BANK NEGARA MALAYSIA
CENTRAL BANK OF MALAYSIA

DRAFT OF SHARIAH PARAMETER REFERENCE 3: MUDARABAH CONTRACT

(SPR3)

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SECTION 1: BACKGROUND AND PREAMBLE

1. *Mudarabah* is a form of Islamic equity-based partnership contract, commonly known as a profit-sharing contract. It is a partnership contract where the capital provider contributes the capital while the manager provides managerial skills to manage the *Mudarabah* capital accordingly. In practice, the *Mudarabah* contract could be categorized into unrestricted/general and restricted/specific *Mudarabah* contracts. It could involve a one-tier or multi-tiered *Mudarabah* arrangements. The parties involved in a *Mudarabah* contract share the profit between them. However, the loss will be borne solely by the capital provider in the absence of misconduct or negligence or breach of the partnership terms and conditions by the manager. Hence, the element of trust based on the fiduciary relationship between the parties is the foundation of this contract.

2. The significant application of a *Mudarabah* contract could be achieved in the combination of financial and managerial resources between the parties. *Mudarabah* is functionally adaptive in the area of general or specific investment, project financing, bridge financing, working capital and SME financing, inter-bank investment, structured products, investment deposits, etc. The capital[1] as wealth entrusted to the manager promotes mutual goodwill among the partners and channels wealth to productive use. The manager in the position of trustee should act in full integrity and is expected to perform in the best manner to achieve the desired aim of the capital provider who has invested his capital without having any control in the management of the venture.

[1] The term 'capital' referred to in this document is *Mudarabah* capital which includes *Mudarabah* funds received from or placed with an entity or individual.

SECTION 2: PURPOSE AND SCOPE

3. The purpose of this Shariah Parameter Reference 3: *Mudarabah* Contract is to provide reference on the nature and features of the contract to the Islamic financial services industry. This parameter will be endorsed by the Shariah Advisory Council of Bank Negara Malaysia. Specific definition and guidelines on the basis of legitimacy in adopting the *Mudarabah* contract are described to facilitate the understanding of the Shariah contract requirements. The features identified in this parameter shall serve to assist the Islamic financial services industry to identify, understand, apply and distinguish the contract from other contracts prevalent in the industry.

4. The features identified and described in this parameter are extracted from the text of fatwas opined by Shariah boards or committees of financial authorities and financial institutions. For each of the fatwa on a particular conditionality, activity, situation or context relating to the contract, the underlying concept and principle is deduced and synthesized to guide the development of the Shariah parameter.

5. The features outlined in this parameter may serve as general guidance for the application of Murabahah contract. Any practice by the Islamic Financial Institutions (IFI) which is not specified in the parameter may be conducted as long as it does not contradict the features outlined in the parameter.

6. This parameter also takes into consideration relevant mechanisms and contracts such as *Wa'd*, *Wakalah*, *Kafalah* and *Rahn* where relevant. These are identified and proposed as secondary features mentioned in this parameter.

7. The aplication of the parameter is confined to the *Mudarabah* contract as endorsed by the Shariah Advisory Council of Bank Negara Malaysia and adopted by the Islamic financial institutions under the purview of Bank Negara Malaysia.

SECTION 3: DEFINITION

Mudarabah is a joint-venture where one party contributes capital, while the other contributes managerial skills

8. The *Mudarabah* contract is a form of partnership between one who contributes capital (*rabb al-mal*/capital provider) and the other who contributes efforts in the form of managerial skills (*mudarib*/manager). *Muqaradah* and *Qirad* are also synonymous with *Mudarabah*. Profit from the outcome of the venture is shared between the capital provider and manager according to mutually agreed profit sharing ratio whilst losses are borne solely by the capital provider, provided such loss is not due to the manager's negligence or violation of specified conditions.

9. In the context of business and trade, it means a joint enterprise in which all the partners share the profit according to a mutually agreed profit sharing ratio but loss is borne solely by the capital provider/investor. This technical definition is adopted for the purpose of this parameter.

SECTION 4: LEGITIMACY OF *MUDARABAH* CONTRACT

Establishment of the legitimacy of Mudarabah via Al-Quran, the Sunnah and Ijma'.

10. The legitimacy of the *Mudarabah* contract is founded on the basis of the *Quranic* verses, the *Sunnah* of the Prophet Muhammad (SAW), and the consensus of Muslim Jurists (*Ijma*').

4.1 THE *QURAN*

11. The following *Quranic* verses imply the general permissibility of commercial ventures including *Mudarabah*.

    i. *"…*others travelling through the land, seeking of Allah's bounty…*"* (Al-Muzammil:20)

    ii. *"*And when the Prayer is finished, then may ye disperse through the land, and seek of the Bounty of Allah; and celebrate the Praises of Allah often (and without stint): that ye may prosper.*"* (Al-Jumu`ah:10)

    These verses do not directly address the permissibility of *Mudarabah* but are interpreted to imply *Mudarabah* by referring to those who travel for the purpose of trading and seeking permissible income including those who undertake labour with someone else's capital in exchange for part of the profit.

4.2 THE *SUNNAH* OF THE PROPHET MUHAMMAD (SAW)

The Narration of Ibnu Abbas

12. Ibnu Abbas r.a. reported that: "When our leader Abbas Ibn Abd al-Mutallib gives his property to someone for *Mudarabah*, he stipulated conditions for his partner not to bring the capital throughout the sea; and not to bring with him the capital crossing a valley; and not to buy livestock with the capital; and if his partner violates the conditions, he should guarantee the loss occurred. These conditions have been brought to the attention of Prophet Muhammad (SAW) and he approved them." (Mu'jam Al-Awsat; Al-Tabrani).

The Narration of Suhayb

13. Suhayb r.a. reported that the Prophet Muhammad (SAW) said: "Three matters that have the blessing (of Allah): A deferred sale, *Muqaradah (Mudarabah)*, mixing the wheat with barley for domestic use and not for sale." (Sunan Ibn Majah).

The Tacit Approval of the Prophet Muhammad (SAW)

14. *Mudarabah* venture has being practised before the Prophet's (SAW) first revelation and he did not raise or show any objections against the practice. This is considered a tacit approval by the Prophet Muhammad (SAW).

4.3 *IJMA'*

15. The Muslim jurists have reached *Ijma'* among them upon conducting *Ijtihad* on the permissibility of the *Mudarabah* contract.

16. It has also been established that the companions of the Prophet Muhammad (SAW) such as Umar, Uthman, Ali, Abdullah Ibn Mas`ud, Abdullah Ibn Umar, Ubaydullah Ibn Umar and A`ishah have placed the property of orphans under the *Mudarabah* contract with no objections from other companions.

SECTION 5: FEATURES OF *MUDARABAH* CONTRACT

17. There are a number of features or principles which are attributable to the *Mudarabah* contract. These include nature of contract, capital, management, profit sharing right and treatment of losses.

5.1 NATURE OF *MUDARABAH* CONTRACT

18. In general the contract of *Mudarabah* allows anyone of the contracting parties to terminate the contract unilaterally.

Unilateral termination of contract

19. Notwithstanding paragraph 18, the contract shall not be terminated unilaterally if the manager has commenced the work or when both parties have agreed not to terminate the contract during a specified time.

No unilateral termination in the case of commencement of work or agreement on specified termination date

5.2 CAPITAL

20. Capital is the principal feature of *Mudarabah* forming the substance of the contract. The capital shall be contributed by the capital provider only. The capital shall be managed by the manager to generate income.

Capital contribution by one party is the essence of Mudarabah

21. The capital of *Mudarabah* may be in the form of monetary or non-monetary assets.

Assets for Mudarabah capital

22. Monetary assets of different currencies shall be valued according to an agreed currency at the time of signing the *Mudarabah* contract.

Valuation of assets in a single currency

Illustration 1: Multi Currency *Mudarabah* Fund

An Islamic Financial Institution has launched a global *Mudarabah* fund. The fund accepts subscriptions of capital investment by investors in various currencies such as USD, Euro, Ringgit Malaysia, Saudi Riyal etc. However, the prospectus has stated that the *Mudarabah* fund is denominated in USD. Hence, all contributions by investors in non-USD currencies will be converted into USD equivalent amount based on the exchange rate on the day of subscription to the *Mudarabah* fund.

23. The mutually agreed currency shall be applicable throughout the *Mudarabah* business venture.

Illustration 2: Multi Currency *Mudarabah* Fund

The same global Mudarabah fund was recently re-launched in China, after 5 years of its initial launch date. The Islamic financial institution managed to collect RMB75 million during this re-launch, which accounts for some 65% of the total fund invested in the *Mudarabah* fund. However, since the Prospectus still states that the *Mudarabah* fund is denominated in USD, all the RMB will be converted into USD equivalent amount based on the exchange rate on the day of subscription to the *Mudarabah* fund.

24. Capital in the form of non-monetary assets which may include intangible assets shall be valued based on the valuation determined by a third party which may include authoritative bodies, experts or valuers, or as agreed upon by the contracting parties at the time of conclusion of contract. *Capital in the form of non-monetary asset*

Illustration 3: Non Monetary Asset *Mudarabah* Capital Contribution

A public transportation company, KL Tranz, has applied for *Mudarabah*-based financing from MNM Bank. The bank approves the application and agrees to provide ten (10) buses to KL Tranz as *Mudarabah* capital valued at RM10 million based on prevailing market value and KL Tranz should manage the operation of these buses.

25. Non-monetary *Mudarabah* capital contributed may be redeemed at its original value invested should it be possible or otherwise at its residual market value upon termination or the expiry of the contract. *Redemption of non-monetary capital*

26. Debts such as account receivables or loans due to a capital provider do not qualify as capital of *Mudarabah*. *Debts and receivables are not allowed as contributed capital*

27. The agreed capital shall be made available to the manager to commence the business activities. *Availability of capital for business*

28. The capital may be fully or partially disbursed or made available to the manager at the time of the conclusion of the contract and based on terms of the contract. *Disbursement of capital*

29. Capital provider and manager may agree for a gradual withdrawal of *Mudarabah* capital by the capital provider.

30. Failure to provide capital by the capital provider as per the agreed schedule shall constitute a breach of promise according to specified terms and conditions of the contract. The manager has an option to terminate the agreement or both parties may agree to revise the agreement based on actual capital contribution. *Failure to contribute committed capital*

31. Where the agreement is terminated the manager has to return the outstanding capital (if any). If the *Mudarabah* expenditure exceeds the actual capital contribution, such liability shall be borne by the capital provider up to the limit of the total amount committed under the contract. *Obligations of the manager and capital provider*

Illustration 4: Failure to Contribute Committed Capital in a *Mudarabah* Fund
In an Islamic private equity *Mudarabah* fund, the investors would have essentially already committed to contributing a certain amount, for example RM10 million each but the actual payment may be made upon request by the manager. The investors do not participate in executive decisions undertaken by the manager. A partner/investor has partly contributed an amount of RM 6 million but failed to contribute the remaining RM 4 million. It is stated in the subscription agreement that upon the failure of any investor to contribute the full payment of capital, the manager has an option to revoke the agreement or revise the agreement to reflect the actual capital contributed.

Capital distribution to capital provider upon liquidation of contract

32. Upon liquidation or maturity of the *Mudarabah* contract, all outstanding capital shall be returned to the capital provider (if any).

Illustration 5: Capital Redemption upon Termination or Expiry
The initial *Mudarabah* capital of a financing contract was RM 500,000. At the end of the *Mudarabah* financing period, the *Mudarabah* capital is in the form of inventory valued at market value of RM 550,000. Trade and other creditors are valued at RM200, 000 and there is a cash balance of RM 300,000. Cash available upon termination is (550,000 – 200,000 + 300,000) RM 650,000. Capital restored is RM 500,000 and profit to be shared is RM 150,000.

Liability capital redemption and profit distribution

33. Any amount due to capital provider under paragraph 32 including profit (if any) shall be deemed as debt due to the capital provider.

Illustration 6: Outstanding Capital and Profits upon Termination
At the end of the *Mudarabah* financing period, the *Mudarabah* capital of RM 500,000 provided by IFI and profits of RM 75,000 due to IFI are not redeemed. The total amount of RM 575,000 becomes a debt due from the manager.

34. The manager shall not guarantee the *Mudarabah* capital.

Capital guarantee due to negligence or breach of contract

35. The capital provider may require the manager to arrange for an independent third party performance guarantee. The guarantee shall be executed as a separate contract and be utilised to cover for any loss or depletion of capital in the event of misconduct, negligence, dishonesty, fraud or breach of the terms of the contract by the manager.

36. The third party guarantor shall be independent from the manager such that it shall not be a related party where the manager has majority ownership and/or having control in the entity nor shall it be either as a subsidiary or an entity that the manager owns or controls.

Third party guarantee of Mudarabah capital

37. The *Mudarabah* third party guarantee may be in the form of performance guarantee of the *Mudarabah* transactions or *Mudarabah* capital itself. For example, capital employed to sell assets or render services may be accompanied by a third party guarantee on payment for such sales and services.

Third party guarantee on the Mudarabah performance

Illustration 7: Permissibility of Performance Guarantee in *Mudarabah* Financing

An IFI (as capital provider) extends a *Mudarabah* trade financing facility to a customer (as manager) with the condition that a third party performance guarantee on loss due to customer's negligence is obtained. The customer as supplier of assets may also obtain third party guarantee on payment due from the purchaser to ensure payment upon delivery of the assets. These types of guarantee are permissible.

38. *Mudarib* may commingle the *Mudarabah* capital with other third party *Mudarabah* capital fund provided that the manager shall observe the agreed terms and conditions of the individual *Mudarabah* contract.

Commingling of Mudarabah capital with other funds

39. *Mudarib* may inject its own fund into the *Mudarabah* capital which will transform the initial *Mudarabah* contract into a *Musharakah* arrangement.

5.3 MANAGEMENT OF *MUDARABAH* VENTURE

40. All works and activities undertaken by the manager in relation to the *Mudarabah* capital shall be Shariah-compliant.

Mudarabah capital for Shariah compliant activities only

41. The manager shall have the exclusive right to manage the *Mudarabah* venture. The capital provider shall be precluded from managing the venture. However, the capital provider has the right to information regarding the conduct of the manager.

Exclusive management right of manager

Illustration 8: Exclusive Management Right in *Mudarabah* Venture

In formalizing the *Mudarabah* financing agreement, the capital provider specifies a condition of its involvement in the pricing strategy of the venture. At the same time it also requests periodic reporting of the performance of the venture. Based on the terms of the *Mudarabah* contract, any involvement in pricing strategy of the venture by the capital provider implies management interference and hence is not permissible. However, periodic reporting which allows effective and timely supervision of the venture without any intervention in the management of the venture is allowed.

No liability of loss from manager except for negligence, misconduct and breach of contract

42. The manager(s) shall not be liable for any loss of capital unless such loss is due to the manager(s) negligence, dishonesty, misconduct or breach of terms of the contract.

Illustration 9: Act of Negligence, Misconduct or Breach of Terms by A Manager

Negligence

Among the typical conditions specified in the *Mudarabah* contract is that the managing partner is to exercise due care and diligence. For example, the assets purchased for sale was kept in the store without Takaful coverage against fire and theft. As a result of fire some of the assets perished. The manager is liable for the loss due to his negligence of not obtaining necessary protection.

Misconduct

The scope of the *Mudarabah* agreement specified that the *Mudarabah* fund should be invested in securities with investible grades and the securities should be from the list agreed by the capital provider. During the course of investments, in anticipation of huge profits the manager invested in non-approved securities with lower ratings. If a loss arises from such investment, the manager is liable for the loss of capital.

Breach of Terms

According to the terms of *Mudarabah* venture, the manager should disclose all relevant information that is significant for the capital provider to form a decision to proceed with investing in the venture. During the presentation of the feasibility study, the manager concealed significant information which is known to the manager to be material to the decision making process. Upon engagement, losses on investment occurred and post-mortem findings indicate that such unfavourable information was not disclosed. This tantamount to the manager breaching the terms of engagement for wilful non-disclosure and hence shall bear such loss of capital.

43. The powers of the manager shall be provided under the terms and conditions of the contract which may include the scope and assignment of management of *Mudarabah* capital to a third party.

44. The scope of the restricted *Mudarabah* contract may specify conditions restricting the manager's role/functions such as determination of location, period for investment, type of project and commingling of funds, provided it does not nullify the purpose/objective of the contract. However, the restrictions shall not unduly constrain the manager. *Restrictions on the manager*

45. Unrestricted *Mudarabah* capital is the capital deployed in the *Mudarabah* contract which does not specify any limiting conditions and the manager is given the discretion provided he acts in the best interests of the capital provider. *Unrestricted Mudarabah capital*

Illustration 10: Unrestricted *Mudarabah* Fund

Aliff Investment launches a *Mudarabah* investment fund which does not restrict the scope of investments in terms of location and sectors. Aliff Investment has the liberty to manage and invest the fund in a manner that serves the best interests of the investors of the *Mudarabah* fund. This qualifies as unrestricted *Mudarabah* fund.

46. A *Mudarabah* contract shall require the manager to deploy the capital to a profitable venture. The manager shall be personally responsible to ensure the proper management of the capital is in the interest of the capital provider. *Single tiered Mudarabah*

47. The manager of a *Mudarabah* contract may assign the capital to another manager in another *Mudarabah* contract with the consent of the primary capital provider. *Multi-tiered Mudarabah*

Illustration 11: Multi-Tiered *Mudarabah*

A *Mudarabah* capital fund subscribed by investors specified that the fund is to be proportionately invested: 30% in Shari'ah approved equities, 30% in Sukuk and 40% in real estate properties. The fund manager allocates the fund according to the three sectors and engaged three managers, each specialised in the different sectors to manage the three separate funds. The performance of each fund is shared between the manager of each fund and the fund manager. The fund manager will then share the portfolio performance of the *Mudarabah* fund with the investors.

5.4 PROFIT SHARING RIGHTS

Mudarabah is profit motivated

48. Profit Sharing is the primary motive of the *Mudarabah* contract.

49. Profit shall be based on revenue after deducting all operating costs of the venture and, taxes (where relevant).

Illustration 12: Profit from *Mudarabah* Venture
Unrestricted *Mudarabah* funds account for 50% of the total capital mobilized by an IFI which include deposit and shareholder funds. The *Mudarabah* contract specifies a profit sharing ratio of 80:20 between investors and the IFI, and that only operational expenses are to be deducted prior to profit distribution to *Mudarabah* investors. In the current operating year, the IFI reported an income of RM 10 million and total expenses of RM 8 million of which 60% is operating expenses. Profit distributable to *Mudarabah* funds is {0.8 X 0.5 X (10 – [0.6 X 8])} = RM 2,080,000.

Profit sharing ratio expressed as a ratio or percentage

50. The profit sharing may be based on a ratio or percentage to be agreed upon by all partners.

Determination and revision of profit sharing ratio

51. The profit sharing ratio shall be determined at the time of the conclusion of contract and may be revised from time to time during the contract subject to mutual agreement.

Illustration 13: Profit Sharing Arrangement
A *Mudarabah* agreement stipulates that the IFI shares 60% of profit after deducting approved expenses as specified in the agreement and accepted by the customer. As such, the profit sharing ratio between the IFI and the customer is 60:40 respectively.

Impermissibility of fixed amount as profit share

52. It is not permissible to include a condition in *Mudarabah* contract that stipulates a pre-determined fixed amount of profit to one partner which deprives the profit share of the other partner.

Permissibility of lump sum or fixed amount as profit share

53. Notwithstanding paragraph 52 and subject to certain conditions, a lump sum amount or fixed amount of profit may be permissible if it does not deprive the other partner from benefiting from, and sharing in, the profit.

Illustration 14: Lump sum profit share in Mudarabah venture

A Mudarabah agreement begins with a simple profit sharing ratio of 50:50. The capital provider further specifies that should the venture achieve a target profit above RM100,000, the capital provider will keep the first RM100,000 with the balance to be given to the manager. During the contract period, if the profit is RM 80,000 the profit share to the manager and capital provider each is RM 40,000. If the profit is RM 150,000, the profit share of the manager is RM50,000 and the profit to the capital provider is RM100,000.

54. The profit sharing ratio may be tiered to a target specific profit rate or threshold amount as per a specified benchmark. Thus any profit rate or return that exceeds a specified benchmark may be allocated to the designated partners based on another formula of distribution such as the level of actual performance as long as this is mutually agreed upon and is included in the contract. *Permissibility of tiered profit sharing ratio*

Illustration 15: Tiered Profit Sharing Ratio- Case A

XYZ Sdn. Bhd. entered into a *Mudarabah* agreement valued at RM1 million of *Mudarabah* capital with Aliff Bank at an agreed profit sharing of 40:60.

<u>(Case A)</u>

In addition, as an incentive for XYZ Sdn. Bhd. – the manager, Aliff Bank stated that if XYZ Sdn. Bhd. could manage to generate a return of more than 15%, then the excess of profit would be allocated solely to XYZ Sdn. Bhd.. At the end of the year, XYZ Sdn. Bhd. managed to generate a return of 21% (RM210, 000). Hence, the distribution of profit will be as follows:

Profit subject to profit-sharing ratio:

15/21 x RM210, 000 = RM150, 000

XYZ Sdn. Bhd : 0.4 x RM150, 000 + The profit exceeding 15% return.
: RM 60, 000 + (RM210,000-150, 000)
: RM60, 000 + RM60, 000
: <u>RM120, 000</u>

Aliff Bank : 0.6 x RM150, 000
: <u>RM90, 000</u>

Illustration 16: Tiered Profit Sharing Ratio- Case B

(Case B):

In addition, Aliff Bank stipulated that if XYZ Sdn. Bhd. could manage to generate a return of more than 15%, then RM10,000 of the excess profits would be for Aliff Bank and the remaining for XYZ Sdn. Bhd. At the end of the year, XYZ Sdn. Bhd. managed to obtain a return of 21% (RM210, 000). Hence, the distribution of profit as follows:

Profit subject to profit-sharing ratio:

15/21 x RM210, 000= RM150, 000

Aliff Bank : 0.6 x RM150, 000 + RM10, 000 of the profit exceeding 15% return.
: RM90, 000 + RM10, 000
: RM100, 000

XYZ Sdn. Bhd.: 0.4 x RM150, 000.00 + The balance of profit exceeding 15% return.
: RM 60, 000 + (RM60,000 - RM10, 000)
: RM60, 000 + RM50, 000
: RM110, 000

55. The profit in the form of certain percentage shall not be linked to the capital investment amount. However, a profit sharing ratio may be ultimately translated into a fixed percentage based on capital investment amount.

Profit pegged to capital contribution

56. The ex-post performance profit amount based on the profit sharing ratio (PSR) which is mutually agreed upon and contracted between the capital provider and the manager may be translated into a fixed percentage yield based on the capital investment amount.

Translation of ex-post performance profit into a fixed percentage

Illustration 17: Profit Sharing Arrangement Based on Performance

A *Mudarabah* fund is launched for investments in a portfolio of shares, sukuk and property investments. On average 15% to 20% return per annum is expected from such investments. The fund declared a profit sharing ratio of 90: 10 between the investors and the fund manager if the yield is 20% or less for one year investment period. The ratio increases in favour of the manager to 80:20 if the yield exceeds 20% for the same period. The fund size is RM100 million.

Scenario 1

If the total expected yield is 20%, how much total profit is shared with the investors?

The total profit distribution to investors should be 0.9 X RM20 million = RM18 million.

Scenario 2

If the total expected yield is 40%, how much profit is earned by the manager?

The total profit payout to manager is 0.2 X 40 million = RM8 million

57. The agreed profit-sharing ratio may vary to correspond with different periods of investment or due to pre-mature withdrawal of capital provided that such conditions are agreed upon at the conclusion of the *Mudarabah* contract. *Investment tenure and profit sharing ratio*

Illustration 18: Profit Sharing Arrangement Based on Investment Tenure

A Mudarabah venture is set up between three capital providers and a venture manager who is tasked to manage a marine theme park. The venture begins with a profit sharing arrangement of 70:30 for the first three years, where the manager will receive 30% of the net profits. Should the venture remains viable thereafter, the profit sharing ratio shall revert to a 60:40 arrangement.

58. A party may undertake (wa'd) to waive his right to the profits (if any), to another contracting party on the basis of *Tanazul* (waiver) at the inception of the contract. The waiver will be effective on the date of profit distribution. *Waiver of rights to profit based on Tanazul*

59. The profit may be measured based on the operating performance of the fund, gains realized from the disposal of ownership rights to the fund or dissolution of the fund. *Various ways of profit measurement*

Illustration 19: Profit Determination for the Period, Upon Sales of Equity Claims and Dissolution.

A *Mudarabah* investment fund valued at RM100 million declared 80:20 profit sharing ratio between the investors and the manager.

Scenario 1

If the investment declares profit on a periodic basis and reported a total fund yield of 10%, investors profit share is RM 8 million for the year.

Scenario 2

If at the end of year 2 based on the net asset value of the investment, fund is sold to third party for RM120 million, investors' share of the gain in disposal of investment is RM 16 million

Scenario 3

Upon maturity of the investment period, the net asset value of the investment is RM 150 million, the investors' share of the net proceeds of the dissolution includes RM 40 million profit in addition to the refund of capital or RM100 million.

60. The profit shall be recognized on a realization basis by selling the assets of the *Mudarabah* partnership (*al-tandid al-haqiqi* / *al-fi'li*) or on a constructive basis *(al-tandid al-hukmi)* by constructive valuation of the assets including accounts receivables.

Actual or constructive profit recognition

61. In the case of constructive valuation which is based on market valuation or a third party verification, the constructive profit reserve may be recorded. The reserve from the constructive valuation may be distributed when gains are realized at the time of disposal.

Profit from constructive valuation as reserve

Illustration 20: Constructive Valuation and Profit Distribution
Initial *Mudarabah* investment value RM50,000 in assets has subsequently appreciated by 30% at market value of RM65,000. Upon liquidation and settlement of RM5,000 of outstanding liabilities, the available net distributable profit to the partners is RM10,000 (65,000 –50,000 - 5,000).

62. If profit was distributed based on estimated figures, a final consolidation and rationalization shall be undertaken at the end of a certain period or at the times of actual realization of profit to arrive at the actual profit available for distribution as per agreed profit sharing ratio.

Final rationalisation of profit distribution

63. Profit shall be finalized, realized and distributed at an agreed period e.g. quarterly, with mutual consent of the contracting parties.

Profit distribution schedule

Illustration 21: Arrangement on Profit Distribution Period
A *Mudarabah* financing is obtained for one year, partly to invest in shares whilst the balance is meant to finance the investment operations. A *Mudarabah* profit is generated from capital gains from share valuation and dividend payout as well as fees from investment services. *Mudarabah* profit is computed on a quarterly basis during the year. In each quarter *Mudarabah* profit from dividends and fees earned are distributed accordingly whilst a reserve is maintained for share revaluation. At the end of the period, upon disposal of the shares, the total profit are realized and distributed.

64. The parties to the contract may agree to set aside a portion of the profit as a reserve (e.g. profit equalization reserve) or for any other purpose. However, for capital protection purposes, the reserve may only be taken from the profit portion of the capital provider(s). *Reserves from capital provider's portion*

65. Unrealized gains recognized during the financing shall be recognized as appreciation of capital and included in the profit and loss measurement/calculation for the *Mudarabah* contract. *Unrealized gains recorded as capital*

Illustration 22: Constructive Valuation and Unrealised Gain

The *Mudarabah* fund employed for commercial purposes may be subject to constructive valuation when assets or investments are purchased and reported in the balance sheet. Any appreciation in the value of the assets or investments shall be recorded as a gain from constructive valuation and maintained as a reserve. Upon disposal of the asset or investments the gain is then realized and distributed to the partners. Alternatively any price reversal such as price depreciation will reduce the reserve accordingly.

66. The partners may mutually agree to set aside a portion of the profit to a third party who is not involved in the partnership. *Profit set aside to a third party*

67. In a multi-tiered *Mudarabah* contract, two or more profit sharing arrangements may be agreed between investor and IFI followed by IFI and the manager. The profit generated by the manager shall be shared with IFI according to the agreed PSR which then is redistributed between the IFI and the investor (*rabb al-mal)* based on the earlier pre-agreed ratio. *Profit distribution in Multi-tiered Mudarabah*

Illustration 23: Profit Distribution Arrangement on A Multi-Tiered *Mudarabah* Venture

A one year restricted *Mudarabah* fund of RM500,000 with a profit sharing ratio of 80:20 between the investor and the Islamic financial institution is established for project financing. With the fund the Islamic financial institution provides one year project financing based on *Mudarabah* with an agreed profit sharing ratio of 70: 30 between the IFI and the customer. At the end of the year a profit of RM 300,000 is recorded from the project. The profit is distributed as follows:

Partners	Total Profit (RM)	PSR	Distributable Profit (RM)
First-Tier Profit Distribution			
IFI (Investors)	300,000	70	210,000
Manager		30	90,000
Second-Tier Profit Distribution			
IFI (Manager)	210,000	20	42,000
Investors		80	168,000

68. The manager shall not guarantee any portion of profit. *Guarantee of profit*

69. Capital contributed by the manager (*Mudarib*) as part of the *Mudarabah* fund shall determine the profit due to or loss suffered by the partner based on the percentage of capital contribution. This is determined prior to profit allocation (if any) to the partner as manager (*Mudarib*) of the capital provider fund. *Profit distribution involving capital contribution by managing partner*

Illustration 24: Capital Contribution by Manager

A manager (*Mudarib*) in a *Mudarabah* contract contributed additional capital that becomes 20% of the total fund. In the *Mudarabah* contract, the manager agrees with the capital provider to share 40% of profits generated by the capital provider fund. The total fund generated RM 100,000 profit. Based on the capital contribution of 20%, the manager earns a profit of RM 20,000. The remaining RM 80,000 profit is then shared between manager and capital provider at RM 32,000 (40%) and RM 48,000 (60%) respectively. If a loss of RM 50,000 is recorded from the total fund, the manager will share the loss of RM 10,000 based on the capital contribution at 20%.

70. The manager shall not be permitted to earn a fee in addition to the share of profit in the *Mudarabah* contract. *Additional fee to the Manager*

71. However, an independent and separate agreement may be constructed between the manager and the capital provider assigning the manager to perform a business activity that is not, by custom, part of *Mudarabah* operation for a fee.

72. Any unsual investment income from Shariah prohibited activities of a mudarabah venture due to entenuating circumstances may be distributed as charity. *Purification of tainted income*

5.5 LOSS LIABILITIES

73. Loss shall be recognized when the liability exceeds the value of the assets at a point in time from a balance sheet perspective. Alternatively, when expenses exceed revenue for a defined period, an operating loss shall be recorded. *Mudarabah* operating loss which is measured during the operating period may be offset against prior or future profits. *Loss to Mudarabah venture*

Illustration 25: Operational Loss of Capital

Due to decline in market prices sale of goods by *Mudarabah* venture is much lower than cost of purchase. As a result the asset value decreases with given amount of outstanding liability and *Mudarabah* capital. Hence, the *Mudarabah* venture reports a loss for the net decrease in capital. *Mudarib* decides to offset the loss against undistributed profit from previous period.

74. Loss shall be solely borne by the capital provider except in the event of misconduct, negligence or breach of contract by the manager. *Liability of capital provider*

Illustration 26: Negligence of *Mudarib*

A *Mudarabah* facility provided by an IFI to a customer enables the customer to engage in business activities designated by the facility. At the end of the period capital loss is reported to the IFI. Upon further investigation, it was found that part of the loss involves business transactions that are not within the designated scope of business. It was decided that the capital loss from such transactions are to be re-instated and returned to the IFI.

75. The manager may not undertake to bear the loss.

76. The manager may bear the loss at the time the loss is realized without any prior condition or undertaking**.**

77. A third party may undertake to bear the loss of capital due to misconduct or negligence on the part of the manager.

Third party undertaking to bear loss

78. The capital provider may take collateral from the mudarib, provided that the collateral could only be liquidated in the event of negligence or misconduct or violation of term of contract by the *Mudarib*.

79. Capital loss shall be recognized when the loss occurs prior to the commencement of the business or due to extenuating circumstances beyond the control of the manager and not due to the negligence or misconduct of the manager.

Types of losses

80. In relation to paragraph 79, the *Mudarabah* agreement may be mutually reviewed to ascertain whether the capital loss impairs the future performance of the business activity and the partners may decide to restructure the agreement accordingly.

Review of Mudarabah contract

81. Operating loss shall be recognized when the loss occurs during the course of ordinary business. The losses may be carried forward to the next period and subsequently, be set-off against prior or future profit.

Operating loss may be carried forward or set off against prior or future profits

Illustration 27: Loss Adjustment

Scenario A

After the conclusion of the *Mudarabah* contract, part of the inventory purchased with *Mudarabah* financing was destroyed by flood. The partners assessed that the damage by flood amounted to 40% of capital impairment. The immediate loss is borne by the capital provider and the financing arrangement was terminated.

Scenario B

During the period of *Mudarabah* financing, capital employed to finance the business resulted in 10% loss of capital at the end of one reporting period. Both partners agree that the reported loss is carried forward to the next period which subsequently reported 40% return on original capital. At the end of the financing period, 30% return on capital is distributable between the partners.

Scenario C

A business is financed using a *Mudarabah* financing facility. The business reported 30% profit over its capital in the previous reporting period. In the current reporting period, the business resulted in 10% loss of capital. Both partners agree that the reported loss is set-off against the previous reporting period profit.

5.6 ENHANCED FEATURES *MUDARABAH* CONTRACT

Origination and Execution of *Mudarabah* Contract

82. Prior to the *Mudarabah* contract, the parties may agree on general terms which include inter alia, the definition of the general contractual framework; the intention of the parties on restrictions on the contract or otherwise; the intention of the parties on having either a revolving transaction or separate transactions; the profit sharing arrangement; and types of guarantees or collaterals involved in the contract in the event of loss due to misconduct, negligence and breach of contract. *Mudarabah Deed/Agreement*

83. A business venture of *Mudarabah* may be in various sectors including but not limited to trading, plantation, construction, manufacturing, investment and services. *Mudarabah business venture*

84. A *Mudarabah* contract may incorporate *Mubara'ah*/*Takharuj* clause whereby:-

    i. An existing capital provider agrees to forgo his right over certain profit if he exits the venture prior to its maturity date; and

    ii. A new capital provider agrees to assume liability of the venture which has commenced operation prior to his participation.

Third Party Guarantee in *Mudarabah*

85. Specific conditions on third party guarantee of the capital are as follows:- *Conditions for third party guarantee*

    i. The legal capacity and financial stability of such a third party as a guarantor shall be independent from the *Mudarabah* contract and partners;

    ii. The third party guarantor shall not hold the majority ownership of the guaranteed party; and

    iii. The guaranteed party shall not hold the majority ownership of the third party guarantor.

86. A third party guarantee on a *Mudarabah* venture with recourse and/or a fee consideration shall be limited to the capital. *Third party guarantee on profit and/or capital*

87. Notwithstanding paragraph 86, a third party may guarantee the capital and expected profit of mudarabah venture subject to the following conditions:-

    i. The guarantee is given voluntarily without recourse and/or a fee consideration; and

    ii. The guarantee contract shall be non-conditional/non-contingent to the *mudarabah* venture.

Termination of *Mudarabah* Contract

Withdrawal of capital prior to commencement of Mudarabah business venture

88. Upon agreement to provide capital or disbursement of funds, the capital provider may withdraw the capital from the venture prior to commencement of the business venture subject to term and conditions.

No entitlement to profit if capital is withdrawn prematurely

89. The capital provider may not be entitled to the profits on capital if the withdrawal is made before the maturity of the investment period in a restricted *Mudarabah* business venture.

Mudarabah contract is binding in certain conditions

90. However, the *Mudarabah* contract shall be binding in the following events:

    i. When the manager has commenced the business. In this event, the contract is binding up to the date of actual or constructive completion.

    ii. When the duration or the termination date of the contract has been determined. However, the contract may be terminated earlier based on a mutual agreement by the parties.

Termination of Mudarabah contract

91. In general, the *Mudarabah* contract may be terminated due to the following circumstances:-

    i. Unilateral termination by any of the parties when the *Mudarabah* does not constitute a binding *Mudarabah* as per paragraph 90.

    ii. Mutual agreement to terminate between the parties.

    iii. The contract expires as at the maturity date agreed by the parties.

    iv. The impairment of the *Mudarabah* fund does not favour the continuity of the venture.

    v. The demise of the manager or the liquidation of the managing institution.

vi. The existence of one of the conditions that would consequently render a *Mudarabah* contract invalid. In this case, the *Mudarib* is deemed as the worker/agent who deserves fair and reasonable wages or fees only.

Illustration 28: Termination of *Mudarabah* Contract

Mudarabah financing for a period of two years provided by an IFI to the customer is reviewed quarterly in terms of the manager's compliance and performance of the funds. In the third quarter of the 1st year it was found that the performance of the fund exceeds expectation and additional financing was granted. Profit was distributed at the end of the first year and the approved capital remains outstanding in the second year. In the second quarter of the second year, the manager activities failed to observe the scope of the financing requirement and thus violated the conditions specified in the contract. The customer appealed to ratify and the financing period continued. However in the third quarter capital is impaired as 50% of the fund is lost. As a result the contract is voidable and IFI has the right to rescind the contract and held the manager liable for any loss due to the violation of the contract.

GLOSSARY

Terms	*Definition*
Bridge financing	A financing taken on a short term basis to bridge the gap between the purchase of one asset and the sale of another.
Capital loss	The excess of the cost of an asset over the proceeds received on its disposal.
Conclusion of contract	Refers to the time the contract becomes effective and enforceable.
Constructive valuation	Valuation of an asset based on appraisal value system e.g. third party valuation.
Multi-tiered *Mudarabah*	*Mudarabah* contract where fund provider invests his capital with a manager who subsequently invests the fund with another manager.
One-tier/single-tier *Mudarabah*	Single level Mudarabah where investor deals direct with entrepreneur.
Operating expenses	Day-to-day expenses incurred during the ordinary course of running a business such as salaries paid to employees, research and development costs, legal fees, office supplies, utility expenses, business licenses and it does not directly related to production or manufacturing of goods or services.
Operating loss	The loss made by a company as a result of its principal trading activity. This is arrived at by deducting its operating expenses from its trading profit, before taking into account any extraordinary expenses.
Performance guarantee	A bank guarantee given to a third party that a customer of the bank will complete a specified contract and will fulfill all its terms.

Terms	*Definition*
Profit sharing ratio	The ratio in which the profits of a business are shared.
Project financing	Money or financing put up for a particular project which are usually secured on that project rather than forming part of the general borrowing of the company.
Purification of non-compliant income	The process of removing income contaminated by prohibited elements from the accounts by channeling the same to charities.
Restricted/specific *Mudarabah*	A Mudarabah contract in which the capitalprovider 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 its operations.
Unrealized gains	A profit that results from holding assets rather than using them.
Unrestricted/general *Mudarabah*	A Mudarabah contract in which the capital provider permits the Mudarib to administer the Mudarabah fund without any restrictions.
Working capital	The part of the capital of a company that is employed in its trading operations. It consists of current assets less current liabilities.