ileihi. Delivery of Al-Muslam Fihi should not be confined to being made from a specific source. This is intended as an extra precaution against Gharar as well as to provide a means for Al-Muslam Ileihi to fulfil the obligation. Therefore, it is not considered permissible to limit the delivery of Al-Muslam Fihi to a source such as Al-Muslam Ileihi's farm or the farm of someone else or the production of a specific country.(15)

4/7 Delivery place of Al-Muslam Fihi.

4/7/1 Parties to the contract should designate the place in which Al-Muslam Fihi is to be delivered.

4/7/2 If both parties to the contract did not determine the delivery place, then it should be determined according to custom.(16)

4/8 Sale of Al-Muslam Fihi before receiving it

4/8/1 This is not considered permissible by the majority of Fuqaha because of the rule that prevents the sale of food, as well as all movable items, before it is received. This is because it is not considered permissible to earn a profit without entering into an obligation to deliver.(17)

4/8/2 The Malikis agreed with the majority of Fuqaha on the prohibition of selling Al-Muslam Fihi before it is received but only if Al-Muslam Fihi is food, otherwise for them it is permitted providing the following conditions are satisfied:

(14) *"Mawahib Al-Jalil"*, [4: 534]; *"Al-Muhadhdhab"*, [1: 297]; *"Al-Mughni"*, [4: 325]; and *"Al-Bada`i'"*, [7: 3171].
(15) *"Al-Bada`i'"*, [7: 3172]; *"Al-Muhadhdhab"*, [1: 298]; and *"Al-Mughni"*, [4: 354-326].
(16) Ahmad Ali Abdullah, op.cit, (pp. 29-30).
(17) *"Al-Bada`i'"*, [7: 3179]; *"Al-Muhadhdhab"*, [1: 301]; and *"Al-Mughni"*, [4: 334-335.

4/8/2/1 In the case of a sale back to Al-Muslam Ileihi, this is considered permissible either at the contract price or lower.

4/8/2/2 In the case of a sale to a third party (not Al-Muslam Ileihi), it is considered permissible to sell Al-Muslam Fihi at the contract price (which is required if the quality is similar to that specified in the contract) or at a higher or lower price (if the quality is different from that specified in the contract).(18)

4/9 Replacement of Al-Muslam Fihi by substituting another kind of goods:

4/9/1 The majority of Fuqaha have prohibited the replacement of Al-Muslam Fihi before it is received except by substituting another kind of similar goods. This is because substitution is considered as a form of sale and according to their jurisprudence an individual cannot sell what he does not own. However, it is considered permissible to replace Al-Muslam Fihi by substituting similar goods that are of the same, lower or better quality as this is not considered as a sale, but as a form of satisfactory fulfilment and out of necessity.(19)

4/9/2 The Malikis have agreed with the majority of Fuqaha on the prohibition of replacing Al-Muslam Fihi if it is food; however, they have made the replacement of Al-Muslam Fihi by a substitution permissible if it is not food, based on the views of their school of Fiqh (jurisprudence) which permits the sale of goods before they are received.

4/9/2/1 If the substitution is made with Al-Muslam Ileihi, then it would be considered permissible on condition that:

- The substitute is similar to Al-Muslam Fihi or of a lower quality, in order to negate suspicion of Riba.

(18) *"Mawahib Al-Jalil"*, [4: 542-544].
(19) *"Al-Bada`i'"*, [7: 397]; and *"Sharh Kitab Al-Nil"*, [8: 84-687].

- Al-Muslam should take delivery of the substitute in order that it should not lead to the exchange of debt against debt.
- The relation between the substitute and the price should be free of Riba.

4/9/3 Some contemporary Fuqaha are of the view that substitution is considered permissible whether or not Al-Muslam Fihi is food subject to the following two conditions:

4/9/3/1 With regard to kind, suitability of the substitute to be considered as Al-Muslam Fihi as specified in the Salam contract.

4/9/3/2 With regard to quantity, the substitute should not be more than Al-Muslam Fihi so that the purchaser does not obtain additional benefit.(20)

5. Parallel Salam

5/1 The Shari'a supervisory board of Al Rajhi Banking and Investment Corporation issued a Fatwa permitting the practice of parallel Salam on condition that the execution of the second Salam contract is not made dependent on the execution of the first one.(21)

5/2 Some contemporary Fuqaha have prohibited parallel Salam, particularly if it is for the purpose of trading and such a transaction becomes recurrent, as this may be suspected as involving Riba.(22)

6. General Rules

6/1 Nullification or cancellation of the contract

This refers to the cancellation of the contract and reversion to the situation of the two parties before entering into the Salam contract. Complete nullification of the delivery of Al-Muslam Fihi in return for repayment of the full amount of the capital of Salam is unanimously

(20) Professor Al-Siddiq Muhammad Al-Amin Al-Darir, *"Salam"*, (pp. 32-34).
(21) Al Rajhi Banking and Investment Corporation, Shari'a Supervisory Board, Fatwa No. (41), (Paraphrased).
(22) Professor Al-Darir, op.cit., (pp. 34-35).

considered permissible by Fuqaha. Partial cancellation of the delivery of Al-Muslam Fihi in return for the corresponding part of the capital of Salam, with the balance being repaid to Al-Muslam, is considered permissible according to the majority of Fuqaha.(23)

6/2 Delivery of Al-Muslam Fihi before or on its due date

6/2/1 Al-Muslam Ileihi should deliver Al-Muslam Fihi on its due date and according to the agreed quality and quantity, and Al-Muslam should accept it.

6/2/2 If Al-Muslam Ileihi delivers a superior quality of Al-Muslam Fihi, then Al-Muslam should accept it on condition that Al-Muslam Ileihi does not ask for a higher price in return for the extra quality because this is considered as a form of satisfactory fulfilment.

6/2/3 If Al-Muslam Ileihi delivers an inferior quality of Al-Muslam Fihi, then Al-Muslam has the option to accept Al-Muslam Fihi on condition that he does not ask for a lower price in return for the inferior quality because he has accepted it as satisfactory fulfilment.

6/2/4 Fuqaha have differed on whether or not it is considered permissible for Al-Muslam Ileihi to deliver a different type of Al-Muslam Fihi than the one agreed upon.

6/2/5 It is considered permissible to deliver Al-Muslam Fihi before its due date on condition that the following are satisfied:

6/2/5/1 Al-Muslam Fihi should be of the agreed upon quality and quantity.

6/2/5/2 Al-Muslam Fihi should be neither of superior quality nor in greater quantity.

6/2/5/3 Al-Muslam Fihi should be neither of an inferior quality nor in lesser quantity because this would be similar to

(23) *"Al-Bada`i'"*, [7: 3179]; and *"Al-Muhadhdhab"*, [1: 302].

"pay less, but ahead of due date" which is prohibited by Shari'a (form of Riba).[24]

7. In Case All or Part of Al-Muslam Fihi Is Not Available on Its Due Date, Al-Muslam Shall Have the Following Options:

7/1 Cancel the contract and have his repayment refunded; or

7/2 Wait until Al-Muslam Fihi is available.

8. It Is Considered Permissible by the Majority of Fuqaha to Transfer or Pledge Al-Muslam Fihi or Use It As A Guarantee Because This Is Generally Considered Permissible in the Case of Debts. This Is the View Adopted in This Standard.

(24) *"Mawahib Al-Jalil"*, [4: 541-542]; *"Al-Muhadhdhab"*, [1: 300-301]; and *"Al-Rawadah Al-Bahiyyah Sharh Al-Luma' ah Al-Dimashqiyyah"*, [3: 321].

Appendix (C)
Reasons for the Standard

In their response to AAOIFI's letter of 30 Jumada I, 1416 A.H., corresponding to 24 October 1995 A.D., Islamic banks gave priority to the preparation of a standard, among others, on Salam and parallel Salam. This was endorsed by the Standards Board in its meeting No. (9) held on 24-25 Rabi' II, 1415 A.H., corresponding to 19-20 September 1995 A.D., in Bahrain.

The empirical study that was conducted by the consultant who commissioned by AAOIFI revealed that Salam financing represented about 5% of the total finance provided by the Islamic banks that participated in the study. The study also showed that the use of Salam financing was mainly in the agriculture sector.

The study also showed that there were differences between Islamic banks in the accounting treatments of Salam financing which rendered their financial statements non comparable. Furthermore, the Islamic banks did not disclose adequate information in their financial statements on the accounting policies applied to Salam financing.

Since the use of Salam financing is relatively recent, the initiative by AAOIFI to prepare an accounting standard for this financial instrument is expected to help in reducing the accounting differences that may emerge as a result of Islamic banks developing their own accounting treatments as has been the case with other financial instruments used by Islamic banks, a practice which has resulted in different methods of recognition, measurement, presentation and/or disclosure.

Appendix (D)
Basis for Conclusions

The Accounting Standards Committee has reviewed the alternatives proposed in the preliminary study[25] to be adopted in the accounting treatments of Salam and Parallel Salam. The Accounting Standards Committee recommended the adoption of the alternatives which were considered to be in compliance with the provisions of the previous Statement of Financial Accounting No. (1): Objectives of Financial Accounting for Islamic Banks and Financial Institutions (Statement of Objectives), and Statement of Financial Accounting No. (2): Concepts of Financial Accounting for Islamic Banks and Financial Institutions (Statement of Concepts).

The condition that the capital of Salam should be known in a form that determines it constitutes the basis which has been taken to measure the value by which the capital of Salam should be recorded in the Islamic bank's books when it is paid (in case of Salam) or when it is received (in case of Parallel Salam). If the capital of Salam is in the form of cash, it is identified by the type of currency and its quantity, but if it is in the form of kind or benefit, it is measured by the fair value of such assets or benefits according to what the two contracting parties agree upon. The use of the fair value instead of the historical cost provides users of financial statements with useful information that helps them in their decisions when dealing with Islamic banks. Such an objective is in line with what is provided for in the previous Statement of Objectives. The use of the fair value also leads to the application of the representational faithfulness concept provided for in the previous Statement of Concepts.

(25) Muhammad Al-Amin Taj Al-Asfiya`, *"Study on the Accounting Aspects of Salam and Parallel Salam"*, Accounting and Auditing Organization for Islamic Financial Institutions, 1417 A.H.-1996 A.D.

Historical cost has been chosen to measure the capital of Salam financing and parallel Salam transactions at the end of a financial period because of the reliability of the information provided by this attribute. It also conforms with what is provided for in the provisions of the previous Statement of Concepts. However, to ensure reliability of the information provided in the financial statements, the standard provides that if it becomes clear to the Islamic bank that there is a strong probability that Al-Muslam Ileihi will not deliver Al-Muslam Fihi, in full or in part, or there is a strong probability that the value of the Al-Muslam Fihi will decline, a provision should be made of the amount of the estimated deficit. Making such a provision will help in providing information that helps in predicting the Islamic bank's future cash flows resulting from Salam financing. The predictive value of information represents one of the qualitative characteristics provided for in the previous Statement of Concepts to achieve reliability.

To provide understandable and comprehensible information, which are qualitative characteristics that accounting information should have, the standard requires that the consideration paid as capital for Salam financing transactions should be presented in the financial statements under the heading Salam Financing. This conforms with the financing nature of the Salam contract which is based on the need by Al-Muslam Ileihi for capital to bridge the financing gap between the time of contracting and receipt of the capital and the date agreed upon to deliver Al-Muslam Fihi to the Islamic bank.

In case the Islamic bank receives Al-Muslam Fihi according to the agreed upon quantities under the contract, the historical cost is used as the basis for measuring and recording the assets at the time of possessing them. Accordingly, Al-Muslam Fihi acquired by the Islamic bank through Salam financing is measured at the time of receiving it at its historical cost which is equivalent to the Salam capital paid by the Islamic bank.

In the case of the receipt of a similar kind of Al-Muslam Fihi, but of a different quality, if the market value (or the fair value if the market value is not available) of Al-Muslam Fihi is equal to the value of the contracted Al-Muslam Fihi, then the received Al-Muslam Fihi is measured and recorded at

book value. However, if the market value (or the fair value if the market value is not available) of the received Al-Muslam Fihi is lower than the book value of contracted Al-Muslam Fihi, the received Al-Muslam Fihi is measured and recorded at market value (or the fair value if the market value is not available) at the time of delivery and the difference is recognized as a loss. This is because the decline in the value of the asset should be taken into account by writing down the book value of the asset to represent the cash equivalent value. This measurement attribute is expected to provided users of the financial statements with relevant information that helps them in their decisions. This is in line with the provisions of the previous Statement of Concepts regarding the qualitative characteristics of accounting information which the financial statements of Islamic banks should contain.

The previous Statement of Concepts gives guidance as to when gains and losses, which are basic elements of the income statement, should be recognized. A loss should, therefore, be recognized once a reciprocal transfer takes place between the Islamic bank and Al-Muslam Ileihi at the time of receiving the substitute of Al-Muslam Fihi. Accordingly, once the Islamic bank accepts the substitute of Al-Muslam Fihi which has a market value lower than the book value of the contracted Al-Muslam Fihi, the difference should be recognized as a loss incurred by the Islamic bank.

The Standard differentiates between the failure of Al-Muslam Ileihi to deliver Al-Muslam Fihi due to negligence and misconduct and any other failure to receive Al-Muslam Fihi or part of it at the due date of delivery. The accounting treatment in the standard is in line with one of the objectives of financial accounting which states: "Determination of the rights and liabilities of all related parties, including any rights ensuing from uncompleted transactions and activities, in accordance with the provisions of Shari'a and its principles of fairness, justice and adherence to the ethics of Islamic dealings.

At the end of a financial period, Al-Muslam Fihi is recorded at historical cost or cash equivalent value, whichever is lower. This should provide relevant information, which is one of the characteristics of the information that financial statements of Islamic banks should contain.

Appendix (E)
Definitions

Salam

Purchase of a commodity for deferred delivery in exchange for immediate payment according to specified conditions or sale of a commodity for deferred delivery in exchange for immediate payment.

Al-Muslam Fihi

The commodity to be delivered.

Al-Muslam Ileihi

The seller.

Al-Muslam

The purchaser.

Ra`s Al-Mal

Capital (cost) paid (in cash, kind or benefit) in a Salam contract; i.e., price.

Parallel Salam

A Salam contract whereby Al-Muslam Ileihi depends, for executing his obligation, on receiving what is due to him –in his capacity as Al-Muslam– from a sale in a previous Salam contract, without making the execution of the second Salam contract dependent on the execution of the first one.

AAOIFI Financial Accounting Standard 28

Murabaha and Other Deferred Payment Sales

Contents

AAOIFI Financial Accounting Standard 28 "*Murabaha and Other Deferred Payment Sales"* is set out in paragraphs 01-53. All the paragraphs have equal authority. This standard should be read in the context of its objective and the Conceptual Framework for Financial Reporting as endorsed by AAOIFI.

All AAOIFI FASs shall be read in conjunction with the definitions, Shari'ah principles and rules key considerations provided by AAOIFI Shari'ah Standards (SS) in respect of such products and matters.

Preface

PR1 Murabaha and Murabaha to the purchase orderer are the most popular and dominant contracts used by Islamic banks and other Islamic Financial Institutions (referred to as "IFI(s)" or the institution(s) in the Standard), hence a very important element in their financial statements. While Murabaha can be executed on a spot basis, its most common use by IFI is in the form of deferred payment transactions.

PR2 In addition to Murabaha, there are several other transactions of Islamic finance which are based on trade but unlike Murabaha, do not require disclosure of the cost and profit to the intended buyer. Such sales may take different forms and for the purpose of this standard are generally referred to as 'deferred payment sales'.

PR3 This standard aims at setting out the accounting rules for measurement, recognition and disclosure of the transactions of Murabaha and other deferred payment sales that are carried out by Islamic banks or IFI.

PR4 This standard supersedes the earlier FAS 2 "Murabaha and Murabaha to the Purchase Orderer" and FAS 20 "Deferred Payment Sale".

Introduction

Overview

IN1 This standard AAOIFI Financial Accounting Standard (FAS) 28 prescribes the accounting and reporting principles and requirements for Murabaha and deferred payment sales transactions and different elements of such transaction.

Rationale for issuing this standard

IN2 In line with the new financial accounting standards development strategy, the AAOIFI Accounting board has initiated a review and revision process for certain FAS. As a part of such process and based on time-to-time feedback received from the market participants, as well as, the changes and updates in the generally accepted accounting principles set out by other standards setting bodies, it was considered imperative to perform a comprehensive review and revision of the existing standards on Murabaha and deferred payment sales. Additionally, the earlier standards did not address the issue of accounting for the purchaser in Murabaha and deferred payment sales transactions.

AAOIFI Financial Accounting Standard 28
Murabaha and Other Deferred Payment Sales

Objective of the standard

1. The objective of this standard is to prescribe the appropriate accounting and reporting principles for recognition, measurement and disclosures to apply in relation to Murabaha and other deferred payment sales transactions for the sellers and buyers, for such transactions.

Scope

2. This standard applies to accounting for Murabaha and other deferred payment sales transaction carried out under Shari'ah principles, excluding Tawarruq and commodity Murabaha transactions.

3. This standard shall not apply to investments made in investment instruments e.g. equity instruments or Sukuk, where the underlying asset for such instrument is a Murabaha or deferred payment sale.

Definitions

4. For the purpose of interpreting and applying this standard, the following short definitions are relevant:

   a. Arboun – is the amount paid by the intending buyer in a sale transaction as a security cum advance payment against the sales price, along with a promise to purchase. In line with contractual terms, it may be forfeited in case of default in promise to purchase by the buyer;

   b. Commodity Murabaha – is a Murabaha product based on commodity transactions in the organized commodity markets, where both the parties to the transaction have intention only to take constructive possession of the commodity;

   c. Control – an institution controls an asset or business, when it has substantially all risks and rewards incidental to ownership of such asset or business, duly meeting both of the following conditions:

      i. it is directly exposed to, or has rights to, variable returns (negative or positive, respectively) from its involvement with such assets or business; and
      ii. it has the ability to affect those returns through its power over the assets or business;

   d. Deferred payment sale – is any kind of sales transaction in which the payment of sales consideration is deferred over a fixed credit term, in installments or on a lump sum basis;

   e. Fair value – The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date;

   f. Hamish Jiddiyyah – is the amount deposited as a security against fulfillment of a contract, or promise, or completion of a transaction by one of the parties to other;

   g. Inventory – in relation to this standard is an asset held for sale in the ordinary course of business or in the process of production for such sale;

h. Murabaha – is sale of goods with an agreed upon profit mark-up on the cost. This could be on a spot basis or deferred payment basis;

i. Murabaha to the purchase orderer – refers to a sale and purchase transaction where the purchaser makes an order and confirmed his order with a promise (Wa'ad) to purchase the specified subject matter from the intended seller on agreed Murabaha terms;

j. Musawama – is a common bargain sale where the cost and profit elements are not necessary to be disclosed. This could be on a spot basis or deferred payment basis;

k. Net realisable value (NRV) – is the estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale, considering the factors specific to the institution;

l. Promise and mutual promise – promise is a constructive obligation assumed by one party (in Murabaha, the purchase orderer). The promise is understood to be binding in religious law on the individual who makes it, unless a legitimate excuse under Islamic Shari'ah arises and prevents its fulfillment. Nevertheless, a promise is understood to be binding from the juristic perspective if it is pending on a cause and the promissee has incurred costs by reason of the promise. Mutual promise is a promise against promise; and

m. Tawarruq – is a kind of sale transaction where the institution buys an asset and sells it to the customer on credit, whereby the customer intends to sell the purchased asset to another party immediately for cash.

Murabaha and other deferred payment sales in the financial statements of the seller

Initial recognition

Inventories

5. Inventory shall be recognized in the books of the institution once it controls the inventory i.e. the time when it essentially acquires substantially all risks and rewards incidental to ownership of such inventory.

6. Inventories shall be initially recognized at cost. The cost of inventory shall comprise all costs of purchase and other costs incurred in bringing the inventory to its present location and condition. It includes all types of taxes (other than those subsequently recovered), transportation and handling costs including related Takaful cost and all other costs directly attributable to bring the asset to its present location and condition including those incurred by the customer in the capacity of agent and any fee paid to the agent. Trade discounts, rebates and similar items should be deducted from the costs.

7. In cases where inventories are acquired on a piecemeal basis or in tranches, each tranche of inventories received shall be recognized when the conditions defined in paragraph 5 are met.

Receivables

8. The seller shall recognize receivables and revenue in its financial statements, when the inventory is sold under Murabaha or deferred payment sale contract. (See paragraphs 23-28 for deferred profit treatment).

9. Receivable shall be recognized at an amount equal to the face value (gross amount or invoice value).

10. The inventory is considered to be sold under Murabaha or deferred payment sale contract at the time of consummation of the Murabaha or deferred payment sale contract i.e. when such contract becomes legally binding on all parties to the contract whether the consideration is received or receivable and the control (entailing essentially all risks and rewards incidental to ownership) of the inventory is transferred to the intended buyer.

Subsequent measurement

Inventories

11. Subsequent to the initial recognition, inventories shall be measured at the lower of cost and net realizable value.

12. In situations where a credit-worthy potential customer has a binding promise to buy the respective inventories at a value equal to or higher than the cost, the seller shall carry inventories at cost irrespective of fluctuations in fair value of inventories, if any.

13. In situations where a binding promise from a credit-worthy potential customer as mentioned above is not available, adjustment in carrying value to write-down to net realizable value (if lower than cost) shall be made and corresponding effect of write-down shall be recognized in the period in which such impact is identified.

14. Any additional handling and holding costs shall be charged to statement of income during the period in which these arise.

Receivables

15. Subsequent to initial recognition, gross receivables shall be carried at their outstanding amount less any allowance for credit losses.

16. Outstanding amounts represent the gross amount of receivables less recoveries or other adjustments including discounts and rebates allowed, if any.

17. Allowance for credit losses[1] shall be accounted for in accordance with the relevant FAS.

De-recognition

18. An asset classified as inventory or receivable shall only be de-recognized in the financial statements if it meets the de-recognition criteria of an asset that is “no future economic benefit is expected to flow to the institution from that particular asset”.

Inventories

19. Considering the de-recognition criteria provided in paragraph 18, inventories shall be derecognized upon either:

    a. the institution transferring control to the buyer in form of sale (see paragraph 18); or

    b. the institution losing control e.g. in form of physical loss or theft; or

[1] Also called provision.

c. Inventories losing their capacity of providing future economic benefits e.g. technological obsolescence, or legal restrictions or there if is no expected buyer.

Receivables

20. Considering the de-recognition criteria provided in paragraph 18, receivables shall be derecognized when:

    a. the customer has completely settled the outstanding amount; or

    b. the carrying amount cannot be recovered due to customer's insolvency; or

    c. the institution decided to waive its right by writing it off or treated it as Hibah to the customer.

Revenue and profit recognition

Revenue

21. See paragraph 8 for recognition of revenue and receivables.

Cost of sales

22. Where inventory is sold under a Murabaha or deferred payment sales contract, the carrying amount of such inventory, along with any direct expenses incurred, shall be recognized as cost of sales in the period in which the related revenue is recognized.

Profit deferment

23. In case of deferred payment Murabaha or other deferred payment sales, the profit arising from the transaction i.e. the difference between revenue and cost of sales recognized, shall be deferred through a deferred profit account. However, in case where the equivalent cash sale price of the goods sold is higher than the cost of sales, the profit to the extent of difference between the cash sale price and the cost of sales shall not be deferred.

24. Deferred profit account shall be presented as a contra-asset of respective receivables.

25. Deferred profit shall be amortized to income over the contractual credit period on a time proportionate basis.

26. For transactions with installments or lump sum payment at the end, with original maturity of more than 12 months, the appropriate method to apply the time proportion basis shall be the effective profit rate method based on the implicit profit in the transaction.

27. For transactions with lump sum payment at the end, with original maturity of 12 months or less, the straight line allocation of profit over the contractual credit period is allowable.

28. In case of defaults or possible defaults, the deferred profit shall be treated in accordance with the respective FAS.

Related accounting treatments

Waivers, discounts and write-offs

29. Where a part of the receivable has been reduced or waived by the seller as a rebate on early settlement of the receivable, or for any other reason, the amount of reduction / waiver shall be recognized in the period in which such settlement occurs, in the following manner:

    a. first, it is to be netted-off against any available balance of deferred profit on such transaction; and

    b. secondly, any remaining balance is to be netted-off against the profit recognized / deferred profit amortized during the current financial period; and

    c. thirdly, any remaining balance is to be recognized in the statement of income as an expense for the period.

Transaction costs

30. Transaction costs incurred, associated with negotiating and arranging a Murabaha or deferred payment sale contract, net of any reimbursements by the customer, shall be charged to the statement of income in the period in which they are incurred.

Structuring and other service fees

31. Any structuring or similar fee charged to the customer shall be recognized when the related services are provided.

Subsequent discounts on inventory

32. Any discount received on cost of inventory, subsequent to consummation of sale, shall reduce the cost of sales.

33. If the discount is passed on to the customer, the same shall be recognized in the statement of income as a discount (deduction) against the gross revenue.

34. If the discount is not passed on to the customer:

    a. in case of cash Murabaha, the same will be recognized in the statement income in the period in which it arises; and

    b. in case of deferred payment Murabaha and deferred payment sales, the same shall eventually increase the amount of deferred profit and amortized accordingly.

Hamish Jiddiyyah and Arboun

35. Subject to the terms of the contract, the initial deposit or advance payment, paid by the buyer shall be recognized as a liability of the seller.

36. Adjustment of, or forfeiture of, Hamish Jiddiyyah or Arboun, against breach of promise or default or other adverse conditions shall be governed by the Shari'ah rules and contractual arrangement between the parties, and accounted for accordingly.

37. Once the Murabaha or deferred payment sale transaction is consummated:

a. Hamish Jiddiyyah, being in the nature of a security deposit, shall continue to be presented as a liability and shall not be set-off against the receivables unless contractually agreed with the buyer; and

b. Arboun, being in the nature of an advance payment, shall be netted off against the receivables.

Charity

38. Any charity payment against defaults and delayed payments by the customer shall not be recognized as an income of the seller and shall be taken directly to charity payable, when received.

Presentation and disclosures

39. In addition to the disclosure requirements stated in FAS 1 "General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions" following are the minimum disclosure requirements in the financial statements of the seller:

a. the accounting policies adopted for Murabaha and deferred payment sales transactions;

b. inventories held for Murabaha and deferred payment sales distinguishing according to the classification as well as identifying the inventory held under binding promise, held under non-binding promise and / or without any promise to purchase;

c. inventories intended to be held for longer periods with information about the nature and risks associated thereto;

d. receivables against Murabaha and deferred payment sales distinguished according to nature and identifying the maturity profiles of the same;

e. receivables distinguishing between secured and unsecured, if any;

f. the sales revenue and cost of sales resulted from Murabaha and other deferred payment sales, respectively, during the period – in the notes to the financial statements;

g. unamortized deferred profits against Murabaha and deferred payment sales receivables, respectively, providing a movement of the same during the period duly disclosed as a deduction from the outstanding amount of receivables;

h. outstanding amounts of Hamish Jiddiyyah and Arboun at the end of the financial period;

i. the amount of profit waived and receivables written off, according to their respective nature, during the period;

j. the amount of charity payments recovered and recoverable, against defaults in payments and other breaches if any.

Murabaha and other deferred payment sales in the financial statements of the buyer

Initial recognition

Recording of purchases

40. The asset which is the subject matter of a Murabaha or deferred payment sale transaction is considered to be purchased under Murabaha or deferred payment sale contract, at the time of consummation of the Murabaha or deferred payment sale i.e. when such contract becomes legally binding on all the parties to it and the control (entailing essentially all risks and rewards incidental to ownership) of the asset is obtained by the buyer.

41. The asset procured shall be initially recognized at cost i.e. the face value (gross invoice value – including the sellers profit on transaction) plus any incidental direct cost of acquisition. The asset so procured shall be reported and classified by the buyer in its books of account according to respective FAS. In case of absence of a specific FAS on the subject, generally accepted accounting principles shall be followed subject to specific requirements of this standard.

Murabaha and deferred payment sales liabilities

42. The buyer shall recognize accounts payable on account of Murabaha and other deferred payment sales an amount equal to the face value (gross invoice value – including the sellers profit on transaction) once the control to the asset is procured.

Subsequent measurement

Murabaha and deferred payment sales assets

43. The asset so procured shall be subsequently measured by the buyer in its books of account according to the accounting principles applicable on appropriate classification under respective FAS or generally accepted accounting principles, subject to specific requirements of this standard.

44. At each period end, assets in nature of inventory shall be tested for their net realizable value (NRV) and other assets shall be subject to impairment testing, in line with the relevant FAS or appropriate generally accepted accounting principles.

Murabaha and deferred payment sales liabilities

45. Subsequent to initial recognition, Murabaha and deferred payment sales payable shall be carried at its outstanding amount.

46. Outstanding amount of accounts payable represent the gross amount of liability less repayments or other adjustments including discounts and rebates allowed by the seller, if any.

Related accounting treatments

Waivers, discounts and write-offs

47. The amount of reduction / waiver against the total amount payable by the seller shall be:

    a. firstly, recognized as a deduction from the value of the respective asset; and

    b. secondly, if the asset is already sold or otherwise disposed off, the balance shall be recognized as an income in the period in which such waiver is provided.

Hamish Jiddiyyah and Arboun

48. Subject to the terms of the contract, the initial deposit or advance payment, paid by the buyer shall be recorded and presented as a deposit or advance against purchases in the books of account of the buyer.

49. Once the Murabaha or deferred payment sale transaction is consummated:

    a. Hamish Jiddiyyah, being in the nature of a security deposit, shall continue to be presented as a deposit and shall not be offset against the accounts payable unless contractually agreed upon with the seller; and

    b. Arboun, being in the nature of an advance payment, shall be netted off against the accounts payable.

Presentation and disclosures

50. In addition to the disclosure requirements stated in FAS 1 "General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions" following are the minimum disclosure requirements in the financial statements of the buyer:

    a. the accounting policies adopted for the purchases based on Murabaha and other deferred payment sales;

    b. accounts payable against Murabaha and deferred payment sales classified according to nature and identifying the maturity profiles of the same;

    c. the nature and estimated value of, the securities provided against such accounts payable;

    d. the amount waived by the seller, according to their respective nature, during the period.

Effective date

51. This standard shall be effective on the financial statements of the institutions beginning on or after 1 January 2019. Early adoption of the standard is permitted.

Transitional provisions

52. The institutions may opt to apply this standard on a prospective basis for transaction executed on or after the effective date. If an institution applies this transitional provision, it shall disclose the impact of the same.

Amendments to other standards

53. This standard supersedes the earlier FAS 2 "Murabaha and Murabaha to the Purchase Orderer" and FAS 20 "Deferred Payment Sale".

Appendices

Appendix A: Adoption of the standard

This standard was presented for the approval in the AAOIFI Accounting Board's 7th meeting held on 2-4 Muharram 1439H, corresponding to 22 – 23 September 2017 and was duly approved.

Members of the board

1. Mr. Hamad Abdulla Al Oqab – chairman
2. Mr. Mohamed Bouya Ould Mohamed Fall – deputy chairman
3. Mr. Abdelhalim Elsayed Elamin
4. Dr. Abdulrahman M. Alrazeen
5. Mr. Aly Hamed El Azhary
6. Dr. Bello Lawal Danbatta
7. Mr. Firas Hamdan
8. Mr. Hondamir Nusratkhujaev
9. Mr. Khalid E. Al Shatti
10. Mr. Mohamed Ibrahim Hammad
11. Mr. Muhammad Jusuf Wibisana
12. Mr. Nader Yousif Rahimi
13. Dr. Saeed Al-Muharrami
14. Mr. Syed Najmul Hussain
15. Mr. Ismail Erdemir

Reservation

The standard was approved unanimously except for the paragraphs 42 and 46, basis for conclusion for which are discussed in BC16 – BC17.

Working group members

1. Dr. Bello Lawal Danbatta – chairman
2. Mr. Abdelhalim Elsayed Elamin
3. Mr. Mahesh Balasubramanian
4. Mr. Nadeem Amjad Khan

Executive team

1. Mr. Omar Mustafa Ansari (AAOIFI)
2. Deloitte KSA team

Appendix B: Basis for conclusions

Scoping out – Tawarruq and commodity Murabaha

BC1 The initial scope of the project, as well as, the preliminary study, consultation notes and initial version of the drafts of the standard included Tawarruq and commodity Murabaha transactions. However, at a stage when the board considered the differences between the substantial economic activity, as well as, the practical application of these transactions particularly including the treasury transactions and at times deposits based on these structures, the board considered that their accounting and reporting might need to be considered separately.

BC2 In particular, the board discussed at length the economic substance of the transaction as a trading activity and the market practices, which at time differ from the requirements of the Shari'ah standard on Tawarruq. Additionally, the Shari'ah standard on Tawarruq allows such transactions in specific situations (as last resort) and discourages their common use on a commercial basis.

BC3 Considering the above factors, the board decided that it will be more appropriate to finalize the standard on Murabaha and other deferred payment sales first, and then develop the standard on Tawarruq and commodity Murabaha transactions ensuring accounting treatments better reflecting the same, as well as, differentiated from normal Murabaha and deferred payment sales transactions.

Scope inclusion and standard supersession – other deferred payment sales

BC4 The board discussed the need for a separate standard (existing FAS 20) for deferred payment sales transactions and evaluated the similarity in major accounting treatments and minor differences. After due consideration, the board decided that the key principles for all deferred payment sales transactions including Murabaha from the economic substance point of view remain the same and accordingly, similar accounting treatment shall be followed insofar a deviation is not required by Shari'ah or by the structure of the transaction (like for example in case of a Murabaha by making the profit and cost known, which may change a few minor treatments). This however shall not include Tawarruq and commodity Murabaha transactions which were scoped out (see BC1 – BC3). Accordingly, the board decided that the revised standard shall include Murabaha and other deferred payment sales transactions and shall supersede the existing FAS 2 and FAS 20.

Using the term inventory

BC5 The board, in line with the new strategy of accounting standards development, considered the definition of inventory under the generally accepted accounting principles whereby inventory is an asset held for sale in the ordinary course of business or in the process of production for such sale. While previously no FAS was using the term inventory to describe the underlying assets for trading transactions, the board decided that in order to depict the true nature of such assets held for sale, and to bring the accounting treatments closer to the generally accepted accounting principles it would be more appropriate to describe them as inventory.

NRV and determining NRV

BC6 The board considered the earlier accounting treatment of "cash equivalent value" for Murabaha inventory (earlier called Murabaha assets) and other possible treatments like "fair value" or "fair value less cost to sell" for the purpose of testing for any decline in value of such inventory. After due deliberations, the board decided it would be more appropriate to record the inventories at the lower

of cost and net realizable value (NRV) term to keep it close to the generally accepted accounting principles. The board was of the view that since these are to be sold in the normal course of business hence the entity specific NRV is the appropriate accounting treatment in case of a decline in value against cost. It was also considered that if a credit-worthy customer has provided a promise to purchase at a price which is cost plus profit, then a downward adjustment for NRV is not needed, even if the market value of the inventory has declined, because technically the NRV for the institution is above the cost.

Recognition of revenue and cost of sales

BC7 Previously the requirements with regard to the recognition and disclosure of gross revenue and cost of sales were not very clear. While the specimen formant provided in FAS 1 required a disclosure with a statement in the notes to the financial statements along with a clarification in this respect and since it was not clearly required in FAS 2, a number of institutions were not applying this practice. The board discussed this issue at length including the definition of revenue and decided that the gross increase of in assets resulting from trading activities shall be considered as revenue of the institution. Similarly, the board decided that de-recognition of inventory (along with other relevant expenses) shall be considered as cost of sales for the institution. That being said, the board decided to continue the accounting for deferment and recording of profits in the books of the seller for transactions involving a credit.

BC8 However, considering the nature of the business of IFIs, the board decided that the sales and cost of sales for such transactions shall be disclosed in the notes to the financial statements instead of directly shown as turnover.

Transitional provisions

BC9 The board considered certain practical difficulties in application of certain requirements of the revised standard which may impact the accounting and computer systems, particularly, with regard to the revenue recognition and the deferred profit amortization. Accordingly, the Board decided to allow the institutions a choice to apply this standard on a prospective basis for transaction executed on or after the effective date.

Recording receivables at gross amount

BC10 The board decided to carry the general accounting treatment with regard to the recording of receivables at gross amount to disclose full amount of Dain receivable and to show the deferred profit or allowance for credit losses (or provision) as contra assets. The board concluded that the amount of Dain is necessary to be disclosed for several reasons primarily driven by Shari'ah including determination of Zakah, determination of transferability of an asset or a pool of assets, determination of tradability of the shares of the institution and to disclose the full legal right of the institution against the debtor.

Justification of deferment of profits for the seller

BC11 The board discussed at length the accounting treatment with regard to deferment of the profits in the hand of the seller in case of a credit Murabaha or any other deferred payment sale as allowed by earlier FAS 2 and FAS 20. The board apprised that while a few may argue that the ideal treatment is to recognize the profit upfront because it is a profit and a receivable from Shari'ah perspective, yet, it would not be fair and equitable, and at time prudent, to record whole amount of profits upfront.

BC12 Accordingly, the board held its view in line with the earlier standards, that since IFIs have multiple stakeholders (including shareholders, who change hand at times, and the investment account holders, who all contribute for the transaction and at time change hands) it would be more just, fair and equitable if the profits are deferred and amortized over the period of the whole transaction (i.e. till credit period). Additionally, the board also apprised that although it is not obligatory to give discount in case of early payment, but it is permissible (though not as a common practice) and at times customary (including because of regulatory requirements, or because of view of certain scholars) to give a discretionary discount, hence it would be more prudent if the profit is amortized over the credit period.

BC13 The board concluded that under the treatment proposed, the revenues earned by the institution are recognized in line with Shari'ah and taking the whole amount of profits to statement of income and distributing the same immediately is not a mandatory Shari'ah requirement. Accordingly, the deferred profit is not considered a liability of the institution and is treated more like a reserve (which is earned from Shari'ah perspective, but not necessarily taken to income for distribution purposes, for the want of fairness, justice, equity and prudence). The board further concluded that reporting the same as a contra asset would reflect better presentation as all the relevant amounts shall be presented at the same place (note) in the financial statements.

Method of amortization of the deferred profits

BC14 The Board discussed the methods of recognition of deferred profits and concluded that it would be more appropriate to not allow the earlier allowed alternative treatment of recognition of deferred profits on recovery basis as it was of the view that this is not in line with the Framework, or in line with the generally accepted accounting principles. Instead, the board decided that the time proportionate allocation is the most suitable method to achieve the objectives of fair, just, equitable and prudent profit sharing amongst stakeholders. The board further discussed the suitable approach to apply the time proportionate method and after due deliberations, decided that the effective rate of return method shall be the best approach to apply the time proportionate basis of profit allocation, particularly for long term transactions, and that this method will provide better matching to the return on investment account holders funds. The board decided that there is no Shari'ah objection on the same because it is merely a method of allocation of profits (which are already earned) over a period to provide just, fair and equitable return to the stakeholders.

BC15 The board further discussed and decided to allow a simplified approach (which was the preferred approach, in view of a few members) for applying the time proportionate method. Under the simplified approach the straight line allocation of profits is allowable for all short-term single bullet payment transactions i.e. the transactions other than those with installments or those with lump sum payment at the end, with original maturity of more than 12 months.

Accounting for the buyer – profit element in the asset value

BC16 The Board further discussed the matter of the profit element in the cost of asset in the hand of a buyer in a Murabaha (credit) or other deferred payment sale transaction. Certain members were of the view that the board shall consider devising a mirror accounting for this purpose of the accounting in the hand of the seller; suggesting that the same would be closer to the generally accepted accounting principles, arguing that it is not against Shari'ah. In addition, they suggested that it will avoid "over-pricing" of the assets in the hand of the buyer. The board considered and evaluated the matter and also consulted certain Shari'ah scholars on this matter and concluded that

the justifications available for deferment of the profit in the hand of the seller i.e. (i) fair, just and equitable distribution of profits amongst stakeholders; and (ii) prudence, are not available in this case hence it may not be concluded that there is no Shari'ah issue in the mirror accounting. Additionally, the board considered that the matter of over-pricing can be catered through the suggested approaches of impairment and NRV testing etc. This view was confirmed by the committee of Shari'ah board for review of accounting, auditing, governance and ethics standards.

BC17 The board further concluded that the issue related to Tawarruq and commodity Murabaha, particularly in treasury, is a bit different from an economic substance perspective and hence the same shall be considered under a separate standard and hence scoped out.

Appendix C: Brief history of the preparation of the standard

H1 The newly formed AAOIFI Accounting Board (AAB / the board) held its 1st meeting on 6 and 7 Jumada II 1437H, corresponding to 15 and 16 March 2016 at Ramee Grand Hotel, Kingdom of Bahrain. In this meeting the contents of revised draft FAS 2 on Murabaha was discussed, on which the work had been commenced prior to formation of the board by appointment of a consultant and several meetings of the Accountings Standards Committee of the earlier board. The attendees discussed a number of issues pertaining to formatting and presentation style, definitions, implementation and application guidelines, formation of working group, consistency with international standards, depreciation methods (for Murabaha assets), and consistency in accounting treatment on both sides of the balance sheet. A working group were formed to continue working on the standard and specific guidance was provided to the consultant and the secretariat in this respect.

H2 The 2nd meeting of the board was held on 25-26 Shawwal 1437H, corresponding to 30-31 July 2016 at Al Baraka Banking Group Head Office, Kingdom of Bahrain. In this meeting the board discussed the draft FAS 2 standard on Murabaha and reviewed and approved of the Murabaha Consultation Notes. The members agreed to change the title of the standard from 'Murabaha to the Purchase Orderer' to 'Murabaha and Other Deferred Payment Sales'

H3 AAB held its 3rd meeting on 22-23 Dhul-Hijjah 1437H, corresponding to 24-25 September 2016 at AAOIFI Office, Kingdom of Bahrain. In this meeting, the board discussed the draft along with remarks and comments submitted by the chairman of the respective working group. The board contemplated the need to merge FAS 2 and FAS 20 into a comprehensive standard on Murabaha and Deferred Payment Sales as well as the possibility to develop a separate standard on Tawarruq and Commodity Murabaha. The board finalized all amendments to be made to the exposure draft, including the set of definitions to be included, the terminologies that require amendment and the disclosures and break-downs that need to be added to the final version of the Standard.

H4 AAB held its 4th meeting on 16-17 Rabi' II 1438H, corresponding to 15-16 January 2017 at the premises of Islamic Development Bank (IDB), Jeddah, Kingdom of Saudi Arabia. In this meeting, the exposure draft of the standard was approved for issuance for comments and public hearing, whereby the working group and the secretariat were directed by the board to issue the exposure draft after ensuring the improvements identified by the board.

H5 The 5th AAB meeting on 19-20 Jumada II 1438H, corresponding to 18-19 March 2017 at the premises of AAOIFI Head Office, Manama, Kingdom of Bahrain discussed Tawarruq and commodity Murabaha. It was agreed to be scoped out due to complications associated with these sales. The accounting treatment and financial reporting for Tawarruq and Commodity Murabaha was decided to be in a separate standard.

H6 The Public hearing for Murabaha was conducted in the months from Rajab to Ramadan 1438H, corresponding to April to June 2017 in the Kingdom of Bahrain, Pakistan, Jordon and UAE.

H7 The working group meeting was held on 28 Dhul-Hijjah 1438H, corresponding to 19 September 2017 to present the comments received from the public hearing event and other industry experts.

H8 The standard was approved as finalized at the 7th AAB meeting held from 2-4 Muharram 1439H, corresponding to 22-23 September 2017 at the premises of AAOIFI Head Office, Seef District, Kingdom of Bahrain.

Financial Accounting Standard No. (10)

Istisna'a and Parallel Istisna'a

Contents

Preface

This standard aims at setting out accounting rules for recognizing, measuring and disclosing the transactions of Istisna'a and parallel Istisna'a that are carried out by Islamic banks and financial institutions.(1) Attached with the standard are details of the juristic bases for the accounting treatments.

Istisna'a contract is usually accompanied with a separate parallel contract, whereby an Islamic bank acts in the first contract as a seller (Al-Sani') of goods (Al-Masnoo', the subject-matter of the contract) to an ultimate buyer (Al-Mustasni') while in the parallel Istisna'a contract the Islamic bank acts as a buyer (Al-Mustasni') of Al-Masnoo' from another seller (Al-Sani').

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

Statement of the Standard

1. Scope of the Standard

This standard addresses the accounting rules of Istisna'a and parallel Istisna'a contracts in the financial statements of Islamic banks relating to measuring and recognizing the costs and revenues from Istisna'a and parallel Istisna'a, the gains and losses accruing therefrom, and their presentation and disclosure in the financial statements of the Islamic bank.

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

2. Accounting Treatment by the Islamic Bank As Al-Sani' (A Seller)

2/1 Istisna'a costs

a) Istisna'a costs consist of: (I) Direct costs, in particular costs of producing Al-Masnoo'; and (II) Indirect costs relating to the contract as allocated on an objective basis. General and administrative expenses, selling expenses, research and development costs shall not be included in an Istisna'a contract costs. (para. 2)

b) Istisna'a costs incurred during a financial period, as well as pre-contract costs as described in (c) below, shall be recognized in an Istisna'a work-in-progress account, and reported under assets in the statement of financial position of the Islamic bank. (In case of parallel Istisna'a, this account shall be called Istisna'a costs account as stated in 2/2 a). Amounts billed to Al-Mustasni' will be debited to Istisna'a accounts receivable account and credited to an Istisna'a billings account. The balance of the latter account shall be offset against Istisna'a work-in-progress account in the appropriate side of the Islamic bank's statement of financial position. (para. 3)

c) Pre-contract costs shall be recognized as deferred costs when they are incurred, and accounted for upon contracting by transferring them to the Istisna'a work-in-progress account. If no contract is signed and it is unlikely that it will be signed in the future, then the deferred costs in question shall be written-off to expense during the current financial period. (para. 4)

2/2 Contract costs in parallel Istisna'a

a) When a parallel Istisna'a exists, the costs of Istisna'a include the price fixed in the parallel Istisna'a contract (direct costs), together with indirect costs including any pre-contract costs as described in 2/1(c). When the subcontractor bills the Islamic bank for contract costs, these will be debited to Istisna'a costs account and credited to the subcontractor's Al-Sani' account under Istisna'a accounts payable. The Istisna'a costs account shall be reported under assets in the statement of financial position of the Islamic bank. (para. 5)

b) Progress billings made by the Islamic bank to the ultimate purchaser (Al-Mustasni') during the period shall be accounted for by debiting an Istisna'a accounts receivable account. The same amount shall also be credited to Istisna'a billings account, the balance of which shall be offset against Istisna'a cost account in the Islamic bank's financial statements. (para. 6)

2/3 Istisna'a revenue and profit at the end of a financial period

2/3/1 Istisna'a revenue and profit

Istisna'a revenue is the total price agreed upon between the Islamic bank as Al-Sani' and the client as Al-Mustasni', including the Islamic bank's profit margin on the contract. Istisna'a revenue and the associated profit margin are recognized in the Islamic bank's financial statements according to either the percentage of completion or the completed contract methods as set up below, taking into consideration what is stated in item 2/3/1/2. (para. 7)

2/3/1/1 Percentage of completion method

a) A part of the contract price commensurate with the work performed during each period in which the

contract is being executed shall be recognized as revenue for that period. (para. 8)

b) The portion of the Istisna'a profit margin recognized during the financial period (Istisna'a profit margin being the difference between the cash price of Al-Masnoo' to the ultimate purchaser and the Islamic bank's estimated total Istisna'a costs) shall be added to the Istisna'a work-in-progress account. Thus, at any point in time, the balance of the Istisna'a work-in-progress account will include the amount of profit recognized to date subject to deduction of any anticipated contract losses, as will be indicated in 2/4 (a) below. (para. 9)

2/3/1/2 Completed contract method

In unusual circumstances where both the percentage of completion and the expected cost to complete the contract cannot be estimated with reasonable accuracy at the end of the financial period, no contract revenue shall be recognized until the contract is fully completed. Thus, until that date, the accumulated contract costs will be carried forward on the Istisna'a work-in-progress account, without any profit element being recognized. (para. 10)

2/3/2 Deferred profits

The contract price may be fully paid by Al-Mustasni' by instalments during the contract based on progress in work. However, all or part of the price may be paid following completion of the contract. In the latter case, the difference between the total price that is paid during the contract and the agreed total price –defined as deferred profits– shall be offset against Istisna'a accounts receivable in the Islamic bank's statement of financial position. This treatment shall

apply whether the percentage of completion method or the completed contract method is used for recognizing and measuring Istisna'a revenues and profit. (para. 11)

Deferred profits shall be recognized using one of the two following methods:

a) Proportionate allocation of deferred profits over the future financial period of credit whereby each financial period shall carry its portion of profits irrespective of whether or not cash is received. This is the preferred method. (para. 12)
b) As and when each instalment is received. This method shall be used based on a decision by the Shari'a supervisory board of the Islamic bank or if it is required by supervisory authorities. (para. 13)

2/3/3 Early settlement

a) If Al-Mustasni' makes a payment in advance of the due date for such a payment, the Islamic bank may waive part of its profit in recognition of this earlier payment. In that case, the amount of profit waived shall be deducted from both Istisna'a accounts receivable account and deferred profits account. (para. 14)
b) The same accounting treatment as in (a) above shall apply if the facts are the same except that the Islamic bank did not grant a partial reduction of the profit when the payment was made, but reimbursed Al-Mustasni' with this amount after receiving the payments. (para. 15)

2/3/4 Parallel Istisna'a revenue and profit

a) Parallel Istisna'a revenue and profit for each financial period shall be measured and recognized according to the percentage of completion method, since in parallel Istisna'a both costs and revenues of Istisna'a are known to the Islamic bank with reasonable certainty. (para. 16)
b) The recognized portion of Istisna'a profits for a financial period shall be added to Istisna'a costs account. Thus, at any

point in time the balance of the Istisna'a costs account shall be equal to the cumulative cost of the Istisna'a contract (the total amount in progress billings authorised by the Islamic bank) plus the total Istisna'a profits recognized up to that point. (para. 17)

c) If the contract price or part thereof is to be paid following the completion of the contract, the accounting treatments in 2/3/2 and 2/3/3 (a, b) shall apply. (para. 18)

2/4 Measurement of Istisna'a work-in-progress, Istisna'a costs and treatment of contract losses at the end of a financial period

a) In the event of applying the percentage of completion method for the recognition of Istisna'a revenue and profit, Istisna'a work-in-progress shall be measured and reported in the statement of financial position of the Islamic bank at a value not exceeding its cash equivalent value (i.e., the difference between the contract price and the expected additional cost to complete the contract). (para. 19)

b) Any expected loss resulting from the valuation of Istisna'a work-in-progress at the end of a financial period shall be recognized and reported in the Islamic bank's income statement. (para. 20)

c) When a parallel Istisna'a exists, Istisna'a costs shall be treated as in (a) and (b) above. (para. 21)

d) The subcontractor may fail to honour his obligation in a parallel Istisna'a resulting in additional cost for the Islamic bank to fulfil its obligation towards Al-Mustasni' (the client). Any such additional costs shall be recognized as losses in valuing the Istisna'a costs and reported in the Islamic bank's income statement, except if there is a reasonable degree of certainty that the Islamic bank shall recover these additional costs. (para. 22)

2/5 Change orders and additional claims

a) The value and cost of change orders authorized by the Islamic bank and Al-Mustasni' shall be added to Istisna'a revenue and costs, respectively. (para. 23)

b) If requisite conditions for recognizing additional claims are met, a related amount of revenue shall be recognized equal to the additional cost caused by such claims. (para. 24)

c) If one or more requisite conditions for recognizing additional claims are not met, the estimated value of these claims shall be disclosed in the notes accompanying the financial statements of the Islamic bank. (para. 25)

d) When a parallel Istisna'a exists, the accounting treatments in (a), (b) and (c) above shall apply for change orders and additional claims. However, the cost of change orders and additional claims are determined by the subcontractor (Al-Sani') in the parallel contract and subject to the approval of the Islamic bank. (para. 26)

2/6 Maintenance and warranty costs of Al-Masnoo'

a) Maintenance and warranty costs of Al-Masnoo' shall be accounted for on an accrual basis. Such costs shall be estimated and then matched with recognized Istisna'a revenue. Actual maintenance and warranty expenditures shall be charged against a maintenance and warranty allowance account when carried out by the Islamic bank. (para. 27)

b) When a parallel Istisna'a exists, the maintenance and warranty cost of Al-Masnoo' shall be accounted for on a cash basis, where such costs are charged by the Islamic bank directly to expense accounts when they are incurred. (para. 28)

3. Accounting Treatment of Istisna'a by the Islamic Bank As Al-Mustasni' (A Buyer)

3/1 Istisna'a billings of completed jobs

a) The amount of progress billings received shall be recognized by debiting an Istisna'a costs account and presented under assets in the statement of financial position of the Islamic bank. The corresponding credit shall be made to Istisna'a accounts payable to Al-Sani'. (para. 29)

b) When a parallel Istisna'a exists, the accounting treatment in (a) above shall apply. (para. 30)

3/2 Receipt of Al-Masnoo'

3/2/1 Receipt of Al-Masnoo' in conformity with specifications and schedule

a) The received (Al-Masnoo') assets shall be recorded at historical cost (i.e., the book value) of the Istisna'a costs account. (para. 31)

b) When a parallel Istisna'a exists, and Al-Masnoo' is delivered to the Al-Mustasni' the balance of the Istisna'a costs account shall be transferred to an asset account that reflects the nature of Al-Masnoo' received. (para. 32)

3/2/2 Late delivery of Al-Masnoo'

If the delay in the delivery of Al-Masnoo' is due to the negligence or fault of Al-Sani' and the Islamic bank is entitled to compensation for damages resulting from the delay, the amount of compensation shall be taken from performance bonds. If the amount of performance bonds is not sufficient to cover the amount of compensation, the balance shall be recognized as Istisna'a accounts receivable due from Al-Sani' and, if necessary, an allowance for doubtful debts account shall be formed. (para. 33)

3/2/3 Al-Masnoo' not conforming to the specification

a) If the Islamic bank declined to receive Al-Masnoo' due to nonconformity to specifications and did not recover the entire amount of progress payments made to Al-Sani', the balance shall be recorded as Istisna'a accounts receivable, and if necessary, an allowance for doubtful debt account shall be formed. (para. 34)

b) If the Islamic bank accepted Al-Masnoo' which does not conform to specifications, such assets shall be measured at the lower of their cash equivalent value or historical cost (the book value). Any resulting uncompensated loss shall be recognized in the Islamic bank's income statement for the current financial period. (para. 35)

3/2/4 Al-Mustasni' refuses to receive Al-Masnoo'

If Al-Mustasni' (the client) refuses to receive Al-Masnoo', the Istisna'a assets shall be measured at the lower of their cash equivalent value or historical cost (the book value). Any resulting loss shall be recognized in the Islamic bank's income statement for the financial period in which the loss is realized. (para. 36)

4. Disclosure Requirements

4/1 The Islamic bank shall disclose the following in its financial statements:

a) Revenues and profits of Istisna'a contracts recognized for the financial period. (para. 37)
b) Accounting methods used for measuring revenues and profits of Istisna'a contracts for the financial period. (para. 38)
c) Cumulative (actual) costs of contracts in progress as well as revenues and profits recognized up to the end of the current financial period. (para. 39)
d) The amount of retention on contracts in progress until they are completed according to the specifications and contractual conditions. (para. 40)
e) Istisna'a receivable and payable accounts presented in the appropriate side of the statement of financial position of the Islamic bank. These accounts shall not be offset against each other. (para. 41)

4/2 The Islamic bank shall disclose the following in the notes accompanying its financial statements:

a) Unsettled additional claims and any contingent fines related to the penalty clauses concerning any delay in delivering Al-Masnoo'. (para. 42)
b) The method used for determining the percentage of completion for contracts in progress. (para. 43)
c) The value of parallel Istisna'a in progress and the time periods they span. (para. 44)
d) The value of Istisna'a contracts that the Islamic bank has signed during the current financial year, but has not yet commenced in executing them, and the time periods they span. (para. 45)

4/3 The disclosure requirements in Financial Accounting Standard No. (1): General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions should be observed. (para. 46)

5. Effective Date

This Standard shall be effective for the financial statements for fiscal periods beginning 1 Muharram 1420 A.H. or 1 January 1999 A.D. (para. 47)

Adoption of the Standard

The standard of Istisna'a and Parallel Istisna'a was adopted by the Accounting and Auditing Standards Board in its meeting No. (15) held on 27-28 Safar 1419 A.H, corresponding to 21-22 June 1998 A.D.

Members of the Board

1. Abdul-Malik Yousef Al-Hamar	Chairman
2. Noorur-Rahman Abid	Deputy Chairman
3. Dr. Ahmed Ali Abdallah	
4. Anwar Khalifa Sadah	
5. Dr. Hussein Hussein Shehata	
6. Farahat Saeed	
7. Salahel-Din Ali Abu Naga	
8. Salahel-Din El-Iskandarani	
9. Dr. Abdul-Sattar Abu Ghoddah	
10. Mohammed Alawi Thiban	
11. Mustapha Bin Hamat	
12. Musa Abdel-Aziz Shehadeh	
13. Nabil Abdul-Elah Nassief	

Appendix (A)
Examples of the Application of Some Aspects of the Istisna'a and Parallel Istisna'a Standard

The purpose of this appendix is to illustrate the application of certain aspects of the standard to Istisna'a and parallel Istisna'a. The appendix does not form part of the standard. Paragraph numbers refer to those in the standard.

Example (1): Parallel Istisna'a Does Not Exist: (profitable contract)

Basic data:

- Contract price 500,000 (2-year contract)
- Total estimated (and actual) contract costs $400,000 (including pre-contract costs of $15,000).

	Year 1	Year 2
Cumulative costs incurred	300,000	400,000 (including pre-contract costs)
Billings	280,000	220,000
Collections from Al-Mustasni' (Purchaser)	230,000	270,000

Treatments by the Islamic Bank As a Seller (Al-Sani')

Para. No.		Year 1		Year 2	
		Dr	Cr	Dr	Cr
3	1. Istisna'a work-in-progress	300,000		100,000	
4	Deferred cost		15,000		
	Cash (accounts payable, etc.)		285,000		100,000
3	2. Istisna'a accounts receivable	280,000		220,000	
	Istisna'a billings		280,000		220,000
	3. Cash	230,000		270,000	
	Istisna'a accounts receivable		230,000		270,000

End of period:

a) Percentage-of-completion can be estimated with reasonable accuracy (percentage-of-completion method).

Para. No.		Year 1	Year 2
8	% of completion	300,000/400,000 X 100=75%	25%
	Revenue recognized	500,000 X 75% = 375,000	125,000
	Istisna'a revenue	(500,000 – 400,000) X 75% = 75,000	25,000

		Dr	Cr	Dr	Cr
9	Cost of Istisna'a revenue	300,000		100,000	
	Istisna'a work-in-progress	75,000		25,000	
	Istisna'a revenue		375,000		125,000

Income statement:

	Year 1	Year 2
Istisna'a revenue	375,000	125,000
Cost of Istisna'a revenue	300,000	100,000
Istisna'a profit	75,000	25,000

Balance sheet presentation:

Para. No.	Assets	end of year 1	end of year 2(*)
3	Istisna'a work-in-progress	375,000	25%
3	Less: Istisna'a billings	(280,000)	125,000
		95,000(**)	—
	Istisna'a revenue	50,000	—

b) Percentage-of-completion cannot be estimated with reasonable accuracy (completed contact method)

		Year 1		Year 2	
Para. No.		Dr	Cr	Dr	Cr
10	Cost of Istisna'a revenue	—		400,000	
	Istisna'a work-in-progress	—		100,000	
	Istisna'a revenue		—		500,000

(*) Istisna'a transactions are concluded and all Istisna'a related accounts are closed by the end of year 2.

(**) If the balance in Istisna'a billings is greater than Istisna'a work-in-progress, the two balances will be presented and matched within the liability section.

Income statement:

	Year 1	Year 2
Istisna'a revenue	—	500,000
Cost of Istisna'a revenue	—	400,000
Istisna'a profit	—	100,000

Balance sheet presentation:

Para. No.	Assets	end of year 1	end of year 2*
3	Istisna'a work-in-progress	300,000	
3	Less: Istisna'a billings	(280,000)	
		20,000	—
	Istisna'a accounts receivable	50,000	—

Example (2): Parallel Istisna'a Exists: (profitable contract)

Basic data:

	Istisna'a Contract	Parallel Istisna'a
Contract price (2-year contract)	500,000	400,000

Para. No.	Assets	Year 1	Year 2	Year 1	Year 2
1	Billings by (Al-Sani') subcontractor (x-co.)			300,000	100.000
2	Billings by Islamic bank to (Al-Mustasni') purchaser (y-co.)	280,000	220,000		
3	Payments to x-co.			290,000	110,000
4	Collections from y-co.	230,000	270,000		

Treatments by the Islamic Bank As Both a Seller (Al-Sani') and a Buyer (Al-Mustasni') in Parallel Istisna'a

		Year 1		Year 2	
Para. No.		Dr	Cr	Dr	Cr
5	1. Istisna'a costs	300,000		100,000	
	Istisna'a accounts payable (x-co.)		300,000		100,000
6	2. Istisna'a accounts receivable (y-co.)	280,000		220,000	
	Istisna'a billings		280,000		220,000
	3. Istisna'a accounts payable (x-co.)	290,000		110,000	
	Cash		290,000		110,000
4	Cash	230.000		270,000	
	Istisna'a accounts receivable (y-co.)		230,000		270,000

End of period:

Only percentage-of-completion method is applicable with parallel Istisna'a. (para. 16)

		Year 1		Year 2	
Para. No.		**Dr**	**Cr**	**Dr**	**Cr**
17	Cost of Istisna'a revenue	300,000		100,000	
	Istisna'a costs	75,000		25,000	
	Istisna'a revenue		375,000		125,000

Income statement:

	Year 1	Year 2
Istisna'a revenue	375,000	125,000
Cost of Istisna'a revenue	300,000	100,000
Istisna'a profit	75,000	25,000

Balance sheet presentation:

Para. No.		**end of year 1**	**end of year 2**
3	Assets		
	Istisna'a costs	375,000	
3	Less: Istisna'a billings	(280,000)	
		95,000	
	Istisna'a accounts receivable	50,000	—
	Liabilities		
40	Istisna'a accounts payable	10,000	—

Example (3): Anticipated Losses on Contract

Assume a 3-year $8 million contract. Contract costs incurred through 1997, the second year of the contract, was $5,700,000. At the end of 1997, the estimated remaining contract cost to complete the contract was $2,500,000.

- Anticipated loss at end of 1997 = 8,000,000 - (5,700,000 + 2,500,000) = $200,000.
- Valuation of Istisna'a work-in-progress at the end of 1997 = 8,000,000 - 2,500,000 = $5,500,000 (para.19).

a) If percentage-of-completion method is used

Assume gross profit recognized in 1996 was $600,000. The balance of Istisna'a work-in-progress through 1997 and the valuation loss will be:

Construction costs incurred through 1997	$5,700,000
Gross profit recognized in 1996	$600,000
Istisna'a work-in-progress balance (immediately before valuation at end of 1997)	$6,300,000
Required valuation (para.19)	$5,500,000
Loss recognized at end of 1997 (para. 20)	$800,000(*)

Adjusting entry at end of 1997	
Loss on Istisna'a contracts	800,000
Istisna'a work-in-progress	800,000

(*) Reversal of $600,000 gross profit recognized in 1996 plus the $200,000 anticipated loss on the contract.

b) If completed contract method is used:

Under this method no profit is to be recognized until the contract is completed (para.10). Thus, the balance in the Istisna'a costs account through 1997 immediately before end of year adjustments will be $5,700,000, and the valuation of this account should not exceed $5,500,000 (para.19).

Adjusting entry at end of 1997 to recognize anticipated loss on contract (para. 20):

Loss on Istisna'a contracts	200,000
Istisna'a work-in-progress	200,000

(Same treatment applies for loss in the case of parallel Istisna'a, except for replacing Istisna'a costs account for Istisna'a work-in-progress account and only percentage-of-completion method is applied).

Appendix (B)
Brief History of
the Preparationof the Standard

On 30 Jumada I, 1416 A.H., corresponding to 24 October 1995 A.D., a letter was sent to the Islamic banks to seek their opinion on the standards to be given priority. After taking into consideration the replies from the Islamic banks, the Accounting and Auditing Standards Board decided in its meeting No. (10) held on 14-16 Ramadan 1416 A.H., corresponding to 3-5 February 1996 A.D., in Jeddah, Kingdom of Saudi Arabia, to give priority to the preparation of a standard on Istisna'a and parallel Istisna'a.

On 1 Dhul-Qa'dah 1417 A.H., corresponding to 10 March 1997 A.D., two consultants were commissioned to prepare the preliminary studies on the juristic and accounting aspects of the standard. These studies were discussed in the Accounting Standards Committee meeting No. (11), held on 7 Safar 1418 A.H., corresponding to 12 June 1997 A.D., in Bahrain. The revised juristic and accounting studies as well as an exposure draft of the standard were discussed by the Committee in its meeting No. (12) held during the period of 13-14 Jumada I, 1418 A.H., corresponding to 14-15 September 1997 A.D., in Bahrain. In its meeting No. (13) held during the period of 12-13 Jumada II, 1418 A.H., corresponding to 13-14 October 1997 A.D., in Doha, the Committee reviewed and discussed the revised exposure draft of the standard and necessary amendments were made in light of the discussions that took place and the comments made by the members.

The exposure draft was submitted to the Shari'a Committee in its meeting No. (8), held on 13-15 Rajab, 1418 AH., corresponding to 13-15 November, 1997 A.D., in Bahrain, and the amendments which it deemed necessary were made.

The amended exposure draft was discussed in the Standards Board meeting No. (14) held on 11-12 Ramadan 1418 A.H., corresponding to 10-11 January 1998 A.D., in Jeddah, Kingdom of Saudi Arabia. The Standards Board made further amendments to the exposure draft and decided that it 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.

Two listening sessions were held, one in Pakistan on 18 Dhul-Hajjah 1418 A.H., corresponding to 15 April 1998 A.D., and the other in Bahrain on 22 Dhul-Hajjah 1418 A.H., corresponding to 19 April 1998 A.D. The listening sessions were attended by more than 230 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 sessions as well as the oral comments that were expressed in the sessions of the listening sessions.

The Accounting Standards Committee held a meeting on 22 Dhul-Hajjah 1418 A.H., corresponding to 19 April 1998 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 two listening sessions.

The revised exposure draft was reviewed and approved by the Shari'a Committee in its meeting No. (8) which was held on 18-19 Muharram 1419 A.H., corresponding to 14-15 May 1998 A.D., after making some changes to the draft.

The Accounting and Auditing Standards Board adopted the proposed standard in its meeting No. (15) held on 27-28 Safar 1419 A.H., corresponding to 21-22 June 1998 A.D.

Appendix (C)
Juristic Rules for Istisna'a and Parallel Istisna'a

1. Characterisation of Istisna'a

According to the majority of Fuqaha (juristic scholars), Istisna'a is a special type of Salam contract, which is used mainly in the field of manufacturing. Hence, according to this viewpoint, Istisna'a is subject to the same provisions and rules as those regulating the contract of Salam.(5)

It should, however, be noted that the emergence of Istisna'a as a separate and independent contract is a result of jurisprudential engineering of the Hanafi school as presented in *"Majallat Al-Ahkam Al-'Adliyyah"* and the resolution of the Islamic Figh Academy.(6) This study is, therefore, based on the provisions of the Istisna'a contract as developed in the Hanafis' jurisprudence and the subsequent development from within that jurisprudence and from other contemporary jurists.

2. Definition

Istisna'a is a sale contract between Al-Mustasni' (the buyer) and Al-Sani' (the seller), whereby Al-Sani'- based on an order from Al-Mustasni'-

(5) Al-Dardir, *"Al-Sharh Al-Saghir 'Ala Aqrab Al-Masalik Ila Mazhab Al-lmam Malik"*, published along with *"Hashiyat Al-Sawi"*, [3: 287-289], Dar Alma'arif: Cairo 1932 A.D.; Ibn Qudamah, *"Al-Mughni"*, [3: 313], Modern Riyad Library, Saudi Arabia, 1401 A.H./1981 A.D., Al-Darir, Al-Siddiq M.A., *"Al-Gharar Wa Atharaho Fi Al-'Uqud"*, 2nd edition, Jeddah: Salih Kamil Series of Doctorate Theses on Islamic Economics, 1995 A.D.; Al-Zuhayli, Wahbah, *"Al-Fiqh Al-Islami Wa Adillatuh,"* Dar Al-Fikr, Beirut 1409 A.H., [4: 631-35].

(6) *"Majallat Al-Ahkam Al-'Adliyyah"*, Istisna'a Contract; Islamic Fiqh Acadamy, Session No. (7), Resolution No. (67/3/7) held on 7-12 Dhul-Qa'dah 1412 A.H., corresponding to 9-14 May, 1992 A.D.

undertakes to have manufactured or otherwise acquired Al-Masnoo'[7] (the subject matter of the contract) according to the specifications and sell it to Al-Mustasni' for an agreed upon price and method of settlement whether that be in advance, by instalments or deferred to a specific future time.[8] It is a condition of the Istisna'a contract that Al-Sani' should provide either the raw material or the labour.

3. Legitimacy of Istisna'a

3/1 According to the Hanafis, Istisna'a' ought to have been prohibited for contravening the general Shari'a rules of *Qiyas* (analogical deduction). They base their argument on the fact that the subject-matter of a contract of sale ought to be in existence and in possession of the seller, which is not the case in Istisna'a. The Hanafis have, nevertheless, approved the Istisna'a contract on the basis of *Istihsan* (juristic approbation) for the following reasons:

a) People have been practicing Istisna'a widely and continuously without condemnation, to the extent of furnishing a case of *Ijma'* (Consensus).
b) It is possible in Shari'a to depart from *Qiyas* based on *Ijma'*.
c) The validity of Istisna'a is called for on grounds of need. People are often in need of commodities that are not available in the market, and hence, they would tend to enter into contracts to have the goods manufactured for them.[9]

3/2 Istisna'a is also valid in accordance with the general rule of the permissibility of contracts as long as this does not contravene any text or rule of Shari'a.[2]

3/3 Some contemporary Fuqaha are of the view that Istisna'a is valid on the basis of *Qiyas* and the general rules of Shari'a because the fact that the subject-matter is non-existent at the time of the constitution of the contract is compensated for by its preponderant existence

(7) The subject matter may be a commodity, service or both.
(8) Abdullah, Ahmad Ali, The Juristic Rules of the contract of Istisna'a and Parallel Istisna'a, Accounting and Auditing Organization for Islamic Financial Institutions, 1418 A.H.-1996 A.D., (pp. 2-8).
(9) Al-Sarakhsi, *"Al-Mabsut"*, [12: 138-139], Dar Al-Ma'rifah, Beirut.

at the time of delivery in the future. This arrangement makes the delivery of the subject-matter free from Gharar (uncertainty).[10]

4. Conditions for the Validity of Istisna'a[11]

For the validity of Istisna'a, the following rules should be fulfilled:

4/1 Al-Masnoo'

4/1/1 Al-Masnoo' must be known and specified to the extent of removing any lack of knowledge of its:

a) Kind, e.g., car, airoplane or house, etc.;
b) Type, e.g., a Toyota car, a Boeing airoplane, a house for low income individuals, etc.;
c) Quality, e.g., as specified according to established tables of specifications; and
d) Quantity.

4/1/2 The Hanafis stipulate that the commodity contracted for ought to be of a type of items that people are used to dealing with through Istisna'a. This is important because the legitimacy of Istisna'a is based, according to their viewpoint, on the customary practices of people.

However, since the legitimacy of Istisna'a is also based on *Qiyas*, general rules of Shari'a, permissibility of whatever has not been considered illegitimate, and *Maslaha* (consideration of the public good or common need), it is therefore considered a permissible contract to be used whenever the need arises irrespective to whether or not it has been commonly practised by people.

4/1/3 Fixing a date for delivering Al-Masnoo'

There are three opinions in the Hanafis School relating to fixing a date for delivering Al-Masnoo'.

a) Imam Abu Hanifa prevented fixing any future date for the delivery of Al-Masnoo'. If a date is fixed, then the contract turns into Salam because this is a characteristic of a binding

(10) Al-Darir, M.S.A., op. cit., (P. 466).
(11) Al-Kasani, *"Bada`i' As-Sana`i' Fi Tartib As-Shara`i'"*, Cairo, [5: 2-3].

contract such as Salam, but not Istisna'a which is open for options.

b) Abu Yusuf and Muhammad Ibn Al-Hasan Al-Shaybani, the companions of Abu Hanifah, accepted the condition of fixing a specific future delivery date on the ground that people have been practicing Istisna'a in that manner.

c) However, Abu Hanifah and his two companions have agreed that in an Istisna'a contract if a delivery date is fixed and it is not in line with what is commonly practised, then the Istisna'a contract turns into a Salam contract.

This standard accommodates the opinion of the two companions of Abu Hanifah who permit fixing a future delivery date. Therefore, fixing a future delivery date is a necessity. This is in line with both the ruling of the Committee of "*Majallat Al-Ahkam Al-'Adliyyah*", which stipulates that Istisna'a is a binding contract, and the resolution of the Islamic Fiqh Academy. This is based on for the following:

a) Al-Masnoo' is a product that should either be manufactured or obtained from the market. Therefore, fixing a future delivery date becomes a necessity in order to remove Gharar (uncertainty).

b) The future delivery date depends, on one hand, on the mutual agreement between the two parties involved and on the other hand, on the time required by Al-Sani' to manufacture Al-Masnoo' and/or to obtain Al-Masnoo' from other parties according to the contract.

c) In Istisna'a contract, fixing a future delivery date is allowed when the need and necessity arise irrespective to whether or not it is commonly practised by people.

4/2 Price

The price should be governed by the following rules:

a) It should be known to the extent of removing ignorance (i.e., lack of knowledge).

b) It cannot be increased or decreased on account of the normal increase or decrease in commodity prices or cost of labour.

Price may be changed by mutual consent of the contracting parties because of making modification in Al-Masnoo' or due to unforeseen contingencies.

5. Binding Nature of Istisna'a

5/1 According to the majority of Hanafi jurists, Istisna'a is a valid but not binding contract. Hence,:

5/1/1 Each partner has the option to rescind the contract before it is implemented. Al-Sani' has the right not to commence manufacturing the goods, while Al-Mustasni' has the right to withdraw from buying Al-Masnoo'.

5/1/2 If Al-Sani' manufactured Al-Masnoo', he would not be obliged to deliver it to Al-Mustasni'. Rather, he has the option to dispense with it in the way he deems fit. This is because the contract is not for the manufactured goods themselves, but for Al-Masnoo' of certain specifications. Al-Mustasni' also has the option to accept Al-Masnoo'.

5/1/3 The Hanafis have three different views if Al-Sani' manufactured Al-Masnoo' according to the specifications and decided to deliver it to Al-Mustasni' in fulfillment of his contractual obligations. These are:

a) The preponderant view is that the contract becomes binding on Al-Sani' who has waived his option by delivering Al-Masnoo'. Yet, the buyer's option remains to be exercised. This view is attributed to the three Imams: Abu Hanifah, Abu Yusuf and Muhammad.

b) Abu Hanifah is also reported to have said that even at this stage Al-Sani' retains his right on an equal footing with Al-Mustasni'.

c) Abu Yusuf is also reported to have expressed a second opinion to the effect that in this situation the contract becomes binding on the two parties.(12)

(12) Al-Sarakhsi, op. cit., [12: 139]; Al-Kasani, op. cit., [5: 3-4]; Al-Babarti, *"Al-Inayah 'Ala Al-Hidayah"*, in *"Fath Al-Qadir"*, [7: 116].

5/2 The majority in the Hanafi School opined that the Istisna'a contract is binding once it has been constituted. A number of jurists have argued in favour of this view.(13)

5/3 Provision (392) of *"Majallat Al-Ahkam Al-'Adliyyah"* reads as follows:

Once the contract of Istisna'a is constituted, it becomes binding and no party has the right to revoke it. If, however, Al-Masnoo' does not conform to the required specifications, Al-Mustasni' has the option to revoke the contract. The commentator on the text says: Istisna'a is a contract of sale and not a mere promise. Once it is constituted, no party, according to Abu Yousuf's point of view, has the right to withdraw unless the consent of the other party is secured (see article 375). Accordingly, Al-Sani' has to deliver Al-Masnoo'.(14)

5/4 In light of the above, all civil legislations based on Shari'a have treated Istisna'a, in line with the ruling of *"Majallat Al-Ahkam Al-'Adliyyah"*, as a binding contract. These are the Jordanian, Yemeni and Sudanese laws of civil transactions as well as the Unified Arab Law proposed by the League of Arab Countries.

5/5 The Islamic Fiqh Academy has also decreed: "The contract of Istisna'a is binding on its parties provided that certain conditions are fulfilled."

These views strengthen one another and confirm that there is a substantiated viewpoint in the Hanafi school professing the binding nature of Istisna'a once it is constituted. It is on this reality that the *"Majallat Al-Ahkam Al-'Adliyyah"*, modern civil Islamic legislations and the Islamic Fiqh Academy developed their viewpoint, which is consistent with Shari'a rules and principles.

6. Legal Consequences of Istisna'a

According to the majority of Hanafi jurists, the legal consequences of Istisna'a are: (I) to transfer reciprocally title of ownership between

(13) Al-Tumurtashi, *"Tanwir Al-Absar"*, with *"Hashiyat Radd Al-Muhtar"*, [5: 223-224] 1386 A.H.; Al-Mihbat Al-Bourhati, Manuscript of Al-Awqaf Library, [2: 575-576] in Al-Qaradaghi, A.M., Istisna'a Contract, 1997 A.D.

(14) Al-Kasani, op. cit. [3: 3].

Al-Mustasni' and Al-Sani'; and (II) to establish the entitlement of Al-Sani' to the agreed upon amount of the contract. This is because Istisna'a is a binding contract.(15) This is the view adopted by recent civil Islamic legislations, and modern transactions, whereby both the transfer of title of ownership is automatic and unconditional and Al-Sani' is entitled to the agreed upon amount once the contract is constituted.(16)

7. Guarantee

7/1 Al-Mustasni' has the right to obtain collateral from Al-Sani' for:

a) The total amount that he has paid.
b) The delivery of Al-Masnoo' in accordance with the specifications and on due time.

7/2 Al-Sani' also has the right to secure collaterals to guarantee that the price is payable on due time.(17)

8. Penalty Clause

It is permissible for Al-Mustasni' to insert a penalty clause in the contract against unfulfillment of obligations by Al-Sani'.(18)

9. Options on Non-Compliance with Specifications

If Al-Masnoo' is not in conformity with the specifications, Al-Mustasni' has the following options:

a) Reject Al-Masnoo', or
b) Accept it without seeking damages.

10. Termination of Istisna'a Contract

The contract of Istisna'a may be terminated under the following conditions:

a) Normal fulfillment of obligations by both parties.
b) Mutual consent of both parties.

(15) Al-Kasani, op. cit. [3: 3].
(16) Abdullah, A.A., op. cit., (P. 59).
(17) Abdullah, A.A., op. cit., (P. 59).
(18) Islamic Fiqh Academy, 7th Session, Resolution No. (67/3/7), held on 7/12 Dhul-Qa'dah, 1412 A.H., corresponding to 9-14 May, 1992 A.D.

c) Judicial rescission of the contract. This is if a reasonable cause arises to prevent the execution of the contract or its completion, and each party may sue for its rescission.[19]

11. Parallel Istisna'a

If Al-Mustasni' (the ultimate purchaser) did not stipulate in the contract that Al-Sani' (the seller) should manufacture the Al-Masnoo' by himself, then Al-Sani' may enter into a second Istisna'a contract in order to fulfil his contractual obligations in the first contract. This new contract is known as parallel Istisna'a, which is in essence a subcontract whereby the obligation of Al-Sani' in the first contract are carried out. Nevertheless,:

a) The Islamic bank as Al-Sani' in the first contract will remain solely responsible for the execution of his obligations as if the parallel contract is nonexistent. Hence, Al-Sani' in the first contract would remain liable for any default, negligence or breach of contract ensuing from the parallel contract.
b) Al-Sani' in the parallel Istisna'a is accountable to Al-Mustasni' (the Islamic bank) in the way and manner by which he performs his obligations. He has no direct legal relationship with Al-Mustasni' in the first contract. The second Istisna'a is a parallel contract, but not a contingent transaction on the first contract. Legally speaking they are different contracts with respect to the rights and obligations.
c) The Islamic bank as Al-Sani' is liable to Al-Mustasni' with regard to any mal-execution of the subcontractor and any guarantees arising therefrom. It is this very liability that justifies the validity of the parallel Istisna'a and which also justifies the charging of profit by the Islamic bank, if any.[20]

(19) See Recent Civil Islamic Legislations; Abdullah, A.A., op. cit, (pp. 61-62).
(20) Abdullah, A.A., op. cit., (pp. 62-66).

Similarities and Differences Between Salam and Istisna'a

Subject	Salam	Istisna'a	Rules and Comments
1. Subject matter of the contract	Al-Muslam Fihi	Al-Masnoo'	Deferred goods, known by specification.
2. Price	Paid at time of contracting	It is permissible to: a) Pay it at time of contracting; b) Defer it; or c) Pay it in instalments.	The means of settlement (in advance, deferred, or instalments) constitute the main difference between Salam and Istisna'a.
3. Nature of contract	Binding	Binding	Salam is originally binding on its parties, However, Istisna'a is considered binding based on the views of some Fuqaha for the sake of *Maslaha* and for not contravening any Shari'a rule.
4. Parallel contract	Parallel Salam	Parallel Istisna'a	Both parallel Salam and parallel Istisna'a are valid provided that: ▪ The two contracts are legally separated; ▪ The legal relationship between the parties to each contract is separate; and ▪ The rights and obligations of each contract are separate.

Appendix (D)
Reasons for the Standard

In their response to AAOIFI's letter of 30 Jumada I, 1416 A.H., corresponding to 24 October 1995 A.D., the Islamic banks gave priority to the preparation of a standard, among others, on Istisna'a and Parallel Istisna'a. This was endorsed by the Accounting and Auditing Standards Board in its meeting No. (9) held on 24-25 Rabi' II, 1416 A.H., corresponding to19-20 September 1995 A.D., in Bahrain.

Istisna'a and Parallel Istisna'a are important modes of financing used by the Islamic banks. The accounting treatments by the Islamic banks of Istisna'a and parallel Istisna'a give rise to numerous problems due to the multiplicity of alternatives available for the treatment of many issues. Among the issues that are susceptible to significant differences in the accounting treatment are:

- Measurement and recognition of the costs of Istisna'a and parallel Istisna'a contracts.
- Measurement and recognition of the revenues and profits of Istisna'a and parallel Istisna'a contracts.
- Valuation of Istisna'a assets at the end of a financial period, especially when contract losses are expected.
- Measurement and treatment of contract maintenance and warranty costs.
- Scope and mode of disclosure of accounting information and policies relating to Istisna'a and parallel Istisna'a transactions in the financial statements of the Islamic bank.

Differences in the accounting treatments of such issues and their disclosure in the financial statements of the Islamic bank are expected to have adverse effects on the comparability of accounting information presented in the

financial statements of Islamic banks. Thus, the standardisation of accounting treatments of Istisna'a and parallel Istisna'a transactions on bases consistent with Statement of Financial Accounting No. (1): Objectives of Financial Accounting for Islamic Banks and Financial Institutions (Statement of Objectives), and the Statement of Financial Accounting No. (2): Concepts of Financial Accounting for Islamic Banks and Financial Institutions (Statement of Concepts) is necessary in order to provide useful information to users of the financial reports of these banks and for ensuring comparability of such information.

Appendix (E)
Basis for Conclusions

This appendix shows the alternatives taken into consideration when choosing the accounting treatment of Istisna'a and parallel Istisna'a and the justifications of the basis on which the chosen alternative was given preponderance.

The Accounting Standards Committee has reviewed in its meetings a number of alternatives, and the alternatives proposed in the preliminary study(21) to be adopted in the accounting treatments of Istisna'a and parallel Istisna'a. The Accounting Standards Committee recommended the adoption of the alternatives which were considered to be in compliance with the previous Statement of Financial Accounting No. (1): Objectives of Financial Accounting for Islamic Banks and Financial Institutions (Statement of Objectives), and the Statement of Financial Accounting No. (2): Concepts of Financial Accounting for Islamic Banks and Financial Institutions (Statement of Concepts).

Recognition of Istisna'a Profit

Two alternative treatments were proposed for the recognition of Istisna'a profit:

a) Percentage of completion method. According to this method, a portion of Istisna'a profit commensurate with the work completed during a period is recognized at the end of the period as a realized profit. That is, Istisna'a profit is allocated over the periods in which the contract is being executed in proportion to the work completed in each period. A crucial condition for applying this method is that the expected cost of completing the contract is estimated with reasonable accuracy.

(21) Abul-Izz, Muhammad Al-Said, *"A Study of the Accounting Aspects of Istisna'a and Parallel Istisna'a"*, Accounting and Auditing Organization for Islamic Financial Institutions, 1418 A.H.-1997 A.D.

b) Completed contract method. According to this method, the entire contract costs and revenues of Istisna'a contract are recognized at the end of the financial period during which the contract is completed.

The first alternative; i.e., percentage of completion method, was chosen for the recognition of Istisna'a and parallel Istisna'a profit, provided that the contract costs can be estimated with reasonable accuracy. However, if the contract costs cannot be estimated with reasonable accuracy, the completed contract method should be used. The percentage of completion method is preferred because it provides for a better matching of Istisna'a revenues and expenses. Furthermore, it reflects in a more accurate manner the outcome of the earning activities of Al-Sani' (the Islamic bank) over the entire time period of contract execution, thereby presenting more relevant information to users of the financial statements.

Furthermore, the percentage of completion method enables investment accountholders to participate in Istisna'a profit as long as they have a contractual relationship with the Islamic bank. However, postponing the recognition of revenue and profits until the contract is completed (i.e., using the completed contract method) denies investment accountholders from their share in Istisna'a profits should they withdraw their funds before the contract is completed. Therefore, the second alternative (the completed contract method) should be applied only in unusual circumstances, i.e., when the first alternative (the percentage of completion method) is not applicable.

Valuation of Istisna'a Assets at the End of a Financial Period

Two valuation bases were considered for measuring Istisna'a assets at the end of the financial period in the financial statements of Al-Sani' (Islamic bank):

a) Historical cost of Istisna'a assets is represented by both the book value of the Istisna'a work-in-progress account in an Istisna'a contract or the book value of the Istisna'a costs account in the case of parallel Istisna'a.
b) Historical cost, as defined in alternative (a) above, provided it does not exceed the cash equivalent value.

Alternative (b) was chosen because it allows timely recognition of any expected losses in the execution of the contract at the end of a financial period. Hence, Istisna'a assets would not be inflated as would happen if these assets were not written down to account for the expected losses. Thus, the chosen alternative provides more relevant information for users of the financial statements.

Maintenance and Product Warranty Costs of Al-Masnoo'

The following two alternatives of accounting for maintenance and warranty costs of Al-Masnoo' were considered:

a) Accrual basis: According to this basis, maintenance and warranty costs expected to take place for each period are estimated and matched against the Istisna'a revenues recognized for the same period. When incurred, actual maintenance and warranty expenditures are charged against the maintenance and warranty allowance account.
b) Cash basis: According to this basis actual maintenance and warranty costs are charged against income for the financial period in which they take place.

The accrual basis (the first alternative) was chosen for Istisna'a contracts because it provides for a better matching of Istisna'a revenues and expenses. The cash basis (the second alternative), however, was chosen for parallel Istisna'a contracts based on the materiality concept because in a parallel Istisna'a such costs are born by Al-Sani' (i.e., the subcontractor).

Appendix (F)
Definitions

Istisna'a

It is a sale contract between Al-Mustasni' (the buyer) and Al-Sani', (the seller) whereby Al-Sani' - based on an order from Al-Mustasni'- undertakes to have manufactured or otherwise acquire Al-Masnoo' (the subject matter of the contract) according to the specifications and sell it to Al-Mustasni' for an agreed upon price and method of settlement whether that be at the time of contracting, by instalments or deferred to a specific future time. It is a condition of the Istisna'a contract that Al-Sani' should provide either the raw material or the labour.

Parallel Istisna'a

If Al-Mustasni' (the purchaser) does not stipulate in the contract that Al-Sani' (the seller) should manufacture Al-Masnoo' by himself, then Al-Sani' may enter into a second Istisna'a contract in order to fulfil his contractual obligations in the first contract. The second contract is called Parallel Istisna'a.

Istisna'a Work-in-Progress Account

This is an asset account in which the Istisna'a contract costs are accumulated. When the percentage-of-completion method is used, a portion of Istisna'a profit commensurate with the work completed during a financial period is also debited to this account.

Istisna'a Costs Account

This is an asset account used when a parallel Istisna'a exists. It accumulates progress billings made by the subcontractor. A portion of the Istisna'a profit commensurate with the work completed during a financial period is also debited to this account.

Percentage-of-Completion Method

An accounting method that recognizes the revenues and profits of Istisna'a contracts as work progresses.

Completed-Contract Method

An accounting method that recognizes Istisna'a costs and revenues only in the financial period in which the contract is completed.

Contract Losses

Losses expected to happen when the sum of the costs accumulated in the Istisna'a account or receivable Istisna'a billing accounts and the estimated additional costs for the completion of the contract exceed the price fixed in the Istisna'a contract.

Change Orders

Approved modifications in the specifications, quantities, design, or other attributes defined in the original Istisna'a contract the implementation of which affects the contract costs.

Additional Claims

Amounts in excess of the agreed Istisna'a contract price which are claimed by Al-Sani' for delays, errors in the specifications and designs or other causes of unanticipated costs caused by Al-Mustasni'. Recognition of these claims by Al-Sani' requires the satisfaction of the following conditions:

a) The existence of a legal basis for the additional claim supported by objective and verifiable evidence.
b) Claims must be due to circumstances that were unforeseeable at the contract date and are not the result of the deficiencies, fault or negligence of Al-Sani'.
c) Costs associated with the additional claim are identifiable and reliably estimable.

AAOIFI Financial Accounting Standard 32

Ijarah

Contents

AAOIFI Financial Accounting Standard (FAS) 32 "*Ijarah"* is set out in paragraphs 01-112. All the paragraphs have equal authority. This standard should be read in the context of its objective and the Conceptual Framework for Financial Reporting as endorsed by AAOIFI.

All AAOIFI FASs shall be read in conjunction with the definitions, Shari'ah principles and rules and key considerations provided by AAOIFI Shari'ah Standards (SS) in respect of such products and matters.

Preface

PR1 Ijarah and Ijarah Muntahia Bittamleek (Ijarah MBT) in their different forms are amongst the most common Islamic finance transactions. These are used commonly by Islamic financial institutions (the institutions) for providing assets to customers in need of financial resources for acquiring such assets in different sectors. A significant proportion of underlying assets in Sukuk structures are also based on such transactions.

PR2 AAOIFI Accounting Board (AAB / the board), in its strive for improvements of the existing financial reporting standards, decided to revise the existing Financial Accounting Standard (FAS) 8 "Ijarah and Ijarah Muntahia Bittamleek" in order to address the issues faced by the market and observations noted over the past several years, as well as, to improve the existing accounting treatments in line with the global best practices. This standard accordingly supersedes the existing FAS 8 "Ijarah and Ijarah Muntahia Bittamleek".

PR3 This standard brings a fundamental shift in the accounting approach for Ijarah transactions, particularly, in the hand of the lessee. In contrast to the earlier accounting approach of the off-balance sheet accounting for Ijarah, the new standard prescribes an altogether different model of accounting in the hand of lessee which entails recognition of the lessee's unencumbered right to the benefits from the use of the asset as 'right-of-use asset' and its corresponding liability.

PR4 It is expected that the new standard will improve the overall accounting and financial reporting practices of the Islamic finance industry and will bring the same closer to the global best practices, without any compromise on Shari'ah principles or the essence of the transaction.

Introduction

Overview

IN1 This standard improves upon and supersedes AAOIFI's Financial Accounting Standard (FAS) 8 "Ijarah and Ijarah Muntahia Bittamleek" originally issued in 1997. This standard aims at setting out principles for the classification, recognition, measurement, presentation and disclosure of Ijarah type transactions including their different forms entered into by an institution, in both the capacities of lessor and lessee.

Rationale for issuing this standard

IN2 The AAOIFI Accounting Board (AAB/ the board), after its constitution in 2015, approved a strategy and plan for improvement in and revision of a significant number of existing FASs. Revision of FAS 8 "Ijarah and Ijarah Muntahia Bittamleek" was already on agenda of the earlier board, and a limited scope revision was already under discussion at the accounting standards committee. However, considering the expected changes, at that time, in the generally accepted accounting principles with regard to lease accounting[1], it was decided that the standard revision shall be made duly considering the principal changes in accounting by the global accounting standard setters.

IN3 The board was also mindful of the fact that eliminating or reducing the financial reporting requirements with regard to any demonstrable differences between Ijarah and Ijarah MBT against conventional leases will jeopardize the sanctity of the transaction's financial reporting and may also adversely impact the reputation of the Islamic finance industry.

IN4 A review of FAS 8 "Ijarah and Ijarah Muntahia Bittamleek" and preliminary study on the topic duly considering the above factors identified that there were needs for improvement in the same in line with the changes in the industry and the global best practices of accounting. Certain observations and comments of certain terminology and approaches used in the said standard were noted from the Shari'ah perspective as well. Accordingly, the board decided to issue a revised standard on the subject of Ijarah.

Significant changes from previous standard

IN5 This standard (FAS 32) brings significant changes from its predecessor standard (FAS 8), inter alia, in the following aspects:

a. changes in the classification. Ijarah transactions under in this standard are classified into the following:

i. operating Ijarah;

ii. Ijarah MBT with expected transfer of ownership after the end of the Ijarah term – either through a sale or gift; and

[1] Both the International Accounting Standards Board (IASB) and US Financial Accounting Standards Board (US FASB) were working on a converged project for revision and improvement in accounting for leases, and exposure drafts of the standards were issued. The project resulted in both bodies revising their respective standards, principally on the same lines although they still maintain differences in respect of certain accounting issues.

iii. Ijarah MBT with gradual transfer – with gradual transfer ownership during the Ijarah term including Diminishing Musharaka Ijarah;

b. new recognition and measurement principles for initial recognition for right-of-use asset, Ijarah liability and advance payments for lessee and lessor accounting;

c. requirement to identify and separate Ijarah and non-Ijarah components, if needed;

d. new recognition and measurement principles for an Ijarah MBT through gradual transfer / Diminishing Musharaka Ijarah, whereby the lessee shall recognize the 'combined asset' (including the right-of-use asset and the proportionate asset already owned by the lessee) whereas the lessor shall recognize the proportionate asset owned. FAS 8 requirements of recording monthly depreciation and gain and loss for such transactions are done away with;

e. allowing effective rate of return/ profit rate method for accounting for rental income, in the hand of the lessor;

f. testing for impairment of right-of-use asset shall be subject to requirements of FAS 30 "Impairment, Credit Losses and Onerous Commitments"; and

g. detailed guidelines are provided for presentation and disclosures with enhanced disclosure by lessor and lessee of information as compared to previous requirements in FAS 8.

AAOIFI Financial Accounting Standard 32
Ijarah

Objective of the standard

1. The objective of this standard is to set out principles for the classification, recognition, measurement, presentation and disclosure for Ijarah (asset Ijarah, including different forms of Ijarah Muntahia Bittamleek) transactions entered into by the Islamic financial institutions (the institutions) on both ends of the transaction i.e. as a lessor and lessee. An institution shall consider the terms and conditions of the contracts and all relevant facts and circumstances when applying this standard and shall apply the same on a consistent basis.

Scope

2. This standard shall apply for accounting and financial reporting for a lessor or lessee, for all Ijarah (asset Ijarah, including Ijarah Muntahia Bittamleek (Ijarah MBT)) transactions unless specifically excluded under paragraph 3.

3. This standard shall not be applied for accounting of:

   a. Sukuk based on Ijarah which shall be subject to accounting under respective FAS;

   b. Ijarah transactions for exploration, extraction, harvesting and otherwise use and sale of natural resources; and

   c. service Ijarah transactions including employment / labour contracts and hiring of professional services and other service based contracts (not involving tangible assets), including intellectual property and detachable rights.

Definitions

4. For the purpose of interpreting and applying this standard, the following short definitions are relevant:

   a. Combined asset – is an underlying asset subject to Ijarah MBT through gradual transfer, or any other form of Ijarah MBT, in which proportionate ownership and right-of-use co-exist on the same asset;

   b. Commencement date – is the date on which the lessor makes an underlying asset available for use by the lessee, in a condition suitable for intended purpose and use;

   c. Contract – is an agreement between two or more parties that creates enforceable rights and obligations;

   d. Control – an institution controls an asset or business, when it has substantially all risks and rewards incidental to ownership of such asset or business, duly meeting both of the following conditions:

      i. it is directly exposed to, or has rights to, variable returns (negative or positive, respectively) from its involvement with such assets or business; and

ii. it has the ability to affect those returns through its power over the assets or business;

e. Deferred Ijarah cost – shall be as defined in paragraph 29;

f. Diminishing Musharaka (Shirkat-ul-Milk) Ijarah – is a hybrid Ijarah product similar to 'Ijarah Muntahia Bittamleek through gradual transfer' comprising of:

i. a co-ownership in which two parties share the ownership of a tangible asset in an agreed proportion (without intention to engage in common business with respect to such asset); and

ii. a promise under which one of the co-owners undertakes to buy in periodic installments the proportionate share of the other co-owner until the ownership / title to such tangible asset is completely transferred to the purchasing co-owner (whereby each transaction takes place as a sale); and

iii. a separate Ijarah contract, whereby one co-owner (lessor) rents out its proportionate share in the asset to the other co-owner (lessee);

g. Effective rate of return method [also referred to as effective profit rate method] – is a method of allocating income from an asset or venture uniformly, and equitably over the contractual (or expected) period of expected benefit from the asset or continuity of venture. This method allocates the cash flows from asset or venture through a uniform rate of return including all cash flows considering all contractual terms (or best expectations) excluding expected future losses. Any fee paid or received, the transaction costs, premiums or discounts are included in the cash flows insofar as these are part of the base contract, or are ancillary costs;

h. Fair value – is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date;

i. Fixed Ijarah rentals – are fixed Ijarah rentals paid by a lessee to a lessor for the right to use an underlying asset during the Ijarah term, excluding variable Ijarah rentals, and include in-substance fixed Ijarah rentals;

j. Forward Ijarah (Ijarah Mawsufah fi al-Dhimma) – is an Ijarah contract for an unidentified (and at times, presently non-existent) asset undertaken by the lessor to be delivered to the lessee according to the agreed specifications;

k. Hamish Jiddiyyah (security deposit) – is the amount deposited as a security against fulfillment of a contract, or promise, or completion of a transaction by one of the parties to other;

l. Ijarah – is a contract, or part of contractual arrangement, that transfers the usufruct of an asset (the underlying asset) for a period of time in exchange for an agreed consideration, from a lessor (the owner of the underlying asset) to a lessee. It has three major elements:

i. a form – which includes an offer and an acceptance;

ii. two parties – a lessor and a lessee; and

iii. the object of the (Ijarah) contract – which includes the rental amount and the service benefit;

m. Ijarah contract modification – is a change (with mutual consent of the parties) in the scope of an Ijarah, or the consideration for an Ijarah, that was not part of the original terms and conditions of the Ijarah (for example, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual Ijarah term);

n. Ijarah Muntahia Bittamleek (Ijarah MBT) – is a hybrid Ijarah arrangement which, in addition to the Ijarah contract, includes a promise resulting in transfer of the ownership of the underlying asset to the lessee, either after the end of the term of the Ijarah period or by stages during the term of the contract. Such transfer of the ownership is executed through a sale or a gift, or a series of sales transactions – independent of Ijarah contract;

o. Ijarah rentals (Ujra) – represent consideration due to the lessor from lessee against transfer of the usufruct (right-of-use) and includes fixed rentals including in-substance fixed rentals, and variable rentals, but does not include any consideration paid or promised for transfer of ownership or proportionate ownership, either as lump sum or as a gradual payment or as a residual value guarantee;

p. Ijarah term – represents the binding period covered by the Ijarah contract, as well as, the reasonably certain optional periods (see paragraph 13);

q. Initial direct costs – are the incremental costs of executing an Ijarah transaction incurred solely and necessarily for the purpose of execution of the Ijarah transaction e.g. costs borne by the lessor on feasibility study, credit assessment or documentation etc. These do include any regulatory costs borne by a manufacturer or dealer lessor for entering an Ijarah MBT transaction;

r. In-substance fixed Ijarah rentals – in-substance fixed Ijarah rentals are rentals that may, in form, contain variability but that, in substance, are unavoidable but do not include any conditions against sale or transfer of ownership of the underlying asset;

s. Lessee – is a party in Ijarah contract that acquires the usufruct of an underlying asset for a period of time in exchange for an agreed consideration;

t. Lessor – is a party in Ijarah contract that transfers the usufruct of an underlying asset for a period of time in exchange for an agreed consideration;

u. Onerous commitment – is a commitment, in which the unavoidable costs of meeting the obligations under the commitment, exceed the economic benefits expected to be received under it;

v. Operating Ijarah – is an Ijarah that is not accompanied with an option of transfer of ownership of the underlying asset to the lessee;

w. Residual value of right-of-use assets (for lessee) – is the amount, if any, expected to be recovered for these assets computed in accordance with paragraph 37;

x. Residual value of underlying assets (for lessor) – is the amount which is expected to be recovered for these assets at the end of their useful life, net of the expected cost of disposal. Residual value of underlying assets is to be estimated at the commencement of the Ijarah;

y. Right-of-use asset (usufruct asset) – is a kind of intangible assets that represents a lessee's legally enforceable right-of-use (or control of usufruct) of an underlying asset (normally being a tangible asset) for the Ijarah term, and includes a 'combined asset' for the purpose of application of this standard;

z. Short-term Ijarah – is an operating Ijarah that, at the commencement date, has an Ijarah term of 12 months or less;

aa. Sub-Ijarah – is an Ijarah transaction for which an acquired right-of-use asset is transferred on an independent Ijarah basis by a lessee ('intermediary lessor') to a third party, and the original Ijarah contract ('head-Ijarah') between the head-lessor and lessee remains in effect;

bb. Underlying asset – is an asset that is the subject of an Ijarah contract, for which the usufruct has been transferred by a lessor to a lessee;

cc. Useful economic life – is the period over which an asset is expected to be available for use or the number of production units or usage units etc. expected to be obtained/ utilized from an asset;

dd. Usufruct – is a legally enforceable limited right related to an asset including the two property interests of (i) usus (use), being the right to use or enjoy such asset and (ii) fructus (fruit), being the right to derive profit or benefit from such asset, but does not entail risks and rewards incidental to ownership; and

ee. Variable Ijarah rentals – are the portion of rentals paid by a lessee to a lessor for the right to use an underlying asset during the Ijarah term that varies because of changes in facts or circumstances occurring after the commencement date, other than the lapse of time (see paragraph 26).

Identifying (and separating) an Ijarah

5. At inception of a contract, an institution shall assess whether the contract is, or contains, an Ijarah. A contract is, or contains, an Ijarah if the contract transfers the usufruct (but not control) of an identified asset for a period of time in exchange for an agreed consideration. Where applicable, the period of time may be agreed in terms of usage factors, rather than the lapse of time factor alone.

6. An institution shall reassess whether a contract is, or contains, an Ijarah only if the terms and conditions of the contract are changed.

Separating components within the Ijarah contract

7. For a contract that is, or contains, an Ijarah, an institution shall account for each Ijarah component within the contract as an Ijarah separately from non-Ijarah components (e.g. service fee,

maintenance charges, toll manufacturing charges etc.) of the contract, unless the institution applies the simplified approach as defined in paragraph 10.

8. Unless the simplified approach under paragraph 10 is applied, a lessee shall account for non-Ijarah components applying relevant FAS, or generally accepted accounting principles, in absence thereof, subject to the condition that such accounting policy shall be in line with the Shari'ah principles and rules.

Lessee

9. For a contract that contains an Ijarah component and one or more additional Ijarah or non-Ijarah components, a lessee shall allocate the consideration in the contract to each Ijarah component on the basis of the relative estimated stand-alone price of the Ijarah component and the aggregate estimated stand-alone price of the non-Ijarah components, that may be charged by the lessor, or a similar supplier, to the lessee.

10. As an alternate, a lessee may adopt a simplified approach whereby the lessee may elect, by class of underlying asset, not to separate non-Ijarah components from Ijarah components, and instead account for each Ijarah component and any associated non-Ijarah components as a single Ijarah component.

Lessor

11. For a contract that contains an Ijarah component and one or more additional Ijarah or non-Ijarah components, a lessor shall allocate the consideration in the contract to each Ijarah and non-Ijarah component (performance obligation identified in the contract) on an estimated relative stand-alone price basis. In case of similar characteristics of different Ijarah components, the lessor may opt to consider the same as a single Ijarah component.

Classification of Ijarah

12. An institution, in its capacity either as a lessor or lessee, shall classify each of its Ijarah as:

    a. an operating Ijarah (see paragraph 4(v));

    b. an Ijarah MBT (see paragraph 4(n)), including the following types:

        i. an Ijarah MBT – with expected transfer of ownership after the end of the Ijarah term – either through a sale or a gift; or

        ii. an Ijarah MBT with gradual transfer – with gradual transfer of ownership during the Ijarah term (including Diminishing Musharaka Ijarah).

Ijarah term

13. An institution, in its capacity of either a lessor or lessee, shall determine the Ijarah term, including the contractually binding period (which may be denoted in terms of units of production or consumption), as well as, the reasonably certain optional periods including:

    a. extension options (periods covered by an option to extend the Ijarah) – if it is reasonably certain that the lessee will exercise that option; and / or

b. termination options (periods covered by an option to terminate the Ijarah) – if it is reasonably certain that the lessee will not exercise that option.

Assessment of probability of exercising the extension (including non-termination) options

14. In assessing the probability of extension of Ijarah term in line with paragraph 13(a) or 13(b), an institution shall consider all relevant facts and circumstances that create an economic incentive for such extension, including the following:

a. as to whether the contractual terms and conditions for the optional periods are at market rates, such as:

i. the amount of rentals for the Ijarah in any optional period;

ii. the amount of any variable rentals for the Ijarah or other contingent payments, such as payments resulting from termination penalties and promise to purchase; and

iii. the terms and conditions of any options that are exercisable after optional periods (for example, a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates or transfer of asset through gift);

b. significant improvements over the underlying assets (leasehold improvements) undertaken (or expected to be undertaken) over the term of the contract that are expected to have significant economic benefit for the lessee when the option to extend or terminate the Ijarah, or to purchase the underlying asset, becomes exercisable;

c. costs relating to the termination of the Ijarah, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee's needs, costs of integrating a new asset into the lessee's operations, or termination penalties and similar costs, including costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location;

d. the importance of that underlying asset to the lessee's operations, considering, for example, whether the underlying asset is a specialized asset, the location of the underlying asset and the availability of suitable alternatives; and

e. conditions associated with exercising the option (i.e. when the option can be exercised only if one or more conditions are met), and the likelihood that those conditions will exist.

15. It would generally be considered that the lessee is reasonably certain to exercise the extension option if:

a. an option to extend or terminate an Ijarah is combined with one or more other contractual features (for example, a promise to purchase) in a manner that the lessee still pays more or less the same amount, in total, as it would otherwise pay by exercising the option;

b. the binding period of an Ijarah is very short – as the exercising of such option would generally be economically more feasible;

c. the lessee's past practice regarding the period over which it has typically used particular types of assets (whether under Ijarah or owned), and its economic reasons for doing so, determine the exercising of the option to be economically more feasible and in line with the lessee's past trends.

16. There is a rebuttable presumption that expressed intention of the lessee to exercise the extension option(s) provides reasonable certainty with regard to extension of Ijarah term.

Subsequent re-assessment of Ijarah term

17. A lessee shall reassess whether it is reasonably certain to exercise an extension option, or not to exercise a termination option, upon the occurrence of either a significant event or a significant change in circumstances that:

    a. is within the control of the lessee; and

    b. affects whether the lessee is reasonably certain to exercise an option not previously included in its determination of the Ijarah term, or not to exercise an option previously included in its determination of the Ijarah term.

18. An institution shall revise the Ijarah term if there is a change in either the contractually binding period or reasonably certain optional periods of an Ijarah. For example, the Ijarah term shall be revised if:

    a. the lessee exercises an option not previously included in the institution's determination of the Ijarah term;

    b. the lessee does not exercise an option previously included in the institution's determination of the Ijarah term;

    c. an event occurs that contractually obliges the lessee to exercise an option not previously included in the institution's determination of the Ijarah term; or

    d. an event occurs that contractually prohibits the lessee from exercising an option previously included in the institution's determination of the Ijarah term.

Accounting and financial reporting by the lessee

Initial recognition

Advance rentals paid

19. Any rentals paid in advance by the lessee prior to the commencement date shall be accounted for and presented as 'advance Ijarah rentals paid'.

20. Once the Ijarah term is commenced, and the gross Ijarah liability and net Ijarah liability are determined, such advance rentals shall be netted-off with the gross Ijarah liability.

Initial recognition

21. At the commencement date, a lessee shall recognize:

    a. a right-of-use (usufruct) asset; and

b. a net Ijarah liability, duly comprising of the following elements:

i. gross Ijarah liability;

ii. deferred Ijarah cost (shown as a contra-liability).

Initial recognition of right-of-use asset

22. At the commencement date, a lessee shall measure the right-of-use asset at cost.

23. The cost of the right-of-use asset shall comprise:

a. the "prime cost" of the right-of-use asset (determined in line with the paragraphs 31 or 32);

b. any initial direct costs incurred by the lessee; and

c. dismantling or decommissioning costs[2].

Initial recognition of Ijarah liability

24. The gross Ijarah liability shall be initially recognized as gross amount of total Ijarah rentals payable for the Ijarah term.

25. At the commencement date, the total Ijarah rentals included in the measurement of the Ijarah liability comprise the following payments for the right to use the underlying asset during the Ijarah term:

a. fixed Ijarah rentals less any incentives receivable;

b. variable Ijarah rentals (see paragraphs 4(ee) and 26) including the supplementary rentals (duly measured at best estimates applying the index rates and other assumptions as of the commencement date; and

c. payments of additional rentals, if any, for terminating the Ijarah, if the Ijarah term reflects the lessee exercising an option to terminate the Ijarah, subject to Shari'ah requirements.

26. Variable Ijarah rentals are the Ijarah rentals that depend on an index or a rate. These include, for example, payments linked to a consumer price index, payments linked to a financial market or regulatory benchmark rate or payments that vary to reflect changes in market rental rates. These also include supplementary rentals which are contingent on certain items e.g. rentals additionally charged after providing certain additional services or after incurring major repair and maintenance.

Special considerations for Ijarah MBT through gradual transfer

27. In case of Ijarah MBT through gradual transfer, or any other form of Ijarah MBT, in which proportionate ownership and right-of-use co-exist on the same asset, the lessee shall account for the combined asset under Ijarah MBT through gradual transfer, comprising of the proportionate:

a. right-of-use asset; and

[2] Dismantling or decommissioning costs, if any, shall be accounted for in line with the generally accepted accounting principles, subject to necessary Shari'ah approvals.

b. ownership of the tangible asset.

28. A combined asset under Ijarah MBT through gradual transfer shall be accounted for in a manner similar to a right-of-use asset in line with the requirements of this standard.

Deferred Ijarah cost

29. Deferred Ijarah cost, is the difference between the gross Ijarah liability and the prime cost of right-of-use asset. It shall be initially deferred through a deferred Ijarah cost account.

30. Deferred Ijarah cost account shall be presented as a contra-liability (of respective liability).

Prime cost of the right-of-use asset

Underlying asset cost method

31. At the commencement date, the prime cost of the right-of-use asset (except for an operating Ijarah) shall comprise of:

a. either of:

i. preferably, the cost of the underlying asset – if acquired specifically by the lessor for the purpose of the intended Ijarah transaction; or

ii. alternatively, the fair value of the underlying asset as of the commencement date – if not acquired specifically by the lessor for the purpose of the intended Ijarah transaction or if the cost is not known to the lessee;

b. less any expected terminal value of the underlying asset (at the end of the Ijarah term), being either of:

i. the promised value (being nil value, in case of expected gift) at which the transfer may take place after the end of the Ijarah term; or

ii. expected fair value of the underlying asset at the end of the Ijarah term, in case of absence of a promised value.

Estimation based on liability method

32. If, the prime cost of the right-of-use asset may not be determined under the underlying asset cost method defined in paragraph 31 due to lack of sufficient information (particularly, in case of an operating Ijarah) the same may be determined through estimation based on the fair value of the total consideration paid or payable (i.e. total Ijarah rentals) against the right-of-use asset, under a similar transaction.

Subsequent measurement

Subsequent measurement of the right-of-use asset

33. After the commencement date, a lessee shall measure the right-of-use asset at:

a. cost;

b. less – any accumulated amortization;

c. less – any accumulated impairment losses;

d. add / less – adjustment for any effect of Ijarah modification or reassessment specified in paragraphs 44-46.

Amortization of right-of-use asset

34. A lessee shall amortize the right-of-use asset from the commencement date to the end of the useful economic life of the right-of-use asset which coincides with the end of the Ijarah term.

35. Amortizable amount of a right-of-use asset shall be amortized according to a systematic basis that is reflective of the pattern of utilization of benefits from the right-of-use asset.

36. Amortizable amount shall generally represent the cost of a right-of-use asset less residual value, if any.

37. Residual value of right-of-use asset shall be equal to:

a. nil value – in case of:

i. an operating Ijarah; or

ii. an Ijarah MBT through sale at fair value after the end of the Ijarah term; or

iii. an Ijarah MBT that does not meet the condition specified in paragraph 37(c); or

b. the estimated "residual value of the underlying asset" at the end of the Ijarah term – in case of an Ijarah MBT through gradual transfer; or

c. the estimated "residual value of the underlying asset" at the end of the Ijarah term less promised purchase price (if any) – in case of Ijarah MBT through sale or gift after the end of the Ijarah term, if it is highly likely that the option of transfer of ownership of the underlying asset to the lessee shall be exercised through purchase or gift.

Impairment of right-of-use asset

38. A lessee shall apply requirements of FAS 30 "Impairment, Credit Losses and Onerous Commitments" to determine whether the right-of-use asset is impaired and to account for any impairment loss identified. The impairment testing shall take into consideration the estimated residual value of the asset in line with the paragraph 37(c).

39. A lessee shall also assess as to whether any commitment(s) including promise(s) to purchase the underlying asset after the end of the Ijarah term or through gradual transfer is onerous in nature and if so, shall account for the same in line with the requirements of FAS 30 "Impairment, Credit Losses and Onerous Commitments".

Subsequent measurement of the Ijarah liability

40. After the commencement date, a lessee shall measure the net Ijarah liability by:

a. reducing the carrying amount of the gross Ijarah liability to reflect the Ijarah rentals made;

b. increasing the net carrying amount to reflect return on the Ijarah liability – by way of amortization of deferred Ijarah cost; and

c. re-measuring the carrying amount to reflect any reassessment, changes or Ijarah contract modifications or to reflect revised Ijarah rentals.

41. The effect of re-measuring of the carrying amount of Ijarah liability (in line with paragraph 40(c)) shall be recognized as a change in the deferred Ijarah cost unless a specified requirement of paragraphs 44, 45 or 46 applies.

42. Deferred Ijarah cost shall be amortized to income over the Ijarah term on a time proportionate basis. It is a rebuttable presumption that for most Ijarah transactions, the appropriate method to apply the time proportion basis shall be the effective rate of return method.

43. After the commencement date, a lessee shall recognize in income statement, unless the costs are included in the carrying amount of another asset (e.g. inventory, property, plant and equipment, Istisna'a assets etc.), both:

a. amortization of deferred Ijarah cost; and

b. variable Ijarah rentals (not already included in the measurement of the Ijarah liability) – as and when remeasured i.e. when the triggering event or condition occurs.

Ijarah contract modifications

Changes in the Ijarah term or future Ijarah rentals

44. After the commencement date, a lessee shall account for changes in the Ijarah term or future Ijarah rentals without a change in the right-of-use asset (except for change in its useful economic life), as follows:

a. change in the Ijarah term – re-calculation and adjustment of the right-of-use asset, the Ijarah liability and the deferred Ijarah cost; or

b. change in future Ijarah rentals only (e.g. resulting from a change in an index or a benchmark rate used to determine those rentals) – re-calculation of the Ijarah liability and the deferred Ijarah cost only, without impacting the right-of-use asset.

Change in right-of use asset: new Ijarah component

45. An Ijarah modification shall be considered as a new Ijarah component to be accounted for as a separate Ijarah for the lessee, if both of the following conditions are met:

a. the modification additionally transfers the right to use of an identifiable underlying asset(s); and

b. the Ijarah rentals are increased corresponding to the additional right-of-use asset.

Change in right-of use asset: de-recognition of earlier Ijarah and recognition of a new Ijarah

46. For an Ijarah modification that does not meet the criteria provided in paragraphs 44 and 45, the lessee shall consider the Ijarah as a modified Ijarah as of the effective date and shall account for the

same as a new Ijarah transaction. Accordingly, the lessee shall recalculate the Ijarah liability, deferred Ijarah cost and the right-of-use asset respectively, as if it was a new Ijarah, duly de-recognizing the earlier Ijarah transaction and balances.

Expenses related to underlying asset

47. Operational expenses related to underlying asset, including any expenses contractually agreed to be borne by the lessee, in line with the Shari'ah principles, shall be recognized by the lessee on an accrual basis in the period in which these are incurred.

48. Major repair and maintenance, Takaful and other expenses incidental to ownership of underlying assets, if incurred by the lessee as an agent, shall be recorded as receivable from lessor.

Recognition exemptions and simplified accounting for the lessee

49. A lessee may elect not to apply the requirements of Ijarah recognition and measurement (in line with paragraphs 20 to 48), to:

    a. short-term Ijarah (see paragraphs 51 and 52); and

    b. Ijarah for which the underlying asset is of low value (see paragraphs 53 and 54).

Accounting for the exempt Ijarah

50. In case of exempt Ijarah (as determined in line with paragraph 49), the lessee shall recognize the Ijarah rentals as an expense on either:

    a. a straight-line basis over the Ijarah term; or

    b. a systematic basis, if considered better representative of the pattern of the lessee's use benefit of the underlying asset.

Short-term Ijarah

51. In case of short-term Ijarah considered exempt under paragraph 49, the lessee shall re-consider the Ijarah as a new Ijarah in case of an Ijarah modification or a change in the Ijarah term.

52. The exemption under paragraph 49, shall be applied to a whole class of underlying assets, that have similar characteristics and operational utility.

Low value Ijarah

53. The choice for Ijarah transactions for which the underlying asset is of low value can be made on an individual asset or Ijarah transaction basis but not on a group / combination basis. The value of an underlying asset shall be considered as of when it is / was new, irrespective of when the Ijarah transaction is executed.

54. The choice provided for in paragraph 53 shall be available if, and only if, the asset is usable for lessee on its own basis, without needing other resources which are not already available with the lessee or being dependent or interrelated with, other assets.

Presentation and disclosure

Presentation

55. Right-of-use assets and net Ijarah liability shall be presented in the lessee's statement of financial position as 'right-of-use assets' (between 'property, plant and equipment' and 'intangible assets') and as a liability, respectively.

56. Advance Ijarah rentals paid in respect of Ijarah transactions yet to commence shall be presented as receivable.

57. Net Ijarah cost shall be presented in the lessee's income statement as a single 'operating expense' commensurate with the nature of use of the right-of-use asset comprising of, and disclosing separately, the:

    a. amortization of right-of-use asset;

    b. amortization of deferred Ijarah cost;

    c. variable Ijarah rentals; and

    d. gain or loss on Ijarah modifications and other adjustments.

Disclosures

[Explanation: if the Ijarah cost is attributable to construction / development of an asset then such disclosures shall be provided while disclosing such attributions]

58. In addition to the disclosure requirements stated in FAS 1: "General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions" following are the minimum disclosure requirements in the financial statements of the lessee:

    a. the accounting policies adopted for the accounting treatments of Ijarah and Ijarah MBT transactions as a lessee duly explaining the types of Ijarah transactions the lessee has entered into;

    b. the amount of right-of-use assets by each major class of assets net of accumulated amortization and accumulated impairment, if any, as well as, disclosing the other balances included or deducted therefrom in line with this standard;

    c. the breakup of the combined assets acquired under Ijarah MBT through gradual transfer, as regards to the proportionate carrying value of:

        i. right-of-use asset; and

        ii. tangible asset;

    d. a summary of, the amount of the gross and net Ijarah liability – distributed as per amount due:

        i. within next 12 months;

        ii. in more than 12 months, but within next 5 years; and

iii. in more than 5 years;

e. future / potential cash outflows not already accounted for as Ijarah liabilities, e.g.

i. ijarah not yet commenced to which the lessee is committed including prospective/ forward Ijarah;

ii. variable Ijarah rentals;

iii. ijarah extension options;

iv. ijarah termination options;

v. commitments / or expected exercise of options to purchase, either the underlying asset after the end of Ijarah term (in case of Ijarah MBT) or the proportionate ownership units of the underlying units during the Ijarah term (in case of Ijarah MBT through gradual transfer);

f. future cash outflows as required to be disclosed under paragraph 58(e), shall be preferably disclosed, if material, with a distributions of cash outflows:

i. within next 12 months;

ii. in more than 12 months, but within next 5 years; and

iii. in more than 5 years;

g. disclosure of nature of assets sold during the period under sale and Ijarah-back transactions and necessary information including:

i. sale price;

ii. carrying value prior to sale;

iii. gain / loss on execution of sale and Ijarah-back transaction;

iv. principal terms and conditions of the transaction(s), if considered material;

h. unamortized deferred Ijarah costs against Ijarah liabilities, providing a movement of the same during the period duly disclosed as a deduction from the outstanding amount of Ijarah liabilities;

i. outstanding amounts of Hamish Jiddiyyah at the end of the financial period;

j. the excess of expected cumulative amount of residual value of right-of-use assets in case of Ijarah MBT in line with paragraph 37(c), which may be subject to contingent impairment in case of either:

i. termination of Ijarah MBT; or

ii. non-execution of the sale or gift transaction after the end of the Ijarah term;

k. the amount of Ijarah rentals waived by the lessor, if any, according to their respective nature, during the period; and

l. the amount of charity payments made and payable, if any, against defaults in payments and other breaches if any.

Accounting and financial reporting by the lessor

Initial Recognition

Advance to vendor

59. Any advance paid by lessor for acquisition of the underlying asset, before the control of the underlying asset is transferred to the lessor, shall be recorded and reported as an advance payment to vendor.

Advance rentals received

60. Any advance rentals received by lessor in respect of an Ijarah transaction (including prospective/ forward Ijarah), shall be recorded and reported as obligation against advance rentals.

Timing of recognition of underlying asset

61. Underlying asset shall be recognized in the books of the lessor once it controls the underlying asset i.e. the time when it essentially acquires substantially all risks and rewards incidental to ownership of such underlying asset.

Recognition of underlying asset

62. Underlying asset shall be initially recognized at cost. The cost of underlying asset shall comprise all costs of purchase and other costs incurred in bringing the underlying asset to its present location and condition. It includes all types of taxes (other than those subsequently recovered), transportation and handling costs including related Takaful cost and all other costs directly attributable to bring the underlying asset to its present location and condition, including those incurred by the customer in capacity of agent and any fee paid to the agent. Trade discounts, rebates and similar items should be deducted from the costs.

63. In cases where underlying asset is acquired on a piecemeal basis or in tranches, each tranche of asset received shall be recognized when the conditions defined in paragraph 61 are met with respect to such tranche.

Initial direct costs

64. Transaction costs, not being eligible for inclusion in the cost of underlying asset, duly incurred by the lessor for arranging the Ijarah transaction shall be recognized and deferred as initial direct costs.

65. Initial direct costs shall be allocated to income statement through amortization over the periods in the Ijarah term in a pattern consistent with that used for allocating Ijarah revenues.

Subsequent measurement

66. Subsequent to initial recognition, the underlying assets shall be measured at cost less accumulated depreciation less accumulated impairment, if any.

Depreciation

67. Depreciable amount of an underlying asset shall be charged to income over its useful economic life on a pattern which is reflective of the expected pattern of economic benefits arising from the same. Normally the straight line method can be considered as most appropriate pattern of flow of economic benefits, unless another systematic method is determined to be more appropriately reflecting such pattern.

68. Depreciable amount shall represent the cost of the underlying asset less residual value.

69. Residual value in respect of an underlying asset shall represent:

    a. the estimated fair value of the underlying asset at the end of the Ijarah term – in case of an operating Ijarah, or an Ijarah MBT through sale at fair value after the end of the Ijarah term; or

    b. nil value – in case of an Ijarah MBT through gift after the end of the Ijarah term; or

    c. the promised sale value – in case of an Ijarah MBT through sale at promised sale value after the end of the Ijarah term; or

    d. the lower of cost or estimated realizable value – in case of an Ijarah MBT through gradual transfer. [Explanation: estimated realizable value to be applicable only if the units' sale is carried out at fair value, and there is an indication of decline in the realizable value at the time of respective proportionate unit transfers. Accordingly, there will generally be no depreciation of such assets].

70. The useful economic life of the underlying asset shall generally represent:

    a. the Ijarah term – in case of all Ijarah transactions except for those on which paragraph 70(b) applies; or

    b. period equivalent to the useful economic life of similar assets (including lessor's own similar assets) – in case of such operating Ijarah transactions whereby, after the end of the Ijarah term, the underlying asset is intended to be used, either for the own use of the lessor, or for use in respect of further (one or more) unrelated operating Ijarah transactions.

Impairment

71. An underlying asset shall be subject to the impairment requirements of FAS 30 "Impairment, Credit Losses and Onerous Commitments".

72. In case of Ijarah MBT through gradual transfer, an underlying asset shall be subject to the provisions related to net realizable value (NRV) of FAS 30 "Impairment, Credit Losses and Onerous Commitments".

Accounting for commitments

73. Any promises / undertakings made by the lessor in relation to an Ijarah transaction, resulting in an onerous commitment shall be accounted for and reported in line with the requirements of FAS 30 "Impairment, Credit losses and Onerous Commitments".

Ijarah revenue and costs

Ijarah revenue

74. Ijarah revenue shall be recognized in income statement of the lessor on an accrual basis, applying, either:

    a. a straight-line basis – preferred method; or

    b. another systematic basis.

75. The lessor shall apply another systematic basis if it can be established that such basis maybe representative of the pattern in which benefit from the use of the underlying asset is diminished.

Applying the effective rate of return method

76. It is a rebuttable assumption that in various Ijarah MBT transactions, the effective rate of return method is better representative of the pattern in which the use of the underlying asset is diminished.

77. Under this method, the gross Ijarah revenue is allocated to income statement over the term of Ijarah in such a manner that a uniform rate of return is produced in form of net Ijarah revenue, over net investment in Ijarah assets whereby:

    a. net Ijarah revenue is the amount of gross Ijarah revenue, net of Ijarah costs (depreciation and amortization); and

    b. net investment in Ijarah assets is the net carrying value of the underlying asset, including the unamortized initial direct cost.

78. While applying the effective rate of return method, any excess of Ijarah revenue recognized over the Ijarah rentals due shall be recognized as accrued Ijarah rentals.

Applying the systematic method for Ijarah MBT through gradual transfer

79. It is a rebuttable assumption that in case of Ijarah MBT through gradual transfer, the most suitable systematic method would be to recognize Ijarah revenue in the financial period in which it is due, on accrual basis, taking into consideration that the revenue shall progressively decrease as the lessee acquires a greater share of the underlying asset.

Ijarah costs

80. Ijarah costs, incurred in earning the Ijarah revenue shall be recognized as an expense in the income statement of a lessor. These include:

    a. depreciation of the underlying asset;

    b. amortization of the initial direct cost; and

    c. other costs incidental to ownership of underlying asset e.g. major repair and maintenance (other than operational repair and maintenance), Takaful and taxes etc.

Presentation and disclosures

81. Ijarah assets shall be presented in the lessor's statement of financial position as 'Ijarah assets'.

82. Net Ijarah revenue shall be presented in the lessor's income statement comprising of:

    a. gross Ijarah revenue recognized during the period;

    b. less: depreciation of underlying asset;

    c. less: expenses related to Ijarah assets including Takaful, registration, legal and repair and maintenance.

83. Advance Ijarah rentals received shall be recognized and presented as a liability in the lessor's statement of financial position.

84. Initial direct costs shall be shown as an addition to the carrying value of the Ijarah assets, reflecting total initial direct costs and unamortized initial direct costs.

Disclosures

85. In addition to the disclosure requirements stated in FAS 1: "General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions" following are the minimum disclosure requirements in the financial statements of the lessor:

    a. the accounting policies adopted for the accounting treatments of Ijarah and Ijarah MBT transactions as a lessor duly explaining the types of Ijarah transactions the lessor has entered into;

    b. the amount of Ijarah assets by each major class of assets, as well as, by each classification of Ijarah transactions, net of (and disclosing separately) accumulated depreciation and accumulated impairment, if any, as well as, disclosing the other balances included or deducted therefrom in line with this standard;

    c. amortization of initial direct costs;

    d. future cash inflows related to Ijarah transactions. This includes cash inflows arising from:

        i. Ijarah rentals;

        ii. extension options and termination options;

        iii. committed / or expected exercise of options to sell, either the underlying asset after the end of Ijarah term (in case of Ijarah MBT) or the proportionate ownership units of the underlying units during the Ijarah term (in case of Ijarah MBT through gradual transfer);

        iv. committed purchases of assets including those ordered, to be procured and given on Ijarah basis;

        v. Ijarah rentals related to Ijarah not yet commenced to which the lessee is committed;

e. future cash outflows as required to be disclosed under paragraph 85(d), shall be preferably disclosed, if material, with a distributions of cash outflows:

i. within next 12 months;

ii. in more than 12 months, but within next 5 years; and

iii. in more than 5 years.

f. outstanding amounts of Hamish Jiddiyyah at the end of the financial period;

g. the amount of Ijarah rentals waived by the lessor, if any, according to their respective nature, during the period; and

h. the amount of charity payments made and payable, if any, against defaults in payments and other breaches if any.

Ijarah MBT: transfer of underlying asset's ownership

Timing of recognition of the transfer of underlying asset

86. In case of an Ijarah MBT, the transfer of asset's ownership may take place through transfer of control (entailing risks and rewards incidental to ownership of such asset) under a separate (i.e. separate from the Ijarah contract):

a. contract of sale – after the end of the Ijarah term (including, in certain circumstances, after early termination of the Ijarah term); or

b. contract of gift – after the end of the Ijarah term; or

c. contracts of sale of proportionate ownership (generally in form of ownership units) – during the Ijarah term.

87. A contract(s), as referred to in paragraph 86 constitute an offer and acceptance (whereby, either party may offer and other accepts), and shall not be confused with the promise for execution of such transaction, at a future date (which is not binding on one of the parties, at least).

88. Transfer of underlying asset's ownership (or proportionate ownership) shall be accounted for by both parties on transfer of control of the underlying asset to the lessee generally coinciding with the timing of consummation of the relevant contract (also see paragraph 89).

Ijarah MBT through gradual transfer – special considerations

89. Gradual transfer of underlying asset's proportionate ownership shall be accounted for by both parties on transfer of corresponding control of the underlying asset to the lessee coinciding with the timing of consummation of the relevant contract, through:

a. offer and acceptance of the transfer of proportionate ownership; or

b. payment against purchase of such units as a continuing arrangement (and acceptance of such payment) if so allowed by the contract and in line with Shari'ah principles, in absence of individual offer and acceptance against each such transfer.

In the books of the purchaser / transferee (previously lessee)

After completion of the Ijarah term

90. On acquisition, the underlying asset acquired, shall be recognized in the books of the purchaser (earlier, the lessee) as an item of property, plant and equipment or investment property or any other category of assets, as suitable according to the nature of the asset, at:

    a. cost, being the consideration paid or payable for the acquisition of asset;

    b. plus: the carrying value of the right-of-use asset, if any (residual value in line with paragraph 37) duly reclassified from the right-of-use asset.

Ijarah MBT through gradual transfer – special considerations

91. The combined asset acquired completely as owned asset, on full transfer of ownership units, shall be reclassified as an item of property, plant and equipment or investment property or any other category of assets, as suitable according to the nature of the asset, at the carrying value (including asset cost, less accumulated amortization (now classified as depreciation), less accumulated impairment, if any).

De-recognition in the books of the seller / transferor (previously lessor)

92. The underlying asset's sale or gift after the end of the Ijarah term or in case of early termination / settlement shall be recorded by the seller / transferor (being previously the lessor), the underlying asset shall be de-recognized and any gain or loss arising on the same being the difference between the carrying value and the consideration received or receivable, shall be recognized in income statement currently.

Ijarah MBT through gradual transfer – special considerations

93. The proportionate ownership of the underlying asset sold under each distinct transaction of ownership transfer shall be accounted for in the books of the seller (earlier, the lessor) by recognizing the consideration received or receivable as the income on unit sales, the corresponding proportionate cost at carrying value, being the cost of sold units while recognizing any gain or loss on such unit sales in the income statement currently.

Transfer of underlying assets with early termination / settlement of Ijarah

94. In case an Ijarah is prematurely terminated and the underlying asset is transferred by the lessor to the lessee, both the transactions shall be accounted for separately in line with the Shari'ah requirements and contractual terms. In such situation, prior to transfer of underlying asset, the Ijarah contract shall be concluded and any gain or loss on the same shall be recognized in the income statement at the time of termination of the Ijarah contract.

95. Once the Ijarah contract is terminated, transfer of underlying asset, shall be accounted for in accordance with paragraphs 96 and 97.

In the books of the purchaser / transferee (previously lessee)

96. In case of an Ijarah transaction being early terminated and purchase of underlying asset by the purchaser (previously lessee), the underlying asset acquired shall be recognized in the books of the

purchaser (earlier, the lessee) as an item of property, plant and equipment or investment property or any other category of assets, as suitable according to the nature of the asset, at:

a. cost, being the consideration paid or payable for the acquisition of asset (but excluding any additional payments made for early settlement / termination of Ijarah, not being a part of purchase consideration);

b. plus: the carrying value of the right-of-use asset;

c. less: impairment identified as a result of early settlement / termination, if any.

In the books of the seller / transferor (previously lessor)

97. In case of an Ijarah transaction being early terminated and sale or gift of underlying asset by the seller / transferor (previously lessor), the underlying asset acquired shall be de-recognized from the books of the seller / transferor (earlier, the lessor) and following shall be recognized, separately, in the income statement currently:

a. gain or loss on early settlement of Ijarah; and

b. gain or loss on disposal of Ijarah asset – being the difference between the consideration received or receivable (if any) and the carrying value of the underlying asset.

Sale and Ijarah-back transactions

98. If an institution (the seller-lessee) transfers an asset to another institution (the buyer-lessor) and duly fulfilling the Shari'ah requirements in this respect, the buyer-lessor unconditionally executes an Ijarah transaction on the same asset back to the same seller-lessee, both the seller-lessee and the buyer-lessor shall account for the transfer contract and the Ijarah applying paragraphs 99-104.

Sale of the asset

99. The sale of the underlying asset from the seller-lessee to the buyer-lessor takes place when the control of the underlying asset duly entailing the risks and rewards incidental to ownership are transferred to the buyer-lessor.

100. The seller-lessee is case of a proportionate transfer of asset for Ijarah-back, shall measure the right-of-use asset proportion after transfer and acquired-back and recognize any gain or loss accordingly.

Accounting for the sale of the asset – by seller-lessee

101. The seller-lessee shall record the transfer of control of the underlying asset and execution of Ijarah as two distinct, independent contracts. This generally includes the legal title as well, unless it can be established otherwise, that the control is transferred, irrespective of the legal title not being transferred.

102. If the fair value of the consideration for the transfer/ sale of an asset does not approximate the fair value of the asset transferred, any gain or loss arising on the same shall be:

a. immediately recognized in the income statement – in case of an operating Ijarah; or

b. deferred and amortized over the Ijarah term – in case of all other types of Ijarah.

103. Deferred gain or loss on sale of the asset shall be shown as a deduction from or addition to, respectively, the Ijarah liability.

Accounting for the buyer-lessor

104. A buyer-lessor shall account for a sale and Ijarah-back transaction in line with this standard as a normal lessor without any special consideration.

Other related accounting treatments

Forward Ijarah

105. In respect of a forward Ijarah transaction, any advance payment made by the prospective lessee to the prospective lessor shall be accounted for in line with the paragraphs 19 and 60 by the lessee and the lessor, respectively. Commitments in respect of forward Ijarah transactions shall be disclosed in accordance with paragraph 58(e)(i). A forward Ijarah transaction shall be subject to other provisions of the standard, on the commencement of Ijarah.

Hamish Jiddiyyah (security deposit)

106. Subject to the terms of the contract, the Hamish Jiddiyyah paid by the lessee shall be recognized as a receivable from the lessor and shall not be netted-off with the Ijarah liability, unless it is to be adjusted against consideration for transfer of ownership or adjustment against rental liability if agreed upon between the parties, at the time of such event taking place. The lessor shall recognize a corresponding liability for the same.

107. Adjustment of, or forfeiture of, Hamish Jiddiyyah, against breach of promise or default or other adverse conditions shall be governed by the Shari'ah rules and contractual arrangement between the parties and accounted for accordingly.

108. Once the Ijarah contract is terminated, Hamish Jiddiyah shall:

a. either be returned by the lessor to the lessee; or

b. shall be adjusted with the sale price / consideration for the transfer of ownership of the underlying asset under a specific authorization of the lessee.

Charity

109. Any charity payment against defaults and delayed payments by the customer shall not be recognized as an income of the seller and shall be taken directly to charity payable, when received.

Effective date

110. This standard shall be effective for the financial periods beginning on or after 01 January 2021. Early adoption is permitted.

Transitional provisions

111. The institution may opt to apply this standard on a prospective basis for transactions executed on or after the effective date. If an institution applies this transitional provision, it shall disclose a fair estimate of the impact of the same.

Amendments to other standards

112. This standard supersedes the earlier AAOIFI FAS 8 “Ijarah and Ijarah Muntahia Bittamleek”.

Appendices

Appendix A: Adoption of the standard

This standard was presented for the approval in the AAOIFI Accounting Board's 16th meeting held on 2-3 Rabi I 1441H, corresponding to 31 October 2019 and 1 November 2019 and was duly approved.

Members of the board

1. Mr. Hamad Abdulla Al Oqab – chairman
2. Mr. Mohamed Bouya Ould Mohamed Fall – deputy chairman
3. Mr. Abdelhalim Elsayed Elamin
4. Dr. Abdulrahman M. Alrazeen
5. Dr. Bello Lawal Danbatta
6. Mr. Firas Hamdan
7. Mr. Hondamir Nusratkhujaev
8. Mr. Irshad Mahmood
9. Mr. Mohamed Ibrahim Hammad
10. Mr. Muhammad Jusuf Wibisana
11. Mr. Nader Yousif Rahimi
12. Dr. Saeed Al-Muharrami
13. Mr. Sulaiman AlBassam
14. Mr. Syed Najmul Hussain
15. Mr. Tarik Bolukbas

Reservation

The standard was approved unanimously.

Working group members

1. Mr. Firas Hamdan - chairman
2. Mr. Ali Chreif
3. Mr. Muhammad Jusuf Wibisana
4. Mr. Saqib Mustafa
5. Mr. Syed Najmul Hussain
6. Mr. Yaser Aljar

Executive team

1. Mr. Omar Mustafa Ansari (AAOIFI)
2. Ms. Farida Cassim (AAOIFI)
3. Mr. Mohammad Majd Bakir (AAOIFI)
4. Ms. Zahra Jassim AlSairafi (AAOIFI)

Appendix B: Basis for conclusions

Reason for revision of the standard

BC1 The AAOIFI Accounting Board (AAB / the board) deliberated on the need for revision of FAS 8 "Ijarah and Ijarah Muntahia Bittamleek" while developing its revised plan in 2016, after its reconstitution. It was also noted that a limited scope revision project for FAS 8 had already been initiated by the predecessor board. FAS 8 originally issued in 1997 catered and responded to the need to distinguish a Shari'ah compliant lease from a conventional lease and to prescribe the correct accounting treatments in line with its true nature in line with Shari'ah. However, considering the fact that there had been significant evolution of the product and its new and innovative variants had become more common, it was eminent to review and revise the standard duly catering to such needs. Accordingly, the oard decided that there is a need to improve the existing FAS 8.

BC2 The board also considered that globally there have been significant changes in lease accounting more recently including major projects by the IASB and the FASB resulting in their respective new standards, which are quite similar to each other (initially planned as convergence standards). In line with the new AAOIFI strategy for financial accounting standards setting, the board decided that the revised standard shall be as close as possible to the new global accounting standards, duly addressing the specific Shari'ah requirements and the specific structure of Ijarah transactions which is not considered by such global standards.

Scope exclusion – service Ijarah

BC3 From Shari'ah standpoint Ijarah has two basic types i.e. asset Ijarah and service Ijarah. Whether or not this standard shall include service Ijarah in its scope was a key question addressed by the working group as well as the board, and was raised during public hearing sessions as well. The board considered that the service Ijarah can be segregated into two types, being human based or technology and equipment based such as, bandwidth, telecommunication minutes etc. Considering the significant differences in nature of the two types of Ijarah, the board decided that this standard shall cover the asset Ijarah only. However, the service Ijarah which involves equipment as well, the same shall be subject to this standard as such contracts will have an Ijarah element subject to the requirements of this standard. For such type of transactions, the measurement of usufruct can be performed by unit of output or other such measures.

Key distinguishing factors between an Ijarah MBT and conventional finance lease

BC4 An Ijarah is principally a lease transaction. The issue of difference with conventional transactions arise only in the terms and conditions, which are generally attached to a conventional finance lease which make it impermissible from Shari'ah perspective and hence Ijarah MBT is principally different from the conventional finance lease.

BC5 The board considered that in an Ijarah MBT, it is a primary condition by Shari'ah that the risks and rewards incidental to ownership are with the lessor throughout the lease term. Whereas, in a finance lease, according to its definition, substantially all risk and rewards incidental to ownership are transferred to the lessee at inception of lease i.e. in substance it is considered to be a sale. It is worth noting that if substantially all risk and rewards in a lease transaction are transferred at inception, the same cannot be termed as Shari'ah compliant. This is because, as per Shari'ah an Ijarah is separate from the sale or gift transaction, as two contracts (or one contract and one

promise) are to be accounted for separately, duly distinguishing the respective risks, rewards and responsibilities of both parties. Considering these factors, the oard reiterated that the option of accounting for Ijarah MBT similar to conventional finance lease is not acceptable.

BC6 The same issue was discussed in detail at the working group and the board as well as public hearings and was also specifically referred to the Shari'ah board's committee for review of financial accounting and governance standards. After due deliberations, it was decided that fundamentally there shall be no difference in accounting for the Ijarah or Ijarah MBT as an Ijarah MBT is essentially an Ijarah transaction and any future commitment for sale or gift cannot be combined with the Ijarah contract.

BC7 It is also worth noting that from the economic substance perspective, the subject matter of an Ijarah transaction is the usufruct whereas the subject matter of a conventional finance lease is the financing. This is the reason that the conventional accounting standards focus on recognition of liability, as the primary requirement. The board also took a considered view that the concept of minimum lease payment cannot be applied in line with Shari'ah principles. In Ijarah the 'gross Ijarah liability' comprise of the total Ijarah rentals and not total lease payments. In other words, total lease payments under conventional accounting standards include guaranteed residual value and other advanced initial deposits etc. which is not acceptable for Ijarah, duly considering the Ijarah and sale / gift as separate transactions.

BC8 The board also considered the nature of a promise for sale and / or gift executable at a future date. Considering various factors including in particular, (i) the nature of a unilateral promise / undertaking as per Shari'ah, and (ii) the prohibition of combing two transactions in one, the board reiterated its view taken earlier at multiple occasions with regard to such transactions, and decided that they do not combine with the Ijarah transaction and do not change the nature of the Ijarah transaction.

Key distinguishing factors - Shari'ah perspective

BC9 The above decisions of the board were based on a thorough analysis of the key distinguishing factors between an Ijarah MBT transaction and conventional finance lease transactions. Certain key distinguishing factors are listed below:

a. in Ijarah MBT, during the lease term, the lessor carries the operational risks related to ownership e.g. theft, destruction, technical obsolescence, unavailability for a period due to major maintenance / repairs etc., as well as, the Takaful / insurance cost and taxes related to ownership of asset;

b. in Ijarah MBT, during the lease term, the lessor carries the market risk related to the ownership of the asset i.e. if for any reason the promise is not executed at the future date, the gain or loss in value of asset relates to the lessor;

c. in Ijarah MBT, the rentals commence from the time the asset is delivered to the lessee in condition good enough for intended use, and not from the time when the funds are disbursed;

d. in Ijarah MBT, no rental is chargeable during the period when asset is not available for the intended use for any reason; and

e. in Ijarah MBT the ownership transfer takes place against a unilateral promise which is not binding on either of the parties and there are situations when such transfer never takes place e.g. destruction or theft of the asset before completion of Ijarah term.

BC10 The board also considered the philosophical foundations of Islamic finance. The fundamentals are based on the prohibition of Riba and permission of trade which means that the time value of money is not acceptable, but the time value of economic resources such as goods, assets, labour and entrepreneurship is acceptable. Accordingly, the board took a considered view that in Ijarah MBT, the price (Ijarah rental) is calculated and charged on the use benefit of asset rather than time value of money (i.e. disbursed financing). As an example, Ijarah rental cannot be charged and recorded until the underlying asset is in possession of the lessee or if the asset is not available for intended use for any reason. In conventional finance lease, on the contrary, the lessor normally commences charging and recording interest on the day financing is disbursed even if the asset is not in existence or in possession.

Operating Ijarah

BC11 The board also noted that there are no significant differences between an operating Ijarah and an operating lease. The distinguishing factor being 'risks and rewards' incidental to ownership belongs to the lessor, whereas the use benefit relates to the lessee. Ijarah in essence are considered to be similar to an operating lease because of the "risk and reward" factor.

BC12 There are however Shari'ah conditions for permissibility of such transactions i.e. if an Ijarah is Shari'ah compliant in both, form and substance, the risks and rewards incidental to ownership are not transferred to the lessee and as a result Ijarah falls within the definition of an operating lease and its accounting should be in line with the same. This issue was debated by the board and further research showed that most other Islamic finance standard setters have also developed their standards for Ijarah in line with accounting treatment for operating leases.

Accounting for usufruct / right-of-use asset

BC13 The global accounting standard setters while revising their accounting standard for leasing took a fundamental shift, whereby the concept of recognition of right-of-use asset was introduced, even in case of operating leases. The board agreed with certain major changes that were brought in by such standards. Particularly, the board agreed that entering into an Ijarah transaction gives rise to a 'right-of-use' asset (which may also be called a usufruct asset).

BC14 Accordingly, the board decided that accounting for usufruct or right-of-use asset in the books of the lessee (irrespective of being an Ijarah or Ijarah MBT) would have an even fair and transparent view of the state of affairs. Therefore, the 'right-of-use' asset shall be accounted for as well as the corresponding liability.

BC15 It must be noted that the transfer of control of the right-of-use asset to the lessee is not the transfer of control of the physical asset.

Acceptability of usufruct / right-of-use asset from Shari'ah perspective

BC16 In Ijarah, a lessee acquires the usufruct of an underlying asset during the Ijarah term and assumes an obligation to make payments to the lessor for granting the right to use that asset. Additionally, the

lessee has an obligation to return the underlying asset to the lessor at the end of the Ijarah term. The lessor has a right to receive payments from the lessee for providing the right to use the underlying asset. The lessor also retains rights associated with ownership of the underlying asset. Having identified the rights and obligations that arise from an Ijarah, the board further considered which of those rights and obligations create assets and liabilities to be accounted for in the books of lessee and lessor.

BC17 The preliminary study phase for the standard consisted with evaluating all concepts and theories by many accounting bodies. An important topic under discussion was the acceptability and recognition of usufruct as an asset. Shari'ah considers right-of-use / usufruct as Maal i.e. transferable, with certain conditions, and has its own characteristics of Maal. It was important to note that the Shari'ah views usufruct as an intangible asset (being actually a right and not a physical asset).

BC18 The board considered the pros and cons of this accounting approach, including Shari'ah issues applicable thereto after due consideration with the Shari'ah board's committee for review of financial accounting and governance standards and decided that usufruct meets the definition of an asset under Shari'ah and under AAOIFI Framework.

Recognition of right-of-use asset, its amortization and residual value

BC19 The board was of the view that from Shari'ah perspective, primarily there is an acquisition of a usufruct by the lessee and for that reason a liability is incurred. Accordingly, the initial recognition of the usufruct is determined as the starting point. Therefore, the standard requires the "prime cost" of the right-of-use asset to be recognized, rather than recording the present value of minimum lease payments.

BC20 The oard, considering the Shari'ah requirements and the specific characteristics of Ijarah transactions, concluded that right-of-use is a kind of intangible asset and amortized accordingly. Amortization will be from commencement date (and not the inception date – see also paragraph BC30) to the end of useful economic life of the right-of-use asset which will coincide with the end of the Ijarah term. Amortization over and above the Ijarah term, if allowed, means that the two transactions are combined for the purpose of accounting.

BC21 Accordingly, the board rejected the idea, even though certain experts during the public hearings suggested to allow amortization of the right-of-use asset over a period over and above the Ijarah term.

BC22 However, the board considered that keeping a residual value of the right-of-use asset at the end of the Ijarah term is an accounting estimate and may be kept if there are additional economic benefits expected. Accordingly, once the Ijarah term is complete, there will be a residual value that shall be amortized on a straight-line basis or any other systematic basis, once it is transferred to the owned assets.

BC23 The board considered that through this option the benefit can be passed on to the future periods whereby the residual value is to be kept at a value close to the value of the asset at that time. This is also in line with requirement in the Shari'ah standards, whereby in the case of an early termination of an Ijarah the lessor is required to compensate the lessee with the additional rentals paid (in an Ijarah MBT) as compared to market norms.

Subsequent measurement – use of fair valuation for right-of-use asset

BC24 The subsequent measurement of the right-of-use asset was discussed at the working group and the issue was also raised at the public hearings, whereby the generally accepted accounting principles normally allow for fair valuation of the right-of-use asset. The board initially considered the proposal, but considering the specific nature of an Ijarah right-of-use asset, took a considered view that it might not be the right approach to allow fair valuation for an asset which has a limited life and which does not reflect the underlying asset, but only the right-of-use of the same. This was also reaffirmed after discussions on the public hearing comments and the working group comments of the same.

BC25 The board considered that if the right-of-use asset is revalued and the value has increased, there is a risk that the periodic financial reports and the income statement will be distorted due to the high amounts of amortization, as this standard does not allow the amortization of right-of-use asset beyond the period of the Ijarah term i.e. during the Ijarah term, there will be a higher charge of amortization which may result in distortion of financial reporting for the period. The release of additional effect of amortization will be done directly through equity so it will not be reflected in the income statement. Considering these factors, the board decided to not allow the fair valuation of right-of-use asset.

BC26 The board evaluated the costs and expenses related to the right-of-use asset. There were two issues highlighted in related to expenses of the underlying asset – an accounting issue and Shari'ah issue. The current market practices are generally to record the expense directly by the lessee. However, the board was of the considered view that these expenses shall be recorded by the lessor, and even if the lessee incurs the same, these shall be recorded as recoverable from lessor (even if lessor has a supplementary rental mechanism to recover the same, which shall be accounted for accordingly as a revenue).

Ijarah MBT through gradual transfer / Diminishing Musharaka Ijarah

BC27 The Board after taking into account industry comments agreed that the accounting for Ijarah MBT through gradual transfer under FAS 8 was having practical impediments and required improvement. In order to avoid the complexities of accounting for Ijarah MBT with gradual transfer, the standard introduces the underlying asset to be termed as a 'combined asset' which includes the proportionate underlying asset as well as the right-of-use asset owned by the lessee.

BC28 It is also considered that if the units are sold at cost (to lessee) depreciation at the end by the lessor is not required, as the residual value is equal to the cost. This shall significantly reduce the accounting complications.

BC29 The board also considered that there are transactions in different parts of the world which are very similar in characteristics to Ijarah MBT with gradual transfer of ownership, such as 'Diminishing Musharaka based on Shirkat-ul-Milk with Ijarah'. The board decided that all such products shall be subject to the same accounting and reporting requirements under this standard.

Ijarah commencement date vs. inception date – issue of future Ijarah

BC30 The board discussed at length the issue of the commencement date vs. inception date accounting. The board, in particular, noted that as per Shari'ah, Ijarah rental can only be charged after

possession of asset (in usable condition) to the lessee and rental is neither earned nor recorded before possession and delivery of asset (irrespective of the pricing mechanism involved, which may take into consideration such period), and this is one of the distinguishing factor between Ijarah MBT and conventional finance leases. The similar issue in related to future Ijarah i.e. Ijarah Mawsufah fi al-Dhimma was also raised and discussed during the public hearings and was duly considered by the board. However, after due deliberations, it was decided that any Ijarah rentals charged and / or received before the commencement date shall be recorded as an advance which shall remain non-remunerative.

Accounting and financial reporting by the Lessor

BC31 Without any principal change from FAS 8, this standard requires that the leased asset shall be recognized at cost and depreciated over the useful life by the lessor and gross rentals shall be recognized as income.

BC32 Generally, it was understood that depreciation shall be based mostly on straight-line method. However, there were situations where certain institutions were using annuity method for depreciation. The board considered if there needs to be change to the depreciation method to allow annuity method as this was further raised during the public hearings of the standard. After due deliberations the board concluded that the annuity method of accounting was not suitable as it does not reflect the pattern of economic benefits, as well as, is against the essence of Shari'ah.

BC33 The board concluded to keep the straight-line method, as a preferred method of revenue recognition and allowing another systematic basis i.e. using the effective rate of return method. This was based on the fact that in certain situations the use of effective rate of return method for recognition of revenue might result in more equitable and fair distribution of profits amongst stakeholders.

Deposits and Hamish Jiddiyah

BC34 The board considered that there are multiple types of deposits or advance payments in Ijarah transactions – most commonly in the form of Hamish Jiddiyah or security deposit. As per Shari’ah these are a receivable of the lessee and payable of the lessor and shall continue to be accounted for until the conclusion of the Ijarah term. After conclusion of the Ijarah term the same can be used as a sale transaction proceed or be refunded, as per the mutual arrangement between the parties.

Lease term and extension options

BC35 The board considered and resolved that the Ijarah term shall include extension and termination options as this is relevant due to the fact that the total term must be estimated and taken into account for depreciation and amortization calculations. The assessment of probability of exercising the extension is also in line with global best practices. There is a rebuttable presumption that expressed intention of the lessee to exercise the extension option(s) provides reasonable certainty with regard to extension of Ijarah term in line with generally accepted accounting principles. Subsequent reassessment is also in line with generally accepted accounting principles.

Appendix C: Brief history of the preparation of the standard

H1 The newly formed AAOIFI Accounting Board (AAB / the board) held its 1st meeting on 6-7 of Jumada II 1437H, corresponding to 15-16 of March 2016 at Ramee Grand Hotel, Kingdom of Bahrain. In this meeting it was decided that high priority shall be bestowed on the revision of the standard on Ijarah.

H2 The consultation notes on Ijarah were presented at the 2nd AAB meeting convened on 25-26 Shawwal 1437H, corresponding to 30-31 July 2016. In this meeting the members reviewed the existing FAS 8 including the scope and the accounting treatment in the books of the lessee. Additionally, the members discussed Ijarah definition, types and accounting for the Ijarah assets and liabilities. The members agreed that there shall be attempts to iron out, as much as possible, the differences between AAOIFI standards and generally accepted accounting principles, especially with respect to Ijarah. The members agreed that an accounting working group should be formed immediately to that effect.

H3 The 1st working group on the Ijarah standard was held on 27 Rajab 1438H, corresponding to 24 April 2017. The members agreed that the definition of an Ijarah would be closer to Shari'ah and the new standard will be from scratch, not an adoption or revision of the existing standard and the standard would include accounting for both lessor and lessee.

H4 The committee of the Shari'ah board for review of accounting and governance standards held its 2nd meeting on 7 Muharram 1439H, corresponding to 27 September 2017. This meeting discussed the Shari'ah aspects of recognition of the usufruct of the Ijarah asset and the transfer of risk and reward.

H5 The initial exposure draft was presented at the 2nd working group held on 12 Ramadan 1439H, corresponding to 7 June 2017. The working group deliberated on the draft and it was recommended to the board.

H6 The AAB held its 10th meeting on 7-8 Shawwal 1439H, corresponding to 21-22 of June 2018 in Beirut, Lebanese Republic. In this meeting the contents of the draft standard were discussed, and it was decided to be presented at the next Board meeting for further discussion.

H7 After incorporating comments and suggestion from the previous board meeting, the draft was presented for the second time at the 11th AAB meeting on 21-22 Dhul-Hijjah 1439H, corresponding to 1-2 September 2018 at the AAOIFI head-office in the Kingdom of Bahrain. The exposure draft was principally approved in this meeting.

H8 The exposure draft was officially issued on 24 Rabi' II 1440H, corresponding to 31 December 2018, after a 3rd working group meeting held on 19 Rabi' II corresponding to 26 December 2018 where members finalized the exposure draft based on instructions from the AAB.

H9 The public hearing for the exposure draft was conducted in multiple jurisdictions during 2019. The first public hearing event for the exposure draft was conducted in February of 2019 in United Arab Emirates (hosted by Abu Dhabi Islamic Bank - ADIB) and Pakistan (hosted by ICAP). Additionally, public hearings were conducted in Egypt (hosted by Egyptian Islamic finance Association – EIFA) and Turkey (hosted by KGK and TKBB) in June of 2019.

H10 A roundtable event on the exposure draft was held on 13 Muharram 1441H, corresponding to 12 September 2019. The event was hosted by Al-Baraka Banking Group, at its headquarters, Bahrain

Bay in the kingdom of Bahrain. A select group of finance and banking leaders, representatives of central banks, CEOs and CFOs of leading banking and financial institutions, leading scholars and experts, and representatives of regional and international organizations, among others participated in the event and contributed their valuable insights.

H11 All comments received from public hearings along with the views and comments from different industry participants on the exposure draft was then presented for discussion at two working group meetings held on 10 Safar 1441H, corresponding to 9 October 2019 and 29 Safar 1441H, corresponding to 28 October 2019.

H12 All comments and recommendations received on the final version of the exposure draft was then presented for discussion at the 16th AAB meeting held on 3-4 Rabi' I 1440H, corresponding to 31 October and 1 November 2019 in the Kingdom of Bahrain. The board deliberated on changes suggested by the working group and the standard was approved for final issuance.

H13 The standard was approved for publishing with instructions for making suggested changes. After due process, the standard was issued on 4 Jumada I 1440H, corresponding to 30 December 2019.

Shari'ah Standard No. (12)

Sharikah (Musharakah) and Modern Corporations

(Revised Standard)

Contents

IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

Preface

The objective of this standard is to explain the basis and general rulings for Sharikat al-'Aqd, (contractual partnership) which is known today as Musharakah, including the rulings for joint partnership, reputation (creditworthiness) partnership, vocation partnership, diminishing partnership and modern corporations. The explanation of these partnerships includes definitions, rulings applicable to each partnership and the Shari'ah limitations that must be taken into account by Islamic financial Institutions (Institution/Institutions).[1]

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

Statement of the Standard

1. Scope of the Standard

This standard covers all forms of traditional Fiqh-nominate partnerships that operate on the basis of Sharikat al-'Aqd (contractual partnership), except the partnerships that are explicitly excluded by this standard as indicated below. The standard also applies to all modern forms of partnerships including diminishing Musharakah. The standard does not cover ownership partnership where the parties jointly own an asset. It does not include rules for Sharikat al-Mufawadah because the practical application of this form of partnership is rare and, if need be, reference should be made to Fiqh books. The standard does not cover Mudarabah, because this form of partnership has a separate standard. In the same vein, it does not cover sharecropping partnerships, such as irrigation and agricultural partnerships. The standard also does not cover, as far as modern partnerships are concerned, regulatory policies and procedures necessary for operations in the market.

2. Definition, Classifications and Types of Sharikat al-'Aqd

2/1 Definition of Sharikat al-'Aqd

Sharikat al-'Aqd (contractual partnership) means an agreement between two or more parties to combine their assets, labour or liabilities for the purpose of making profits.

2/2 Classifications of Sharikat al-'Aqd

Sharikat al-'Aqd is classified into two main categories:

First Category: Traditional Fiqh-Nominate Partnerships.

Second Category: Modern Corporations.

2/2/1 The traditional Fiqh-nominate partnerships are as follows:

a) Sharikat al-'Inan (contractual partnership)

b) Sharikat al-Wujuh or Al-Dhimam, i.e. partnership of credit-worthiness or reputation (liability partnership)

c) Sharikat al-A'mal (vocational partnerships and partnerships for undertaking difficult work or accepting jobs)

2/2/2 Modern corporations and their well-known forms are as follows:

a) Stock company

b) Joint-liability company

c) Partnership in commendum

d) Company limited by shares

e) Allotment (Muhassah) partnership

f) Diminishing partnership (this partnership has originated from Sharikat al-'Inan)

3. First Category: Traditional Fiqh-Nominate Partnerships

3/1 General rulings for Sharikah, especially Sharikat al-'Inan

Sharikat al-'Inan is a partnership between two or more parties whereby each partner contributes a specific amount of money in a manner that gives each one a right to deal in the assets of the partnership, on condition that the profit is distributed according to the partnership agreement and that the losses are borne in accordance with the contribution of each partner to the capital.

3/1/1 Conclusion of a Sharikah contract

3/1/1/1 A Sharikah contract can be concluded by agreement between the parties concerned on the basis of offer and acceptance. The contract of partnership should, if necessary, be documented and registered officially. The objectives of the partnership must be clearly spelt out in the document of partnership or in the articles of association of the company.

3/1/1/2 It is permissible for the Institution to enter into a partnership contract with non-Muslims or conventional banks to carry out operations acceptable by Shari'ah

unless it has become evident that the funds or items presented by these entities for the purpose of the partnership are from non-permissible sources. In operating a partnership with non-Muslims or conventional banks, arrangements must be made to obtain all necessary assurances and guarantees that rules and principles of the Shari'ah are observed during operations of the partnership. Among such guarantees is one to the effect that the operations of the company be either managed or supervised by an entity that observes the Shari'ah rules.

3/1/1/3 It is permissible for the Institutions to include conventional banks as partners in a syndicated financing which operates on the basis of Shari'ah, provided that the Institution secures the right to manage the partnership's operations and that such operations are subject to the Shari'ah supervision. [see Shari'ah Standard No. (24) on Syndicated Financing]

3/1/1/4 It is permissible for the partners to amend at any point of time the terms of a partnership contract. They may make changes to the ratio of profit-sharing, taking into account that any losses are shared according to the share of each partner in the partnership capital.

3/1/2 The capital of Sharikah

3/1/2/1 In principle, the capital of Sharikah should be contributed in the form of monetary assets on which one can rely in order to determine the amount of the capital and to recognise profit or loss. Nevertheless, it is permissible, with the agreement of all partners, to provide tangible assets (commodities) as the capital of Sharikah after the monetary values of these assets are determined and expressed in currency in order to know the share contributed by each partner.

3/1/2/2 If partners have contributed their partnership capital in different currencies, these currencies must be translated into the currency of the Sharikah at current exchange rates so as to determine the shares and liabilities of each partner.

3/1/2/3 The share of each partner in the capital should be determined, whether it is contributed in the form of one lump sum or by more than one payment over time; i.e., when there is a need for additional funds to increase the capital.

3/1/2/4 It is not permitted that debts (receivables) alone be used as a contribution to the Sharikah capital. However, debts may form part of the contribution to the capital where they become inseparable from other assets that can be presented as a contribution to the capital in Sharikah, such as when a manufacturing firm use its net assets as a contribution to the capital. [see Shari'ah Standard No. (21) on Financial Paper]

3/1/2/5 The funds of current accounts, although they are juristically classified as loans to the Institutions, can be presented as a contribution to the capital in a Sharikah either with the Institution itself or with a third party.

3/1/3 Managing a Sharikah venture

3/1/3/1 In principle, each partner is entitled to act in the interest of the partnership in the following transactions: spot or deferred sales; taking possession or custody of the partnership receivables; making payments or deposits and providing or receiving a mortgage on behalf of the partnership; asking for payment of debts, admission of liabilities, taking up legal actions, cancellation of contracts, rejecting defective goods, renting the assets of the partnership, processing transfers of rights and

debts; requesting credit facilities in the interest of partnership; and doing what is customary in the interest of trading. A partner is not entitled to act against the interest of the partnership or to perform actions that will damage the partnership, such as giving out grants or loans, unless all the partners have consented to such an action. However, the partner may give out short-term minor loans that will not, according to customary practice, affect the operation of partnership.

3/1/3/2 It is permissible for the partners to agree that the management of the partnership will be restricted to certain partners or to a single partner. In this case, the other partners are bound to abide by their consent not to act on behalf of the partnership.

3/1/3/3 It is permissible for the partners to appoint a manager other than one of the partners and pay him a fixed remuneration that will be included in the expenses of the Sharikah. It is also permissible that the partners set aside a portion of the investment profit plus a fixed remuneration as a form of incentive for the manager. However, if the management is carried out from the outset for a percentage share in the profit earned, this action classifies the manager as a Mudarib and he is only entitled to a share in the profit, if any, and deserves no further remuneration for management services.

3/1/3/4 It is not permitted, in a Sharikah contract, to specify a fixed remuneration for a partner who contributes in managing the Sharikah funds or provides some form of other services, such as accounting. However, it is permissible to give him a greater share of profit than he would receive solely on the basis of his share in the partnership capital.

3/1/3/5 It is permissible that one of the partners be appointed to provide services that are mentioned in item 3/1/3/4 provided that the appointment is based on an independent contract from the Sharikah contract so that he may be dismissed as a manager at any point of time without the need to amend or to terminate the Sharikah contract. In this case, the appointed partner may earn a specific remuneration.

3/1/4 Guarantees in a Sharikah contract

3/1/4/1 All partners in a Sharikah contract maintain the assets of the Sharikah on a trust basis. Therefore, no one is liable except in cases of misconduct, negligence or breach of contract. It is not permitted to stipulate that a partner in a Sharikah contract guarantees the capital of another partner.

3/1/4/2 It is permissible for a partner in a Sharikah contract to stipulate that another partner provides a personal guarantee or a mortgage to cover cases of misconduct, negligence or breach of contract.

3/1/4/3 A third party may provide a guarantee to make up a loss of capital of some or all partners. This guarantee is circumscribed with the conditions that (I) the legal capacity and financial liability of such a third party as a guarantor are independent from the Sharikah contract, (II) the guarantee should neither be provided for consideration nor linked in any manner to the Sharikah contract; (III) the third party guarantor should not own more than a half of the capital in the entity to be guaranteed, and (IV) the guaranteed entity should not own more than a half of the capital in the entity that undertakes to provide a guarantee. In case of a third party's undertaking to guarantee, the partner benefiting from such

an undertaking is not, however, entitled either to claim that the Sharikah contract becomes null and void or to refuse to meet his obligations under the contract if the guarantor fails to meet his voluntary promise to cover the loss of his capital, on the grounds that he (the beneficiary) entered into the Sharikah contract taking into account the state of such a third party's undertaking to guarantee the loss of his capital.

3/1/5 The outcome of Sharikah investments (profit and loss)

3/1/5/1 The Sharikah contract should incorporate a provision specifying the manner of sharing profits between the parties. The allocation of profits must be made in a manner that gives each partner an undivided percentage of profit, not a sum of money or a percentage of the capital. [see item 3/1/5/9]

3/1/5/2 It is not permitted to defer the determination of the profit percentages due to each partner until the realisation of profit. The profit percentage for each partner must be determined at the conclusion of Sharikah contract. The parties may bilaterally agree to amend the percentages of profit-sharing on the date of distribution. Also, a partner may relinquish, on the date of distribution, a part of the profit that is due to him in favour of another party.

3/1/5/3 In principle, the shares of profit may be in proportion to the percentage of each partner's contribution to the Sharikah capital. Nevertheless, the partners may agree to make profit-sharing not proportionate to their contributions to capital, provided the additional percentage of profit over the percentage of contribution to the capital is not in favour of a sleeping partner. If a partner did not stipulate a condition that he be

a sleeping partner, then he is entitled to stipulate an additional profit share over his percentage of contribution to the capital even if he did not work.

3/1/5/4 It is a requirement that the proportions of losses borne by partners be commensurate with the proportions of their contributions to the Sharikah capital. It is not permitted, therefore, to agree on holding one partner or a group of partners liable for the entire loss or liable for a percentage of loss that does not match their share of ownership in the partnership. It is, however, valid that one partner takes, without any prior condition, the responsibility of bearing the loss at the time of the loss.

3/1/5/5 It is permissible for the partners to agree on the adoption of any method of allocation of profit, either permanent or variable, for example, by agreeing that the percentages of profit shares in the first period are one set of percentages and in the second period are another set of percentages, depending on the disparity of the two periods or the magnitude of the realised profit. This is allowed provided that using such a method does not lead to the likelihood of a partner being precluded from participation in profit.

3/1/5/6 It is not permitted to start the allocation of profit between the partners unless the operating costs, expenses and taxes are deducted in calculating the profit and the capital of the Sharikah is maintained intact.

3/1/5/7 It is not permitted that the conditions or modes of profit allocation in a Sharikah contract include any clause or condition that may result in the probable violation of the principle of sharing profit. For example, if a predetermined amount of profit or a specific percentage of capital is assigned to one of the partners, this assignment will be rendered void. If the assignment

is amended before profit comes forth, profit shall be divided in accordance with what partners agreed on as to amendment. Otherwise, profit shall be divided based on each partner's respective share in capital.

3/1/5/8 Taking into account the provisions of item 3/1/5/3, it is permissible to agree that if the profit realised is above a certain ceiling, the profit in excess of such a ceiling belongs to a particular partner. The parties may also agree that if the profit is not over the ceiling or is below the ceiling, the distribution will be in accordance with their agreement.

3/1/5/9 The profit may be finally distributed on the basis of the proceeds of selling all the existing assets, known as actual valuation, or on the basis of constructive valuation of assets which means valuation of the assets of the Sharikah at fair value. The receivables must be valued at the cash value that is expected to be realised, i.e. after deduction of an allowance for doubtful debts. In valuing receivables, it is not permitted to take account of the time value of money (interest) or the notion of discount on the basis of current value, i.e. a discount of the amount of the debt as consideration for earlier payment, and cash amounts shall be recognized as is.

3/1/5/10 It is not permitted that the final allocation of profit take place based on expected profit, i.e. it is necessary that the allocation of profit take place on the basis of actual profit earned through actual or constructive valuation of the sold assets.

3/1/5/11 It is permissible to allocate some funds to any of the partners on account, i.e. before actual or constructive valuation, on condition that the final actual settlement will take place at a later stage. In this case, the parties

should undertake to reimburse to the Sharikah any amount that they have received in excess of their share of profit after actual or constructive valuation.

3/1/5/12 If the subject matter of Sharikah is assets acquired for leasing that bring in income or the subject matter is services that bring in revenue, then the amount distributed to the partners annually is on account, and it is subject to settlement and reimbursement at the end of the Sharikah.

3/1/5/13 It is permissible, based on the articles of association or a decision of the partners, not to distribute the profits of the company. It is also permissible to set aside periodically a certain ratio of profit as a solvency reserve or as a reserve for meeting losses of capital (investment risk reserve) or as a profit equalisation reserve.

3/1/5/14 It is permissible to agree on setting aside a proportion of profit for non-partners as a charitable donation.

3/1/6 Maturity of Sharikah

3/1/6/1 Each partner is entitled to terminate the Sharikah (i.e. to withdraw from the partnership) after giving his partner/s due notice to this effect, in which case he shall be entitled to his share in the partnership, and this withdrawal would not necessitate the termination of the partnership of the remaining partners. It is permissible for the partners to enter into a binding promise for the continuity of the partnership for a period of time. In this case, it is permissible for the parties to agree to terminate the partnership before such a fixed period. In all these cases, the obligations and actions that took place before termination will remain unaffected and they will continue to exist.

3/1/6/2 It is permissible for a partner to issue a binding promise to buy, either within the period of operation or at the time of liquidation, all the assets of the Sharikah as per their market value or as per agreement at the date of buying. It is not permissible, however, to promise to buy the assets of the Sharikah on the basis of face value.

3/1/6/3 A Sharikah venture comes to an end at the expiry date or before the expiry date if the partners agree to terminate it prematurely, or, in the case of partnership in a particular business, by actual liquidation of the assets that constitute the subject matter of the partnership. The termination of a Sharikah can take place on the basis of constructive liquidation. In this case, the Sharikah will be regarded as if it has been ended and the parties have commenced a new partnership whereby the assets that were not sold through actual liquidation, but have been valued on the basis of constructive liquidation, will be considered as the capital of the new partnership. If the liquidation is based on the expiry date, then all the existing assets shall be sold according to current market values and the proceeds will be used as follows:

a) Payment of liquidation expenses.

b) Payment of financial liabilities from the net assets of the partnership.

c) Distribution of the remaining assets among the partners in accordance with their percentage of contribution to the capital. If the assets fall short and the partners do not recover all of their contributed capital, the distribution shall take place on a pro rata basis to the shares of capital.

3/2 Partnership in creditworthiness or reputation (liability partnership)

3/2/1 A partnership in creditworthiness (partnership of liability) is a bilateral agreement between two or more parties to conclude a partnership to buy assets on credit on the basis of their reputation for the purpose of making profit, whereby they undertake to fulfil their obligations according to the percentages determined by the parties. In addition, the parties should determine for each partner the percentage of profit sharing and of liability sharing, which latter may, by agreement, differ, downwards or upwards, from the percentage of profit sharing.

3/2/2 The partnership in creditworthiness has no monetary capital. This is because the subject matter of the partnership is an obligation or a liability that is contingent on creditworthiness (outstanding reputation). This is the obligation of the partners to pay the amount of debts created through purchases on credit, which form the liability of the partners. Therefore, the parties should agree on the ratio of liability for which each partner is responsible when paying such debts.

3/2/3 The profit shall be distributed according to the agreement. However, the loss will be borne by each partner according to the ratio that each partner had undertaken to bear in proportion to overall assets that are purchased on credit. It is not permitted that the contract of partnership incorporates a provision that specifies a lump sum from the profit for a particular partner.

3/3 Service partnerships (professional or vocational partnerships and partnerships in skilled trades)

3/3/1 A service partnership is an agreement between two or more parties to provide services pertaining to a profession, vocation or skilled trade or to render some services or professional advice or to manufacture goods, and to share profit according to an agreed upon ratio.

3/3/2 The service partnership has no monetary capital. This is because the subject matter of the partnership is rendering services. There is no Shari'ah implication regarding any disproportion in the services the partners or their representatives may have rendered. The partners may also distribute different types of services among themselves and may assign some or all partners a set of services or a particular service in a way that will achieve the integration and purpose of the overall service to be rendered.

3/3/3 The profit shall be distributed among the partners according to the agreed ratio, but the contract should not specify that a lump sum be paid from the profit to a particular partner.

3/3/4 If the service partnership requires capital goods (e.g., equipment or tools), then it is permissible for each party to provide the necessary goods that his services require, in which case each partner owns the goods he has provided. The partners may contribute funds to acquire the goods on the basis of a partnership in ownership. It is also permissible for a party to a Sharikah contract to provide the capital goods required by the partnership in consideration for fees that will be charged against the Sharikah operation as expenses.

4. Second Category: Modern Corporations

4/1 Stock company

4/1/1 Definition of a stock company

4/1/1/1 A stock company is a company of which the capital is partitioned into equal units of tradable shares and each shareholder's (co-owner's) liability is limited to his share in the capital. It is a form of financing partnership. The rules of Sharikat al-'Inan apply to this company except on the issue of the limited liability of the shareholders and the fact that this type of company cannot be unilaterally terminated by one party or a minority of its shareholders. [see items 4/1/2/1 and 4/1/2/9]

4/1/1/2 The stock company has a juristic personality through its incorporation by law in such a way that it cannot avoid its obligations to people dealing with it. This separates the liability of the company from the liability of its shareholders (the co-owners) and also establishes for it a separate legal capacity as required for necessary legal arrangements, irrespective of the legal capacity of the shareholders. By definition, a stock company is entitled to initiate legal claims through its representative. It is subject to the jurisdiction of the place of its incorporation.

4/1/2 Shari'ah Rulings relating to a stock company

4/1/2/1 The contract forming a stock company is binding during the duration designated by the articles of association for the continuity of the company on the basis of the undertaking of the parties not to dissolve the company unless the majority of the partners have consented to do so. Therefore, no one is entitled to dissolve (to terminate) the company in respect to his shares. However, a shareholder is entitled to sell his shares or to relinquish title to them in favour of another person.

4/1/2/2 It is permissible for the issuer of shares to add a certain percentage to the actual value of the shares on the subscription date in order to recover issuing expenses, provided that such percentage is appropriately estimated to reflect the actual expenses incurred.

4/1/2/3 It is permissible to issue new shares in order to increase the capital provided the new shares are issued at the fair value of the old shares. This should be done in accordance with the opinion of experts in valuation of the company's assets. In other words, the new issues can be issued at a premium or at a discount to their nominal value, or issued at a market value.

4/1/2/4 It is permissible that a shareholder underwrite an issue of shares without any consideration. In such a case, there is an agreement between a person and the company on the date of incorporation of the company, or of a share issue, to the effect that such a person is undertaking to buy all or part of the shares issued. In other words, it means an undertaking to subscribe all the remaining shares that are not subscribed at its nominal value. However, it is permissible for a shareholder to ask for consideration for services provided other than the underwriting, such as conducting feasibility studies or marketing the shares.

4/1/2/5 It is permissible that a part of payment for subscription of shares be made in an instalment and that the other instalments be deferred. In this case, the paid instalment is a contribution to the Sharikah capital, and the deferral of some instalments constitutes an undertaking to increase his share of capital in the company subsequently. This is permissible provided the instalments cover all the shares and that the company's liability is confined to the value of the subscribed shares.

4/1/2/6 It is not permitted to purchase shares using interest-based loans, provided by either a broker or any other person, in consideration for mortgaging the shares as a security for payment.

4/1/2/7 It is not permitted for someone to sell shares that he does not own and the promise of a broker to lend the shares to him at the date of delivery does not constitute ownership or possession of the shares. This is not allowed especially if the broker stipulates that the seller must pay the price of the shares so that he can deposit it and earn interest in return for such a loan.

4/1/2/8 In the legitimate public interest, it is permissible for the relevant authorities to organise trading in shares in such a way that trading will not take place except through specific licensed stockbrokers.

4/1/2/9 It is permissible to restrict the liability of a company to its paid up capital if this is made public, in order to make the customers of the company aware of the financial position of the company without any uncertainty or lack of transparency.

4/1/2/10 It is permissible to sell shares in the company subject to rules and regulations of the company that do not conflict with Shari'ah, such as pre-emptive rights of the existing shareholders to purchase the shares.

4/1/2/11 It is permissible to mortgage the company's shares. However, this is subject to the rules and regulations of the company vis-à-vis the right of the shareholders to mortgage their ownership rights to undivided shares in the company.

4/1/2/12 It is permissible to issue shares "to the order of" (nominative shares).

4/1/2/13 It is permissible to issue "bearer shares". This is executed by handing over to the investor a certificate that represents a right to shares in the company and receiving their value in cash or acquiring a counter deed recognising a debt against the shareholder. In this case, the common ownership of shares represented by the certificate is vested in the holder of the certificate of shares at any time.

4/1/2/14 It is not permitted to issue preference shares, i.e. shares that have special financial characteristics that give them a priority at the date of liquidation of the company or at the date of distribution of profit. However, it is

permissible to grant certain shares, in addition to being entitled to rights attached to common shares, certain procedural and administrative privileges, such as a right of vote.

4/1/2/15 It is not permitted to issue *Tamattu'* (enjoyment) shares: shares that entitles the holder a participation in the net profit, but not to vote and which are gradually redeemed before the termination of the company through distribution of profits.

4/2 Joint-liability company

4/2/1 Definition of Joint-liability Company

4/2/1/1 A joint-liability company is a form of personal partnership. It is a necessary requirement that this partnership is publicly declared as a registered company assigned a unique title (trademark).

4/2/1/2 A joint-liability company has a juristic personality and independent financial liability unrelated to the liability of the partners. Nevertheless, all the partners are personally responsible for the obligations and liabilities of the company if the existing assets cannot meet the liabilities of the company.

4/2/1/3 In addition to maintaining documents of the joint-liability company, the partners are also obliged to maintain commercial documents relating to external trade activities.

4/2/2 Shari'ah Rulings relating to Joint-liability Companies

4/2/2/1 A creditor of a joint-liability company is entitled to demand fulfilment of all or part of his rights from any of the partners in any way the creditor deems fit. Therefore, the creditor is not obliged to claim such fulfilment from the company first.

4/2/2/2 The contract of a joint-liability partnership is not binding; hence, a partner is entitled to withdraw from the partnership on the following conditions:

a) If the partners did not set a duration for the company. If they agreed on a duration, then such duration must be observed.

b) The partner should notify the other partners of the intention to withdraw.

c) If the unilateral withdrawal from the partnership would not cause damage to other partners.

4/2/2/3 It is not permissible for the partner to bring in a substitute for himself without the agreement of the other partners.

4/3 Partnership in commendum

4/3/1 Definition of partnership in commendum

4/3/1/1 Partnership in commendum is a form of financing partnership. This is because the personality of the operating partner is important for the sleeping partner and because there is a difference in terms of determination of the ownership of the partners, whereby the ownership is calculated based on disproportionate lots and not on the basis of proportionate shares that are equal in number.

4/3/1/2 This form of company consists of managing partners and sleeping partners. The managing partners in this partnership are jointly liable for the obligations of the company from their personal wealth on the basis of joint-liability. The liability of each sleeping partner is limited to the number of lots he owns and his liability does not extend to his personal assets. It is permissible to limit the liability of some investors

without any consideration for limiting their liability, in which case the company consists of joint-liability partners and partners with limited liability. [see item 4/1/2/9]

4/3/1/3 It is not permissible for the sleeping partners to interfere in the operations of the company. The law does not even allow that their names be mentioned on the date of the registration of the company. Only the funds collected from the sleeping partners are mentioned.

4/3/1/4 The management of the company may be delegated either to one of the joint liability partners or to a third party. The sleeping partners are not entitled to manage the company.

4/3/2 Shari'ah Rulings relating to the partnership in commendum

4/3/2/1 Profit must be distributed according to the ratio of lots or agreement. Losses are borne by managing and sleeping shareholders partners, according to the ratio of their shares in the capital.

4/3/2/2 It is not permissible to stipulate that a sleeping partner has a right to an amount of profit according to a particular percentage of the capital or a lump sum. [see item 3/1/5/8]

4/4 Company limited by shares

4/4/1 Definition of a company limited by shares

The company limited by shares is a form of personal partnership. The subscription in this company is in accordance with equal numbers of shares and it comprises of managing partners and sleeping partners.

4/4/2 Shari'ah Rulings relating to the company limited by shares

4/4/2/1 The managing partners in this company are liable for the obligations of the company from their personal

assets on the basis of joint liability. They are in the position of a person who works as a Mudarib and simultaneously participates in a partnership. The sleeping partners' liability is limited to the number of the shares each partner owns and does not extend to his own assets. In this case, the liability of sleeping partners is equivalent to that of the capital providers in a Mudarabah contract. It is permissible to limit the liability of some investors without any consideration for limiting their liability, in which case the company consists of joint liability partners and partners with limited liability. [see item 4/1/2/9]

4/4/2/2 It is not permissible for the sleeping partners to interfere in the operations of the company. The law does not even allow that their names are mentioned on the date of the registration of the company. Only the funds collected from the sleeping partners are mentioned.

4/4/2/3 The management of the company may be delegated either to one of the managing partners or to a third party. The sleeping partners are not entitled to manage the company.

4/4/2/4 Profit must be distributed according to the ratio of participation or agreement. Losses are borne by the managing shareholding partners and sleeping shareholding partners according to their shares in the capital. And any excess losses shall be borne by managing partners.

4/4/2/5 It is not permissible to stipulate that a sleeping partner has a right to an amount of profit according to a particular percentage of the capital or a lump sum.

4/5 Allotment/particular (Muhassah) partnership

4/5/1 Definition of allotment partnership

4/5/1/1 The definition of Sharikat al-'Inan is applicable to an allotment partnership [see item 3/1]. This type of partner-

ship belongs to the personal (private) form of company. The reason for this is that the partners take into account before concluding a partnership each ones financial strength and ability to meet financial obligations from his personal assets.

4/5/1/2 Sharikat al-Muhassah has no juristic personality because people other than the partners do not know about it. This partnership does not have any separate financial liability as an entity.

4/5/2 Shari'ah rulings relating to Muhassah Company

4/5/2/1 The rulings for and basis of a Muhassah company do not differ from those for an 'Inan partnership. [see item 3/1]

4/5/2/2 The liability of partners is personal and, as such, they are liable for the liabilities of the company from their personal assets. The rules for and classification of an allotment partnership do not differ from 'Inan partnership.

4/5/2/3 The contract of a Muhassah partnership is not binding. However, if the parties agree to make it binding for a particular period of time, then they shall be bound by such an agreement. [see 4/3/2/2]

4/5/2/4 A partner in Sharikat al-Muhassah is entitled to terminate his partnership on condition that (I) he notifies other partners of his intention to withdraw and (II) the unilateral withdrawal from partnership would not cause damage to other partners or clients of the company. The partnership can be liquidated by way of actual or constructive liquidation of the company's assets.

5. Diminishing Musharakah

5/1 Diminishing Musharakah is a form of partnership in which one of the partners promises to buy the equity share of the other partner

gradually until the title to the equity is completely transferred to him. It is necessary that this buying and selling should not be stipulated in the partnership contract. In other words, the buying partner is allowed to give only a promise to buy. This promise should be independent of the partnership contract. In addition, the buying and selling agreement must be independent of the partnership contract. It is not permitted that one contract be entered into as a condition for concluding the other.

5/2 The general rules for partnerships must be applied to a diminishing partnership, especially the rules for Sharikat al-'Inan. Therefore, it is not permitted that the contract of diminishing partnership include any clause that gives any of the parties a right to withdraw his share in the capital.

5/3 It is not permitted to stipulate that one partner should bear all the cost of insurance or maintenance on the ground that he will eventually own the subject matter of the partnership.

5/4 Each partner should contribute part of the capital. The contribution may be in the form of cash or tangible assets that can be translated into a monetary value, for example, a land for building or equipment required for the operation of partnership. The loss, if any, shall be borne periodically by the parties in accordance with the participation ratio of each partner as the equity stake of one partner decreases and the stake of the other partner increases.

5/5 The ratio of profit or income of the partnership that each partner (the Institution and customer) is entitled to should be clearly determined. However, it is permissible for the partners to agree on a ratio of profit sharing that is disproportionate to the ratio of equity ownership. It is also permissible for the partners either to maintain the ratio of profit already determined even if the ratio of equity shares has changed, or to agree on amending the ratio of profit sharing due to the change in the ratio of equity shares. In doing so, they must ensure that the principle of allocation of losses in accordance with the ratio of equity share of ownership is maintained.

5/6 It is not permitted to stipulate that one partner has a right to receive a lump sum out of the profits. [see item 3/1/5/8]

5/7 It is permissible for one of the partners to give a binding promise that entitles the other partner to acquire, on the basis of a sale contract, his equity share gradually, according to the market value or a price agreed at the time of acquisition. However, it is not permitted to stipulate that the equity share be acquired at their original or face value, as this would constitute a guarantee of the value of the equity shares of one partner (the Institution) by the other partner, which is prohibited by Shari'ah.

5/8 The partners may arrange for the acquisition of the equity share of the Institution in a manner that serves the interests of both parties. This includes, for example, a promise by the Institution's client to set aside a portion of the profit or the return he may earn from the partnership for the acquisition of a percentage of the equity of the Institution. The subject matter of the partnership may be divided into shares, in which case the Institution's partner can purchase a particular number of these shares at certain intervals until the partner becomes the owner of the entire shares and consequently becomes the sole owner of the subject matter of the partnership.

5/9 It is permissible for either of the partners to rent or to lease the share of the other partner for a specified amount and for whatever duration, in which case each partner will remain responsible for the periodical maintenance of his share on a timely basis.

6. Date of Issuance of the Standard

This Standard was issued on 4 Rabi' I, 1423 A.H., corresponding to 16 May 2002 A.D.

Adoption of the Standard

The Shari'ah Standard on Sharikah (Musharakah) and Modern Corporations was adopted by the Shari'ah Board in its meeting No. (8) held in Al-Madinah Al-Munawwarah on 28 Safar - 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D.

Appendix (A)
Brief History of the Preparation of the Standard

In its meeting No. (5) held in Makkah Al-Mukarramah on 8-12 Ramadan 1421 A.H., Corresponding to 4-8 December 2000 A.D., the Shari'ah Board decided to give priority to the preparation of a Shari'ah Standard on Sharikah (Musharakah) and Modern Corporations.

On Saturday 15 Dhul-Hajjah 1421 A.H., corresponding to 10 March 2001 A.D., the Fatwa and Arbitration Committee recommended to the Shari'ah Board the commissioning of a Shari'ah consultant to prepare a juristic study and an exposure draft on the Shari'ah Rules for Sharikah (Musharakah) and Modern Corporations.

In its meeting held on 18 Muharram 1422 A.H., corresponding to 12 April 2001 A.D., the Fatwa and Arbitration Committee discussed the exposure draft of the Shari'ah Rules for Sharikah (Musharakah) and Modern Corporations and asked the consultant to make amendments in light of the comments made by the members. The Committee also held a meeting on 20 Jumada II 1422 A.H., corresponding to 8 September 2001 A.D. and made some amendments in light of the comments made by the members.

The revised exposure draft of the Standard was presented to the Shari'ah Board in its meeting No. (7) held in Makkah Al-Mukarramah on 9-13 Ramadan 1422 A.H., corresponding to 24-28 November 2001 A.D. The Shari'ah Board made further amendments to the exposure draft of the standard and decided that it should be distributed to specialists and interested parties in order to obtain their comments and discuss them in a public hearing.

A public hearing was held in Bahrain on 29–20 Dhul-Hajjah 1422 A.H., corresponding to 2-3 February 2002 A.D. The public hearing was attended by more than thirty participants representing central banks, institutions,

accounting firms, Shari'ah scholars, academics and others who are interested in this field. Some of the members of the Shari'ah Board responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Standards Committee in its meeting held on 21-22 Dhul-Hajjah 1422 A.H., corresponding to 6-7 March 2002 A.D., in the Kingdom of Bahrain discuss the comments made about the exposure draft. The Committee made the necessary amendments, which it deemed necessary in light of both the discussions that took place in the public hearing, and the written comments that were received.

The Shari'ah Board in its meeting No. (8) held on 28 Safar – 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D., in Al-Madinah Al Munawwarah discussed the amendments made by the Shari'ah Standards Committee, and made the necessary amendments, which it deemed necessary. Some paragraphs of the standard were adopted by the unanimous vote of the members of the Shari'ah Board, while the other paragraphs were adopted by the majority vote of the members, as recorded in the minutes of the Shari'ah Board.

The Shari'ah Standards Review Committee reviewed the standard in its meeting held in Rabi' II 1433 A.H., corresponding to March 2012 A.D. in the State of Qatar, and proposed after deliberation a set of amendments (additions, deletions, and rephrasing) as deemed necessary, and then submitted the proposed amendments to the Shari'ah Board for approval as it deemed necessary.

In its meeting No. (41) held in Al-Madinah Al Munawwarah, Kingdom of Saudi Arabia on 27-29 Sha'ban 1436 A.H., corresponding to 14-16 June 2015 A.D., the Shari'ah Board discussed the proposed amendments submitted by the Shari'ah Standards Review Committee. After deliberation, the Shari'ah Board approved necessary amendments, and the standard was adopted in its current amended version.

Appendix (B)
The Shari'ah Basis for the Standard

Permissibility of Partnership

The Fuqaha have classified partnerships into four categories, namely Sharikat al-'Inan (contractual partnership), Sharikat al-Abdan (skilled trade partnership), Sharikat al-Mufawadah (agency-like partnership) and Sharikat al-Wujuh (creditworthiness or reputation partnership). The most important of all is Sharikat al- 'Inan (contractual partnership). The permissibility of this form of partnership is established by the Qur`an, the Sunnah and practical consensus of the Fuqaha.

The permissibility of Sharikah is supported by the Saying of Allah, the Almighty: ***{"...And, verily, many partners oppress one another, except those who believe and do righteous good deeds, and they are few..."}***.(2)

Among the Sunnah provisions that support the permissibility of partnership is the case of Al-Sa`ib Ibn Abu Al-Sa`ib Al-Makhzumi who was a partner of the Prophet (peace be upon him) in business at the beginning of Islam. On the day when the Prophet (peace be upon him) conquered Mecca, he met Al-Sa`ib, then he (peace be upon him) said: *"Welcome my brother and my partner. He jokes not (i.e. he is serious in business) and do not argue (unnecessarily)."*(3)

Moreover, partnership is one of the main transactions in all societies since the advent of Islam. This constitutes, therefore, a practical consensus for the permissibility and validity of partnerships.

The partnerships for which the jurists have clarified their rules are the origins of the modern corporations, such as joint-stock companies whose

(2) [Sad: 24]

(3) The Hadith had been related by Al-Hakim who deemed it authentic [2: 61]. Al-Dhahabi agreed with Al-Hakim.

financial standing and obligations are related to the volume of the shares of the company and on its juristic personality, not on the personality of the shareholders. Therefore, the general rules for various partnerships in Shari'ah will govern modern forms of corporations. However, the procedural systems relating to representation of partnership companies and bureaucratic, administrative and accounting procedures are required by Maslahah (consideration of the public good or common need), which is an acceptable source for validating human actions provided it is employed in line with the principles of Shari'ah.

The general basis of Sharikah is agency (Wakalah) because each partner is acting as a principal partner, on one hand, and acting in the interest of the partnership, on the other hand, as an agent for the remaining partners. Unlike other partnerships, *Sharikat al-Mufawadah* combines rules of agency and guarantee simultaneously.

Conclusion of Sharikah Contract

- It is permitted to conclude a partnership contract with non-Muslims or conventional banks for carrying out permissible operations in association with necessary guarantees that they will observe Shari'ah precepts and principles. The Shari'ah basis for this is the Hadith stating: *"The Messenger of Allah has prohibited concluding partnership with Jews and Christians unless the selling and buying is in the hands of the Muslim"*.[4] The cause of the prohibition is the fear of being involved in interest-based transactions or in concluding impermissible contracts and this fear is absent when there are guarantees to observe and apply Shari'ah rulings.[5] Al Baraka Forum has issued a resolution in support of partnership between Islamic banks and conventional banks.[6]
- The basis for the permissibility of an agreement on amending the terms of partnership and the profit sharing ratio is that this action does not lead to a possibility of precluding a partner from getting a share of profit.[7]

(4) *"Musannaf Ibn Abu Shaybah"* [6: 9].
(5) See: Ibn Qudamah, *"Al-Mughni"* [7: 110-111].
(6) See: Resolution No. (9/1): *"Fatawa Nadwat Al Baraka"* No. 9, (P. 151).
(7) See: Resolution No. (11/8): *"Fatawa Nadwat Al Baraka"* No. 11, (P. 194).

Capital of Sharikah

- The basis for the permissibility that Sharikah capital may be contributed in the form of tangible assets other than cash, after valuation, is that the purpose of Sharikah is to give partners a right to use the contributed money freely and to share the profit. This objective is realisable even if the capital is contributed in the form of tangible assets just as it is in the case of a contribution in cash. Therefore, it is just as valid to present tangible assets for Sharikah investment as to present cash. At the liquidation, each one of the partners will be entitled to the equivalent value of the assets presented at the conclusion of the Sharikah.(8) This is the view of the Maliki and the Hanbali scholars.(9)
- The basis for the requirement that a payment of contribution to Sharikah capital in a currency different from the designated currency of partnership must be valued according to the current exchange rate at the time of payment is that this action is a currency exchange between two currencies which is permitted provided it is carried out at the current exchange rate. This is evidenced by the Hadith in which Ibn Umar asked the Prophet (peace be upon him) concerning selling camels at (a place in Medina called Al-Baqi') in a currency and collecting payment in a different currency. The Prophet (peace be upon him) endorsed the transaction provided it had taken place according to the current exchange rate.(10)
- The basis for the requirement that the investments of parties in the capital should be properly determined is that failure to do so will lead to ambiguity in respect to the capital. It is not permissible that the capital of Sharikah be ambiguous since certainty as to the amount of the capital is a benchmark for sharing profit. The equitable distribution of profit is not possible if the amount of capital contributed by each party is ambiguous.(11)
- The basis for rejecting payment of partnership capital in receivables alone is that debts owed to a partner by another partner cannot actually be used in partnership operations, as they are not assets in possession.

(8) *"Al-Mughni"* [7: 124]
(9) *"Hashiyat Al-Dusuqi"* [2: 517]; and *"Al-Mughni"* [5: 17].
(10) The source of the Hadith has been stated earlier.
(11) *"Al-Mughni"* [7: 125].

Again, this may potentially lead to Riba when the partner is the one in debt.(12) However, if the receivables are combined with other assets and the ratio of debt to the total assets is negligible, then debt and the other assets can be presented as a contribution to partnership capital. The basis for this is the principle of *Taba'iyyah* (things dependent on another thing) as per the legal maxim: "A thing which in fact follows from another thing follows it also in law and judgment cannot be given separately for a thing that follows from another" and the legal maxim: "The law is flexible in things that follow from another".

- The basis for allowing current accounts as capital in partnership is that, in spite of their being considered as loan, they are presumed to be possessed by the accountholders because the funds are available on demand. This is because the Institutions are obliged by their regulations and directives of the supervisory bodies to pay the owner on demand or accept cheques against these accounts irrespective of the financial situation of the Institution.

Managing a Partnership

- The basis for the right of each partner to participate in the management of the partnership is that partnership is based on elements of agency and trust. The element of agency requires that each party be entitled to be involved in the operations in a manner that is in the interest of the partnership. The element of trust requires that each party act for the benefit of the partnership.(13)
- The basis for not allowing a fixed remuneration for a partner who assists in the management is that this may lead to guaranteeing the capital of this partner, or to his not being exposed to risk of loss, if any, in proportion to his contribution in the capital.
- The basis for the permissibility of appointing, by a separate independent contract, one partner to manage the partnership and the permissibility of paying him wages is that the partner becomes an employee of the company and he is not acting in the capacity of a partner.

(12) *"Hashiyat Al-Dusuqi"* [3: 517]; and *"Al-Mughni"* [5: 17].
(13) See: *"Al-Mughni"* [7: 128].

Guarantees in Partnership

- The basis of the requirement that a partner is not liable except in cases of misconduct or negligence, and of the impermissibility of a stipulation to the effect that a partner guarantees the capital of another partner, is that partnership operates on the basis of trust, and to hold a trustee liable for losses (except in the case of misconduct or negligence) is impermissible.(14)
- The basis for allowing a party to a partnership to require a guarantee or a mortgage from another party as security against cases of misconduct and the like is that this requirement does not conflict with the rules for partnership. Again, the general principle of contracts and partnerships is that parties are required to observe stipulated terms as far as possible.(15)
- The basis for the permissibility of a "promise to guarantee" by a third party whose financial liability is independent from the parties to a partnership is that this action is a mere charitable act and an undertaking that is independent of the partnership contract. In other words, a fulfilment of a promise by a third party is not a condition for the permissibility of the contract. In addition, the third party's guarantee does not adversely affect the established Shari'ah principle against guaranteeing capital or profit. A resolution was issued by International Fiqh Academy in support of the permissibility of a third party's promise to guarantee.(16)
- The basis for the requirement that the guaranteeing Institution should not be the owner of the guaranteed Institution or vice versa is that by ownership the transaction becomes in substance a guarantee by a partner of the capital of another partner.

Outcome of Partnership Investment (Profit and Loss)

- The basis for the impermissibility of an agreement to determine the profit share on the basis of a lump sum or a percentage of the capital is because this is inconsistent with the sharing of profit and because profit is not realised unless the capital is maintained intact.

(14) See: Ibn Qudamah, *"Al-Kafi"* [2: 230]; and *"Al-Mubdi"* [4: 256].
(15) See: Fatwa (1/5) of Al Baraka First Forum, 1403 A.H.: *"Qararat Wa Fatawa Nadwat Al Baraka"* (P. 18).
(16) International Fiqh Academy resolution No. 30 (5/4).

- The basis for the impermissibility of deferring the statement of the profit ratio of each party until profit is realised is because such a procedure involves uncertainty which may potentially lead to dispute. However, the parties are entitled to amend the profit ratio or to relinquish a right to profit on the date of distribution. This is because the profit belongs to them; hence, it is permissible for them to make amendments or relinquishments.
- The basis for the requirement that the profit share may be either proportionate or disproportionate to the contribution of each party in the capital is that an individual deserves a share in profit on the basis of the funds contributed, the work done or the risk borne. If an individual is involved in any of these three, then it is allowed for the parties to agree on a profit ratio accordingly. This is the opinion of the Hanafi and Hanbali schools.(17)
- The basis for the impermissibility of one party bearing losses or that each party bear a portion of losses that may not be proportionate to the share of each party in the capital is the saying of Ali Ibn Abu Talib (may Allah be pleased with him): "Profit distribution is according to agreement of the partners and loss must be borne in proportion to the contribution in the capital."(18) Therefore, it is a void condition that one party should bear the loss of other parties and such a condition facilitates misappropriation of the property of others.
- The basis for the permissibility of the partners agreeing on any method for allocation of profit, whether fixed or variable during a particular period, is that this agreement is circumscribed with a condition that the method adopted should not contravene any Shari'ah principle, which means the method should not preclude a party from sharing in profit.
- The basis for not allowing final distribution of profit before deduction of expenses and expenditure is that there is no profit unless the capital is maintained intact.

(17) See: Al-Mirghinani, *"Al-Hidayah Sharh Al-Bidayah"* [3: 7-8], Al-Maktabah Al-Islamiyyah edition; Al-Kasani, *"Bada`i' Al-Sana`i'"* [6: 62-63]; and Ibn Muflih, *"Al-Mubdi"* [5: 4], Al-Maktab Al-Islami edition

(18) This Athar has been reported by Ibn Abu Shaybah in his *"Musannaf"* [4: 268], Riyadh: Maktabat Al-Rushd.

- The basis for the impermissibility of specifying a lump sum profit amount for one partner is that this action is inconsistent with sharing in profit.
- The basis for not allowing a partner to earn a share of profit and a fee simultaneously is that this fee is a lump sum that may preclude sharing in profit due to the possibility that the partnership business may not realise enough profit to cover it. The basis for allowing a partner to receive, based on a separate contract, a fee is that the contract that entitles a partner to a fee is not part of the partnership contract and because this fee is not inconsistent with sharing in profit, as the partner in this case is considered to be a third party.
- The basis for the permissibility of an agreement that if the profit realised is above a certain ceiling, the profit over such ceiling belongs to a particular partner, is because this constitutes a valid condition that is not inconsistent with profit sharing.(19) Moreover, the capital provider is the one who will bear losses, if any.
- The basis for the permissibility of distributing profit based on constructive valuation is that the use of this method is permitted by Shari'ah(20) and was used in a number of cases, such as Zakah and theft. The basis for the permissibility of constructive valuation is also the saying of the Prophet (peace be upon him): *"If a co-owner of a slave frees his part, the slave will be set free against his property if he has property; otherwise, it will be valued by fair value and freed."*(21)
- The basis for the permissibility of distributing funds to partners on account, i.e. subject to settlement and refund of any additional profit acquired over the contribution to the capital on the date of actual liquidation, is because this action causes no damage to any of the partners since the distributed funds on account are subject to settlement at a later stage.

(19) *"Al-Bahr Al-Zakhkhar"* [5: 83], Dar Al-Kitab Al-Islami edition.

(20) See: Resolution No. (4) of the Islamic Fiqh Academy under the auspices of Muslim World League that was issued in the 16th session held in Mecca on 21-26/10/1422 A.H.; the International Islamic Fiqh Academy resolution No. 30 (5/4) and Fatwa No. (8/2) issued during the Al Baraka's 8th Forum on Islamic Economics in *"Fatawa Al Baraka"* (P. 134).

(21) This Hadith has been related by Muslim, See: *"Sahih Muslim"* [2: 1140].

- The basis for allowing distribution of partnership revenues, including the capital assets, prior to liquidation of the partnership is that the partners suffer no damage from this and also the distribution is subject to review and reimbursement when liquidation is actually effected.(22)

Termination of Partnership

- The basis for the rule that termination of partnership will not affect obligations and actions that took place before it is protection of the remaining partners against any potential damage.
- The basis for the impermissibility of a promise by one of the partners to buy assets of the partnership at face value is that this constitutes a guarantee of the capital which is prohibited by Shari'ah. The basis for the permissibility of a promise to buy the assets of partnership at the market value is that this does not constitute a guarantee of capital.

Modern Corporations

- The permissibility of modern corporations is dependent on the principle of Shari'ah that human transactions are, in principle, permissible (*Mubah*) as long as there is no clear injunction against them, especially in view of the fact that the categorisation of any one or more of these corporations had parallels in Shari'ah-nominate contracts, such as 'Inan partnership, Mudarabah and the like.(23)

Stock Companies

- The basis for the permissibility of underwriting issues of shares without taking consideration is that this is an undertaking that does not involve an impermissible act, such as taking a commission for a guarantee. The International Islamic Fiqh Academy has issued a resolution in this respect.(24)
- The basis for the impermissibility of buying shares using an interest-based loan provided by a stockbroker or other party against a mortgage of the shares is that this is an interest-based transaction secured by

(22) See: International Islamic Fiqh Academy Resolution No. 30 (5/4), and resolution of Islamic Fiqh Academy under the auspices of Muslim World League during its 16th session.

(23) See: Abdul-Aziz Al-Khayyat, *"Al-Sharikat"* [2: 158-159].

(24) See: The International Islamic Fiqh Academy Resolution No. 63 (1/7).

shares.[25] In this case, both transactions are prohibited by an explicit source that indicates that Allah, the Almighty, has cursed a person who lives on interest-based transactions, a person who pays such interest, and a person who notarises or acts as a witness for such transactions.

- The basis for the impermissibility of selling shares that the seller does not own is that this constitutes selling of an item that one does not own or an involvement in a transaction without bearing a risk which is prohibited by Shari'ah.
- The basis for allowing a mortgage of shares is that mortgaging is permissible. Moreover, anything that can be sold may be presented as a mortgage as in the case of shares unless the bylaws of the company state otherwise in which case the conditions stated must be observed.
- The basis for the permissibility of "shares to the order of" (nominative shares) is that this is a form of transferring ownership of shares to another investor. The acceptance by the remaining shareholders of the bylaws of the company that give a right to transfer is an implied consent to the transfer of ownership.[26] The basis for the permissibility of "bearer shares" is that it is a sale of shares by a shareholder to another investor. The acceptance by the remaining shareholders of the bylaws of the company that give a right to sell is an implied consent to the sale. The fact that the identification and personality of the new shareholder (the purchaser) is not known to other shareholders will not affect the sale as they may be provided with this information if need be.[27]
- The basis for the impermissibility of issuing preference (preferred) shares is that preference shares are inconsistent with profit sharing and involve depriving other partners of their fair share of profit.[28]
- The basis for the impermissibility of issuing shares that entitle the holder a participation in the net profit and entitles the company to gradually redeem the participation through the distribution of profits before the termination of the company, is because the funds the certificate holders receive constitute profit in respect of their shares. The claim that the

(25) See: International Islamic Fiqh Academy Resolution No. 63 (1/7).
(26) See: International Islamic Fiqh Academy Resolution No. 63 (1/7).
(27) See: International Islamic Fiqh Academy Resolution No. 63 (1/7).
(28) See: International Islamic Fiqh Academy Resolution No. 63 (1/7).

participations are redeemed in consideration for the distributed profit is invalid. Therefore, the certificate holders remain owners of the shares and are entitled to proceeds when the company is liquidated.(29)

Joint Liability Company

- The basis for the permissibility of the undertaking of partners in a joint liability company to be jointly responsible is that the joint liability in this way is subject to the rules for guarantees. The permission granted by each of them to the others to act on behalf of the company is subject to the rules of agency as in the case of Mufawadah partnership which combines elements of guarantee and agency. The partners have consented to be liable jointly because there is no gain at the expense of any of the partners and no one is to be cheated.(30)
- The basis for the impermissibility of bringing in a substitute partner in a joint liability company when the other partners did consent to it is that the personality of the partner is significant for the partners because the liability of the company includes his personal assets and the substitute may not be in the same financial position as the partner.

Partnership in Commendum

- The basis for the impermissibility of sleeping partners of partnership in commendum or company limited by shares being entitled to interfere in the management of the company is that they have agreed not to do so and this agreement does not affect the rules of partnership.
- The reason why the financial liability of the sleeping partners in partnership in commendum is limited to their shares is that they are in the position of capital providers in a Mudarabah contract.

Allotment (Particular) Partnership

The basis for the permissibility of unilateral termination of participation in this kind of partnership by any of the partners is that, in principle, unilateral termination of participation is allowed provided such action inflicts no damage to any of the partners as per the saying of the Prophet (peace be upon him): *"No harm to be inflicted and no reciprocal harm."*(31)

(29) See: International Islamic Fiqh Academy Resolution No. 63 (1/7).
(30) See: Abdul-Aziz Al-Khayyat, *"Al-Sharikat"* [2: 235].
(31) The Hadith has been related by Ibn Majah in his *"Sunan"* [2: 784].

Diminishing Partnership

- The basis for saying that all the general rules for partnerships, especially the rules for 'Inan partnership, are applicable to diminishing partnerships is to safeguard this new form of partnership from becoming a mere interest-based financing transaction in which a client undertakes to pay another party for his finance in addition to a share in the partnership income.
- The basis for the impermissibility of one partner being responsible for the expenses of insurance or maintenance is that this condition is in conflict with the nature of the partnership contract.[32]

(32) See: Fatwa No. (219) of the Fatwas of Kuwait Finance House.

Appendix (C)
Definitions

Contract Partnership (Sharikat al-'Aqd)

Contract partnership is an agreement between two or more parties to combine their assets or to merge their services or obligations and liabilities with the aim of making profit.

Partnership of Ownership (Sharikat al-Milk)

Partnership of ownership (Sharikat al-Milk) is the combination of the assets of two or more persons in a manner that creates a state of sharing the realised profit or income or benefiting from an increase in the value of the partnership assets. This combination of assets for making profit necessitates bearing losses, if any. The ownership partnership is created by events beyond the partners' control such as the inheritance rights of heirs in the legacy of a deceased person. This partnership is also created by the wish of the partners such as when two or more parties acquire common shares in a particular asset.

Mufawadah Partnership

Mufawadah partnership is any partnership in which the parties are equal in all respects, such as funds contributed by them, their right to act and their liability, from the commencement of the partnership to the date of its termination.

Sharecropping Partnership (Muzara'ah)

Sharecropping is partnership in crops in which one party presents land to another for cultivation and maintenance in consideration for a common defined share in the crop.

Irrigating Partnership (Musaqat)

Irrigating partnership is a partnership that depends on one party presenting designated plants/trees that produce edible fruits to another in order to work on their irrigation in consideration for a common defined share in the fruits.

Agricultural Partnership (Mugharasah)

Agricultural partnership is a partnership in which one party presents a treeless piece of land to another to plant trees on it on the condition that they share the trees and fruits in accordance with a defined percentage.

Distribution of Proceeds and Profits

Distribution of proceeds and profits is a process of termination an undivided ownership in the company by the final distribution of the assets whereby rights of each partner are defined and common shares are partitioned into identified sets for each partner. This is why distribution is defined as identification of undefined shares or proceeds of a particular person.

Shari'ah Standard No. (13)

Mudarabah

(Revised Standard)

Contents

IN THE NAME OF ALLAH, THE ALL-MERCIFUL, THE MOST MERCIFUL

All praise be to Allah, the Lord of all the worlds, and blessings and peace be upon our master, Muhammad, and his household and all his companions

Preface

The aim of this standard is to explain the Shari'ah rulings for restricted and unrestricted Mudarabah, whether the Islamic financial Institution (Institution/Institutions)[1] is acting in the capacity of a Mudarib (entrepreneur) or in the capacity of an investor.

(1) The word (Institution/Institutions) is used here to refer, in short, to Islamic financial institutions including Islamic Banks.

Statement of the Standard

1. Scope of the Standard

This standard covers Mudarabah contracts between the Institution and the other entities or individuals. It also covers joint investment accounts and special purpose investment accounts if these accounts are administered on the basis of Mudarabah.

The standard does not cover Sukuk of Mudarabah (Mudarabah Certificates) or other types of partnership contracts, as these are covered by separate standards.

2. Definition of Mudarabah

Mudarabah is a partnership in profit whereby one party provides capital (Rab al-Mal) and the other party provides labour (Mudarib).

3. Agreement of Mudarabah Financing

3/1 It is permissible, on the basis of a general framework or a memorandum of understanding, to conclude Mudarabah financing contracts for a particular sum of money and within a particular defined duration provided that the memorandum of understanding will be later implemented in line with specific or successive Mudarabah transactions.

3/2 The memorandum of understanding should define the general contractual framework, indicating the intention of the parties to use either unrestricted or restricted Mudarabah financing instrument, either through revolving transactions or separate transactions. Also, the memorandum of understanding should indicate the profit ratio, and type of guarantees that shall be presented by the Mudarib to cover situations of negligence, misconduct or breach of contract and other relevant issues in this regard.

3/3 If the Mudarabah contract is actually concluded on the basis of the memorandum of understanding, the contents of the memorandum become an integral part of any future contract, unless the parties had originally agreed to exempt themselves from some of the obligations mentioned therein.

4. Mudarabah Contract

4/1 The Mudarabah contract may be concluded using terms such as Mudarabah, Qirad or Mu'amalah.

4/2 Both parties should possess the legal capacity to appoint agents and accept agency. Therefore, a Mudarabah contract may not be concluded in the absence of two contracting parties with absolute legal capacity or of their agents who enjoy legal capacity similar to that of the contracting parties.

4/3 The general principle is that a Mudarabah contract is not binding, i.e. each of the contracting parties may terminate it unilaterally except in two cases:

4/3/1 When the Mudarib has already commenced the business, in which case the Mudarabah contract becomes binding up to the date of actual or constructive liquidation.

4/3/2 When the contracting parties agree to determine a duration for which the contract will remain in operation. In this case, the contract cannot be terminated prior to the end of the designated duration, except by mutual agreement of the contracting parties.

4/4 A Mudarabah contract is one of the trust-based contracts. Therefore, the Mudarib is investing Mudarabah capital on a trust basis in which case the Mudarib is not liable for losses except in case of breach of the requirements of trust, such as misconduct in respect to the Mudarabah fund, negligence and breach of the terms of Mudarabah contract. In committing any of these, the Mudarib becomes liable for the amount of the Mudarabah capital.

5. Types of Mudarabah

Mudarabah contracts are divided into unrestricted and restricted Mudarabah.

5/1 An unrestricted Mudarabah contract is a contract in which the capital provider permits the Mudarib to administer a Mudarabah fund without any restrictions. In this case, the Mudarib has a wide range of trade or business freedom on the basis of trust and the business expertise he has acquired. An example of unrestricted Mudarabah is when the capital provider says, "Do business according to your expertise". However, such unrestricted business freedom in an unrestricted Mudarabah must be exercised only in accordance with the interests of the parties and the objectives of the Mudarabah contract, which is making profit. Therefore, the actions of the Mudarib must be in accordance with the business customs relating to the Mudarabah operations: the subject matter of the contract.

5/2 A restricted Mudarabah contract is a contract in which the capital provider restricts the actions of the Mudarib to a particular location or to a particular type of investment as the capital provider considers appropriate, but not in a manner that would unduly constrain the Mudarib in his operations.

6. Guarantees in a Mudarabah Contract

The capital provider is permitted to obtain guarantees from the Mudarib that are adequate and enforceable. This is circumscribed by a condition that the capital provider will not enforce these guarantees except in cases of misconduct, negligence or breach of contract on the part of Mudarib.

7. Requirements Relating to the Capital

7/1 In principle, the capital of Mudarabah must be provided in the form of cash. However, it may be presented in the form of tangible assets, in which case the value of the assets is the contribution to the Mudarabah capital. The valuation of the assets may be conducted by experts or as agreed upon by the contracting parties.

7/2 The capital of Mudarabah should be clearly known to the contracting parties and defined in terms of quality and quantity in a manner that eliminates any possibility of uncertainty or ambiguity.

7/3 It is not permissible to use a debt owed by the Mudarib or another party to the capital provider as capital in a Mudarabah contract.

7/4 For a Mudarabah contract to be valid and for the Mudarib to be considered as having control over the capital, the capital must be, wholly or partially, put at the disposal of the Mudarib, or the Mudarib must have free access to the capital.

8. Rulings And Requirements Relating to Profit

8/1 It is a requirement that the mechanism for distributing profit must be clearly known in a manner that eliminates uncertainty and any possibility of dispute. The distribution of profit must be on the basis of an agreed percentage of the profit and not on the basis of a lump sum or a percentage of the capital.

8/2 In principle, it is not permissible to earn a share of profit in addition to a fee in a Mudarabah contract. However, it is permissible for the two parties to construct a separate agreement independent of the Mudarabah contract assigning one party to perform, for a fee, a business activity that is not by custom part of Mudarabah operations. The independence of this separate agreement means that if the contract of providing this activity is terminated, this will not affect the contract of Mudarabah.

8/3 The parties shall agree on the ratio of profit distribution when the contract is concluded. It is also permissible for the parties to change the ratio of distribution of profit at any time and to define the duration for which the agreement will remain valid.

8/4 If the parties did not stipulate the ratio of profit distribution, then they shall refer to customary practice, if any, to determine the shares of profit. If the customary practice is that the profit is distributed equally, then this will be applied as such. If there is no customary practice in this regard, the Mudarabah contract is regarded void

ab initio, and the party who acts as the Mudarib should receive a common market price for the kind and amount of services that he provided as Mudarib.

8/5 If one of the parties stipulates that he should receive a lump sum of money, the Mudarabah contract shall be void. This rule does not apply to a situation where the parties agree that if the profit is over a particular ceiling then one of the parties will take the additional profit and if the profit is below or equal to the amount of the ceiling the distribution of profit will be in accordance with their agreement.

8/6 It is not permissible for the capital provider to give the Mudarib two amounts of capitals on condition that the profit earned on one of the two amounts would be taken by the Mudarib while the capital provider would take the profit earned on the other amount. It is not also permissible for the capital provider to state that the profit of one financial period would be taken by the Mudarib and the capital provider would take the profit of the following financial period. Similarly, it is not permissible to assign the profit from a particular transaction to the Mudarib and the profit from another transaction to the capital provider.

8/7 No profit can be recognised or claimed unless the capital of the Mudarabah is maintained intact. Whenever a Mudarabah operation incurs losses, such losses stand to be compensated by the profits of future operations of the Mudarabah. The losses brought forward should be set against the future profits. All in all, the distribution of profit depends on the final result of the operations at the time of liquidation of the Mudarabah contract. If losses are greater than profits at the time of liquidation, the balance (net loss) must be deducted from the capital. In this case, as he is a trustee the Mudarib is not liable for the amount of this loss, unless there is negligence or misconduct on his part. If the total Mudarabah expenses are equal to the total Mudarabah revenues, the capital provider will receive his capital back without either profit or loss, and there will be no profit in which the Mudarib is entitled to a share. If profit is realised, it must be distributed between the parties as per the agreement.

8/8 The Mudarib is entitled to a share of profit as soon as it is clear that the operations of the Mudarabah have led to the realisation of a profit. However, this entitlement is not absolute, as it is subject to the retention of interim profits for the protection of the capital. It will be an absolute right only after distribution, i.e. when actual or constructive valuations take place. It is permissible to distribute the realised profit among the parties on account, in which case the distribution will be revised when actual or constructive valuation takes place. The final distribution of profit should be made based on the selling price of the Mudarabah assets, which is known as actual valuation. It is also permissible that the profit be distributed on the basis of constructive valuation, which is valuation of the assets on the basis of fair value. Receivables shall be measured at the cash equivalent, or net realisable value, i.e. after the deduction of a provision for doubtful debts. In measuring receivables, neither time value (interest rate) nor discount on current value for extension of period of payment shall be taken into consideration.

8/9 If the Mudarib has commingled his own funds with the Mudarabah funds, the Mudarib becomes a partner in respect of his funds and a Mudarib in respect of the funds of the capital provider. The profit earned on the two commingled funds will be divided proportionately to the amounts of the two funds, in which case the Mudarib takes the profit attributable to his own funds, while the remaining profit is to be distributed between the Mudarib and the capital provider according to the provisions of the Mudarabah contract.

9. Duties and Powers of the Mudarib

The Mudarib should employ his best efforts to accomplish the objectives of the Mudarabah contract. The Mudarib should assure the capital provider that his money is in good hands that will act to find the best ways of investing it in a permissible manner.

9/1 If a Mudarabah contract is concluded on an unrestricted basis, the Mudarib is permitted, in general, to do what entrepreneurs do in his field of activity, including the following:

9/1/1 Attending to all permissible investment or trading fields that are feasible, given the amount of the capital at his disposal, and in which he believes that his expertise, and technical and professional qualifications are likely to give him the ability to compete effectively.

9/1/2 Carrying out the work himself or appointing another person to carry out some work if necessary, such as buying a commodity or marketing it for him.

9/1/3 Choosing as far as possible appropriate places and markets that are seemingly free of risks.

9/1/4 Safeguarding the Mudarabah funds or depositing them in the custody of a trustworthy person whenever appropriate.

9/1/5 Selling and buying on a deferred payment basis.

9/1/6 The Mudarib may do, either by permission or appointment of the capital provider, the following:

a) The Mudarib may, at any time, combine a Mudarabah contract and a partnership (Sharikah) contract, irrespective of whether this takes place at the outset of the contract or after the commencement of Mudarabah operations, and of whether the partnership contribution is from the Mudarib himself or from a third party. The mixture of unrestricted investment deposits with the Institutions' funds is an example of this kind of combination.

b) The Mudarib may accept funds from a third party on a Mudarabah basis if this new contract will not affect his investment and management responsibility in respect of the first Mudarabah contract.

9/2 It is permissible for the capital provider, on the basis of his interests, to place restrictions on the actions of the Mudarib. Thus, Mudarabah operations may be restricted to a specified time and place, so that the Mudarib may only invest the Mudarabah funds during a particular time period or in a specified country or in a market of a particular

country. In addition, the Mudarabah operations may be restricted to investment in certain sectors such as services or trade sectors or a single commodity or a group of commodities. However, restricting the Mudarabah operations to certain commodities is circumscribed with a condition that such commodities must be commonly available so that, other things being equal, the restriction will not prevent the objectives of the Mudarabah contract from being achieved. For example, the commodities to which the Mudarabah is restricted must not be scarce, seasonal (and out of season) or in very limited supply with the consequence that the objectives of the Mudarabah contract cannot be achieved.

9/3 The capital provider is not permitted to stipulate that he has a right to work with the entrepreneur (Mudarib) and to be involved in selling and buying activities, or supplying and ordering. However, the Mudarib should refer to him in performing any action and should not act without consulting him. Also, the capital provider is not entitled to lay down conditions that will restrict movements or actions of the Mudarib, such as a stipulation that the Mudarib must enter into a partnership with others or a stipulation that the Mudarib must mix his personal funds with the Mudarabah funds.

9/4 The Mudarib must carry out all the work that any similar asset or fund manager would be liable, by custom, to do. In this case, the Mudarib is not entitled to a fee for this work as this is part of his responsibilities. If the Mudarib appoints another party on an Ijarah (hiring contract) basis to carry out such work, the wages for the worker must be paid from the personal funds of the Mudarib and not from the Mudarabah funds. The Mudarib may hire against the account of Mudarabah funds another party, at the prevailing rate, to execute work that is not by custom the responsibility of the Mudarib.

9/5 The Mudarib is not entitled to sell items for the Mudarabah operation at less than the common or market price, or to buy items for the Mudarabah operation at a price higher than common prices, unless if such action in either case is intended to achieve an objective that is obviously in the interest of the Mudarabah.

9/6 It is not permissible for the Mudarib to make a loan or a gift or a charitable donation out of the Mudarabah funds. Likewise, the Mudarib is not entitled to waive a right associated with the Mudarabah operation unless the capital provider has consented to his doing so.

9/7 If the Mudarib has a right to receive living expenses from the Mudarabah funds that has been approved by the capital provider, then he is entitled to the amount so approved for him. If there is no agreement on this, then the Mudarib should take living expenses in accordance with custom and reason. The Mudarib is also entitled to travelling expenses in accordance with custom and reason.

10. Liquidation of a Mudarabah Contract

10/1 A Mudarabah contract can be liquidated in the following manner:

10/1/1 Being a non-binding contract, it can be liquidated by unilateral termination of the contract by one of the parties. [see item 4/3]

10/1/2 With the agreement of both parties.

10/1/3 On the date of maturity if the two parties had earlier agreed to set a time limit for it. [see item 3/4]

10/1/4 When the funds of Mudarabah contract have been exhausted or have suffered losses.

10/1/5 The death of the Mudarib or the liquidation of the institution that acts as Mudarib.

10/2 On the maturity of a Mudarabah operation, the assets should be liquidated in the manner explained in item 8/8.

11. Date of Issuance of the Standard

This Standard was issued on 4 Rabi' I, 1424 A.H., corresponding to 16 May 2002 A.D.

Adoption of the Standard

The Shari'ah Standard on Mudarabah was adopted by the Shari'ah Board in its meeting No. (8) held in Al-Madinah Al-Munawwarah during the period of 28 Safar to 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D.

Appendix (A)
Brief History of the Preparation of the Standard

In its meeting No. (5) held in Makkah Al-Mukarramah during the period of 8-12 Ramadan 1421 A.H., corresponding to 4-8 December 2001 A.D., the Shari'ah Board decided to give priority to the preparation of a Shari'ah Standard on Mudarabah.

On Saturday 15 Dhul-Hajjah 1421 A.H., corresponding to 10 March 2001 A.D., the Fatwa and Arbitration Committee recommended to the Shari'ah Board the commissioning of a Shari'ah consultant to prepare a juristic study and an exposure draft on the Shari'ah Standard for Mudarabah.

In its meeting held on 18 Muharram 1422 A.H., corresponding to 12 April 2001 A.D., the Fatwa and Arbitration Committee discussed the exposure draft of the Shari'ah Rules for Mudarabah and asked the consultant to make amendments in light of the comments made by the members. The Committee also held a meeting on 20 Jumada II, 1422 A.H., corresponding to 8 December 2001 A.D., and made some amendments in light of the comments made by the members.

The revised exposure draft of the Standard was presented to the Shari'ah Board in its 7th meeting held in Makkah Al-Mukarramah during the period of 9-13 Ramadan 1422 A.H., corresponding to 24-28 November 2001 A.D. The Shari'ah Board made further amendments to the exposure draft of the Standard and decided that it should be distributed to specialists and interested parties in order to obtain their comments with the objective of discussing them in a public hearing.

A public hearing was held in Bahrain during the period of 29-20 Dhul-Hajjah 1422 A.H., corresponding to 2-3 February 2002 A.D. The public

hearing was attended by more than thirty participants representing central Institutions, Institutions, accounting firms, Shari'ah scholars, academics and others who are interested in this field. Some of the members of the Shari'ah Board responded to the written comments that were sent prior to the public hearing as well as to the oral comments that were expressed in the public hearing.

The Shari'ah Standards Committee in its meeting held during the period of 21-22 Dhul-Hajjah 1422 A.H., corresponding to 6-7 March 2002 A.D., in the Kingdom of Bahrain discussed the comments made on the exposure draft. The Committee made the amendments which it considered necessary in light of both the discussions that had taken place in the public hearing and the written comments that had been received.

The Shari'ah Board in its 8th meeting held on 28 Safar - 4 Rabi' I, 1423 A.H., corresponding to 11-16 May 2002 A.D., in Al-Madinah Al-Munawwarah discussed the amendments made by the Shari'ah Standards Committee, and made the necessary amendments, which it deemed necessary. Some paragraphs of the standard were adopted by the unanimous vote of the members of the Shari'ah Board, while the other paragraphs were adopted by the majority vote of the members, as recorded in the minutes of the Shari'ah Board.

The Shari'ah Standards Review Committee reviewed the Standard in its meeting held on Rabi' II, 1433 A.H., corresponding to March 2012 A.D., in the State of Qatar, and proposed after deliberation a set of amendments (additions, deletions, and rephrasing) as deemed necessary, and then submitted the proposed amendments to the Shari'ah Board for approval as it deemed necessary.

In its 41st meeting held in Al-Madinah Al-Munawwarah, Kingdom of Saudi Arabia during the period of 27-29 Sha'ban 1436 A.H., corresponding to 14-16 June 2015 A.D., the Shari'ah Board discussed the proposed amendments submitted by the Shari'ah Standards Review Committee. After deliberation, the Shari'ah Board approved necessary amendments, and the Standard was adopted in its current amended version.

Appendix (B)
The Shari'ah Basis for the Standard

Permissibility of Mudarabah and Its Rationale

- Mudarabah, known also as Qirad, is a contract that arranges cooperation in business investment between capital on one hand and entrepreneurship on the other, whereby the contracting parties jointly and commonly own the realised profit as per the agreement. The party providing the capital is known Rab al-Mal and the investor is known as Mudarib or 'Amil (literally. worker) or Muqarid.(2)

Mudarabah contract derives its permissibility from the following:(3)

a) From the Qur`an is the Saying of Allah, the Almighty: ***{"Others travelling through the land, seeking of Allah's bounty"}***.(4) This verse is interpreted to mean those who travel for the purpose of trading and seeking permissible income in order to provide for themselves and their family.

b) From the Sunnah is the Hadith that says, "Al-'Abbas Ibn Abdul-Muttalib used to pay money for Mudarabah and to stipulate to the Mudarib that he should not travel by sea, pass by valleys or trade in livestock, and that the Mudarib would be liable for any losses if he did so. These conditions were brought before the Prophet (peace be upon him) and he approved them".(5) Among the Hadiths regarding the permissibility of Mudarabah is the case that states that "Umar Ibn

(2) Al-Marghinani, *"Al-Hidayah Sharh Bidayat Al-Mubtadi"* [3: 202]; Al-Kasani, *"Bada`i' Al-Sana`i'"* [6: 56 and 57]; Ibn Rushd, *"Bidayat Al-Mujtahid"* [2: 236]; and Ibn Qudamah, *"Al-Mughni"* [3: 26].

(3) *"Takmilat Al-Majmu'"* [14: 357-360]; *"Subul Al-Salam"* [3: 76]; *"Bidayat Al-Mujtahid"* [2: 236]; *"Al-Hidayah"* [2: 202]; *"Al-Mughni"* [5: 26]; and *"Al-Muhadhdhab"* Printed with *"Al-Majmu'"* [14: 357].

(4) [Al-Muzzammil (The One Wrapped in Garments): 20].

(5) The Hadith has been related by Al-Bayhaqi [6: 111].

Al-Khattab gave one man the funds belonging to an orphan for the purpose of Mudarabah and the man was trading with these funds in Iraq".(6)

c) Ibn Al-Mundhir mentioned that there is generally consensus among the scholars in respect to the permissibility of a Mudarabah contract.(7)

- The rationale for making this contract permissible includes the following:

a) Money cannot increase unless it is associated with work. It is also not permissible to provide money in return for a periodic pre-agreed payment (rent) to a person who is willing to invest it as this will constitute a debt with Riba.

b) The Mudarabah contract is made permissible to facilitate investment cooperation between capital providers who are not prepared to invest and manage their money themselves, and competent business or investment experts who lack adequate capital. In other words, there are some individuals who are rich but lack business or investment know-how and others who have business or investment expertise but lack money. This situation thus calls for the permissibility of the Mudarabah contract so as to combine the interests of the two parties.(8)

Moreover, a Mudarabah contract is an instrument that was commonly used in trade and which usage expanded in modern times to include business, services, and agricultural or horticultural and industrial activities.

a) The business philosophy of conventional banks depends on the concept of renting out money and making profit in doing so, while Shari'ah prohibits this philosophy because of its being Riba. The Mudarabah financing instrument has been an essential instrument to develop Islamic financial Institutions (Institution/Institutions). This instrument is used by these institutions to attract unrestricted or restricted investment accounts and to reinvest these funds in various activities.

(6) The Hadith has been related by Al-Bayhaqi in *"Al-Ma'rifah"* (see: Al-Zayla'i, *"Nasb Al-Rayah"*).
(7) *"Al-Mughni"* [7: 133-134].
(8) *"Takmilat Al-Majmu'"* [14: 371].

Contract of Mudarabah

- The basis for the rule that both parties to a Mudarabah contract must be legally capable to appoint, or act as, an agent is because each party acts as an agent of the other party and appoints the other party to act on his behalf. The entitlement to appoint or act as an agent entitles one to conclude a Mudarabah contract.
- The basis for regarding a Mudarabah contract initially as a non-binding contract is that the Mudarib is using the capital provider's funds with his consent in a contractual relationship in which the Mudarib is just an agent, and an agency contract is not binding.
- The basis for making a Mudarabah contract binding once the work has commenced is that a unilateral termination of the contract at this stage might frustrate the objective of the parties to make profit and might cause damage to the Mudarib since he might not receive any compensation for his work.
- The basis for allowing a time limit for the operation of a Mudarabah contract is that a Mudarabah contract is, in essence, an agency contract, which is subject to a designated duration.(9) The International Fiqh Academy has issued a resolution in this respect.(10)
- The basis for considering the Mudarib as a trustee with respect to the Mudarabah funds is that the Mudarib is using another person's money with his consent, and the Mudarib and the owner of the funds share the benefits from the use of the funds. In principle, a trustee should not be held liable for losses sustained by the funds. Rather, the risks of such losses must be borne by the Mudarabah funds.

Guarantees in a Mudarabah Contract

- The basis for allowing guarantees in a Mudarabah that would be used in case of misconduct and negligence of the Mudarib is that in such a case the Mudarib then becomes liable for losses and must bear the consequences of these actions.(11)

(9) *"Al-Mughni"* [7: 133-134].

(10) Resolution No. 122 [5: 13].

(11) This is the opinion of the Shari'ah Board of Al Rajhi Company, see *"Al-Mudhakkirah Al-Tafsiriyyah"*. It is also endorsed in the First Al Baraka Forum.

Requirements Relating to the Capital

- The basis for it being permissible that the capital of Mudarabah may be constituted by the value of tangible assets contributed is that the objective of Mudarabah is to make profit. This objective can be realised whether the capital is contributed in the form of tangible assets or cash. This rule is based on the view of the Maliki and the Hanbali jurists.(12)
- The basis for the requirement that the capital of Mudarabah should be clearly known and should be defined in terms of quality and quantity in a manner that eliminates any possibility of uncertainty or ambiguity is because recognition of profit is dependent on the recovery of the capital on the date of liquidation. However, recovery of the capital cannot be ascertained if its amount was not known earlier, and this lack of knowledge may potentially lead to a dispute.
- The basis for not allowing a debt owed by the Mudarib to the capital provider be contributed as capital in a Mudarabah contract is because, as a principle, Mudarabah capital must be (at the conclusion of a Mudarabah contract) an asset that is available and cannot be used on the spot for the Mudarabah operations. A debt fails to meet this requirement, as it is a receivable that is not available for use when the contract is concluded. Moreover, considering a debt as capital of Mudarabah involves potential Riba. This is because the creditor may be suspected of having extended the debt tenure in order to get additional consideration (for the extension) from the debtor under the name of Mudarabah.
- The basis for the requirement that the Mudarabah operation is valid only if the capital is presented to the Mudarib is because the Mudarib is the manager of the Mudarabah operation, and the trustworthy trustee for the Mudarabah capital and income. Therefore, it is necessary that the capital be fully released to the Mudarib so that he will be able to protect and invest the capital and achieve the objective of the Mudarabah contract.(13)

(12) *"Hashiyat Al-Dusuqi"* [3: 517]; and *"Al-Mughni"* [5: 17].
(13) *"Al-Hidayah"* [3: 203]; and *"Hashiyat Al-Dusuqi"* [3: 517].

Rules and Requirements Relating to Profit

- The basis for the requirement that the profit ratio is known is because profit is the subject matter of a Mudarabah contract and a lack of knowledge as to the subject matter renders a contract void.
- The basis for the requirement that the profit share of each party be a percentage of the profit and not a lump sum is because a Mudarabah contract is a form of partnership for sharing profit. Any condition that allocates a lump sum to one party would not be consistent with the sharing of profit. This is because the Mudarabah operation may not realise a profit other than the lump sum which goes to one party, thus excluding the other party from partnership in profit.
- The basis for the impermissibility of simultaneously receiving a share of profit and a fee for managing a Mudarabah is likewise that the fee is provided in the form of a lump sum and the Mudarabah operation may not realise a profit other than the lump sum, thus precluding the sharing of profit.
- The basis for the permissibility of an agreement to change the ratio of profit distribution at any time is that the profit is a right belonging to the parties and an agreement in the manner described does not lead to a prohibited act, such as preclusion of sharing in profit. Rather, the agreement makes the parties partners in profit.(14)
- The basis for nullifying a Mudarabah contract when the contract is silent on the ratio of profit distribution and there is no customary practice according to which the profit is to be distributed to each party is that the subject matter of a Mudarabah contract is profit. The lack of knowledge as to the subject matter nullifies contracts.
- The basis for nullifying a Mudarabah contract when one party stipulates entitlement to a lump sum is because a Mudarabah is about sharing profit and this form of condition precludes sharing of profit and may potentially lead to one party being wrongfully deprived of his rights.

(14) See: Al Baraka's 11th Forum, Fatwa No. (8); Al Baraka's 4th Forum, Fatwa No. (5). This is also seconded by the Fatwa of the Shari'ah Board of Faisal Islamic Bank, Sudan (P. 107), which was published in *"Dalil Al-Fatawa Al-Shar'iyyah Fi Al-A'mal Al-Masrafiyyah"*, Islamic Economic Centre, International Islamic Bank, (P. 53).

- The basis for not allowing an agreement that the Mudarib be entitled to the profit earned on one of two capital funds, while the profit earned on the other capital fund belongs to the capital provider, is that such an agreement may preclude the sharing of profit and may potentially lead to one party being wrongfully deprived of his rights.
- The basis for stating that profit is not realised unless the capital is recovered or maintained intact is the Hadith in which the Prophet (peace be upon him) said: *"The instance of a Musali (a person who performs prayer) is that of a businessperson who will not secure profit unless the capital is secured. Likewise, a supererogatory prayer is not acceptable unless the obligatory prayer is performed"*.(15) This Hadith shows that distribution of profit prior to recovery of the capital, or unless the capital is maintained intact, is invalid. Moreover, profit is an addition to the capital and such an addition cannot be recognised or realised unless the capital that is the source of the profit is maintained.
- The basis for the requirement that the Mudarib is preliminarily entitled to a profit when realised, i.e. prior to distribution (an encumbrance right), and that the net profit earned will be known absolutely only after allocation through actual or constructive valuation, is analogous to the contract of sharecropping. The Mecca based Islamic Fiqh Academy has issued a resolution in support of constructive valuation.(16)

Duties and Powers of the Mudarib

- The basis for allowing the Mudarib freedom of action in an unrestricted Mudarabah is that the Mudarib has the aim of achieving the objective of the capital provider, which is making profit, and this is not possible unless the capital is vigorously put into operation.
- The basis for not allowing the capital provider to stipulate a right to work with the entrepreneur (Mudarib) or to be involved in acts relating to Mudarabah operations is because such a stipulation would curtail

(15) The Hadith has been related by Al-Bayhaqi in his *"Sunan"*, and was narrated by Ali Ibn Abu Talib. Al-Bayhaqi stated that there is a weak narrator in the chain of transmission of this Hadith, *"Al-Mawsu'ah Al-Fiqhiyyah"* [38: 74].

(16) Resolution No. (4) of the Islamic Fiqh Academy under the auspices of Muslim World League issued in the sixth session that was held in Mecca. This is also the view that was endorsed by Al Baraka's 8th Forum, Fatwa No. (2).

the freedom of the Mudarib, limit the investment scope and hinder the Mudarib in achieving the objective of the Mudarabah contract, i.e. making profit.

- The basis for not allowing the Mudarib to make a loan, gift or charitable donation from the Mudarabah fund is because these actions do not benefit the Mudarabah operation, rather, they involve potential loss to the capital provider.
- The basis for allowing the Mudarib, when acting in the interest of the Mudarabah and in the event that the parties did not specify an amount of money for expenses, to obtain personal expenses from the Mudarabah funds as per customary practice is because what is known by custom is deemed to apply as a condition even if the parties did not clearly stipulate it. Again, the permission for the Mudarib to obtain common personal expenses in these cases is granted by custom.

Liquidation of Mudarabah Contract

- The basis for allowing liquidation of a Mudarabah contract unilaterally or by agreement of the parties or at the maturity date is because a Mudarabah contract is non-binding if the parties did not stipulate a term for its maturity.
- The basis for allowing constructive valuation is because Shari'ah has endorsed the concept of valuation. In addition, this is allowed because it is a valid tool that passes rights to owners appropriately. The actual valuation of assets for distribution is based on a common sense because this is the principle.
- The basis for allowing a Mudarabah contract be terminated on the grounds of loss of capital is that when the capital has been lost, the Mudarib is not able to put it to work in a business, and that the fund that was assigned for the Mudarabah is no longer in existence, thus entailing the termination of the Mudarabah contract.
- The basis for allowing termination of a Mudarabah contract due to the death of the Mudarib is that a Mudarabah contract is similar to contract of agency or, at least, it includes agency and an agency contract is terminable by the death of the agent.

Appendix (C)
Definitions

Sharikah

Sharikah is an agreement between two or more parties to merge their assets or to combine their services, obligations and liabilities with the aim of making profit.

A Mudarabah contract is distinguished from a Sharikah (Musharakah) contract in the following respects:

a) The basis for earning a share of profit in Sharikah is the required capital contribution of all parties, whether in the form of cash, commodities, services or liability in the case of reputation partnership and that the subject of the contract is based on a single element, i.e. capital. The basis for earning a profit in a Mudarabah, on the other hand, comes from two elements: the first element is the existence of capital that is subject to, and similar to, the conditions of Sharikah capital; the second element is the work done by the Mudarib that is different from the capital of the venture.

b) In Sharikah, the work, as a general rule, is to be done jointly by the parties, whereas in Mudarabah it is the Mudarib who works.