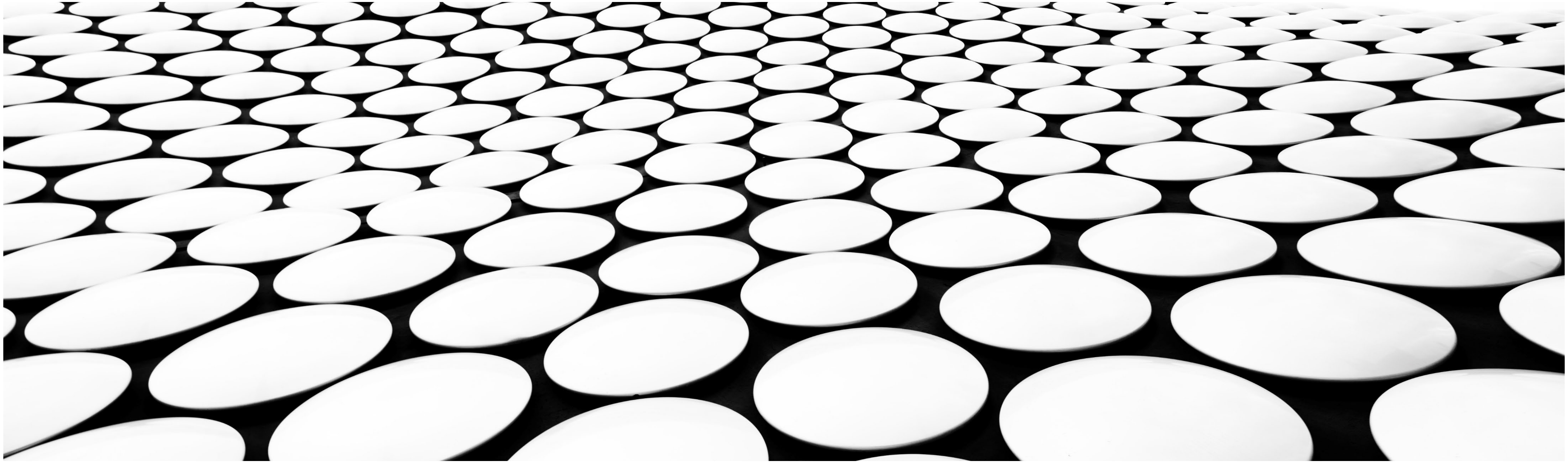
MUDARABA

PRESENTATION OF AN ITEM WITH CHARACTERISTICS OF EQUITY AND LIABILITY

DISCUSSION PAPER PRESENTED BY THE SOCPA REPRESENTATIVE

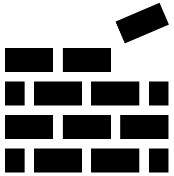


INTRODUCTION

MUDARABA - DEFINITION

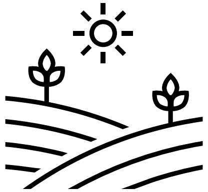
- “Mudaraba – is a profit-oriented participation between capital and work. [Explanation: Generally, in the context of an institution, it is conducted between investment accountholders as owners of capital and the institution as a Mudarib. The institution announces its willingness to accept the funds of investment accountholders, the sharing of profits being as agreed upon between the two parties, and the losses being borne by the owner of funds except if these were due to misconduct, negligence or violation of the conditions agreed upon by the institution. In the latter cases, such losses would be borne by the institution.];”
- Source: AAOIFI

MUDARABA - SIMPLIFIED



Both Investor (capital provider) and Working Partner (Mudarib) agree to embark on a business venture.

Investor contributes capital for business operations, while Working Partner undertakes responsibility of managing business leveraging their expertise.



In the event of venture's success and profit generation, profit is distributed between partners based on a predetermined ratio.
In the event of venture incurring a loss it is borne solely by Investor.

TYPES OF MUDARABA

Unrestricted Mudaraba

This type grants the Mudarib the freedom to choose any business activity they deem suitable, as long as it's Sharia-compliant. The Rabb-ul-Mal (capital provider) has limited control and cannot restrict business decisions beyond ensuring adherence to Islamic principles.

Restricted Mudaraba

The Rabb-ul-Mal has more control. They can specify the type of business, geographical location, or even restrict the use of funds to a particular project. This reduces risk for the capital provider but limits the Mudarib's flexibility.

RELEVANT IFRS STANDARDS?

IAS 32:

- Definition of a financial liability
- Definition of an equity instrument

Mudaraba does not meet the definition of a financial liability or equity instrument as defined in IAS 32

Details explained in the analysis section

CURRENT PRACTICE OF ACCOUNTING FOR MUDARABA

REVIEW OF FINANCIAL STATEMENTS TO UNDERSTAND CURRENT PRACTICES

APPROACH TO REVIEW

1. Identify a sample of IFI's across the world covering all relevant geographical areas – Total of 23 IFI's reviewed. Sample includes IFI's from Saudi Arabia, Bahrain, Bangladesh, United Kingdom, Indonesia, Kuwait, Malaysia, Nigeria, Oman, Qatar, South Africa, Sri Lanka, Turkey, United Arab Emirates & Yemen.
2. Review financial statements relating to these IFI's specifically relating to the presentation of Mudaraba transactions.

FINANCIAL STATEMENTS REVIEWED

1. Bank Albilad (Saudi Arabia)
2. Alinma Bank (Saudi Arabia)
3. Bahrain Islamic Bank (BISB)
4. Ithmaar Bank B.S.C (Bahrain)
5. Al Rayan Bank PLC (UK)
6. Kuwait Finance House (K.S.C.P.)
7. Warba Bank K.S.C.P. (Kuwait)
8. Lotus Bank Limited (Nigeria)
9. JAIZ Bank PLC (Nigeria)
10. Qatar First Bank LLC (Public)
11. Bank Islam Malaysia Berhad
12. Bank Nizwa SAOG (Oman)
13. Bank Muscat SAOG – Meethaq (Oman)
14. PT BANK SYARIAH INDONESIA Tbk
15. Türkiye Finans Katılım Bankası AŞ (Turkey)
16. Kuveyt Türk Katılım Bankası A.Ş. (Turkey)
17. Islami Bank Bangladesh Limited
18. Global Islami Bank (Bangladesh)
19. Albaraka Bank Ltd (South Africa)
20. Tadhamon Bank (Yemeni Joint Stock Company)
21. Emirates Islamic Bank PJSC (UAE)
22. Al Hilal Bank P.J.S.C (UAE)
23. Amana Bank PLC (Sri Lanka)

MUDARABA CLASSIFIED AS:

Framework used for preparation of financial statements	As Equity (Number of IFI's and entity number from previous slide)	As Liability (Number of IFI's and entity number from previous slide)	Category between Equity and Liability (Number of IFI's and entity number from previous slide)
IFRS OR EQUIVALENT	-	10 (IFI 1,2,6,7,11,17,18,19*,21,22,23)	-
IFRS AND WITH OTHER REGULATIONS	-	2 (IFI 9,15)	1 (IFI 8)
AAOFI	-	-	7 (IFI 3,4,10,12,13,19*,20)
OTHER	-	2 (IFI 5,16)	1 (IFI 14)

* Al Baraka Bank Ltd (South Africa) presents 2 separate sets of financial statements – IFRS as well as AAOIFI framework.

ANALYSIS

ANALYSIS

Divergent Presentation in Financial Statements	Islamic Financial Institutions applying AAOIFI standards classify Mudaraba balances in a separate category, distinct from liabilities or equity. However, IFIs using IFRS or local equivalents treat Mudaraba as a liability.
Mudarabah vs. Traditional Liability	Unlike traditional liabilities, Mudaraba does not involve a contractual obligation to repay the capital. Repayment occurs only if the Mudarib breaches specific conditions, distinguishing it from conventional financial liabilities.
Mudarabah vs. Equity (IAS 32)	Mudaraba differs from equity under IAS 32, because the Rabb-ul-Mal does not have a residual interest in the Mudarib's assets, ownership rights, voting rights, or influence over management.

ANALYSIS

Profit-Sharing and Risk Alignment	The Rabb-ul-Mal's returns are performance-dependent, aligning with investment risk-sharing rather than fixed obligations or residual claims. This makes classification under IAS 32 challenging.
IAS 32's Gaps in Addressing Islamic Finance	IAS 32 does not account for arrangements like Mudaraba, where: Obligations are conditional, returns are based on profit-sharing without a fixed return or residual interest, the provider of funds lacks a direct claim on the entity's assets.
Incompatibility of IAS 32 with Islamic Finance Characteristics	IAS 32 emphasizes unconditional obligations for liabilities and residual interests for equity. These criteria fail to align with the conditional and performance-based nature of Mudaraba contracts.

MUDARABA IN PRACTICE

RESTRICTED AND UNRESTRICTED MUDARABA AND VERSIONS WITH VARIOUS RIGHTS

CAN WE DRAW PARALLELS FROM IAS 32 PARAGRAPH?

IAS 32 paragraph 28:

“The issuer of a non-derivative financial instrument shall evaluate the terms of the financial instrument to determine whether it contains both a liability and an equity component. Such components shall be classified separately as financial liabilities, financial assets or equity instruments in accordance with paragraph 15.”

IAS 32 paragraph 15:

“The issuer of a financial instrument shall classify the instrument, or its component parts, on initial recognition as a financial liability, a financial asset or an equity instrument in accordance with the substance of the contractual arrangement and the definitions of a financial liability, a financial asset and an equity instrument.”

ANALYSIS - IAS 32 PARAGRAPH 28:

Evaluation of Liability and Equity Components	IAS 32 requires issuers of non-derivative financial instruments to assess whether the instrument includes both liability and equity components. If both exist, they must be classified separately.
Potential Components in Mudarabah Contracts	A liability component might arise if the Mudarib is obligated to return part of the capital under specific conditions.
Incompatibility of IAS 32 with Islamic Finance Characteristics	Separating liability and equity components requires more guidance and detailed analysis of contractual terms to determine if these elements are distinct and identifiable.

ANALYSIS - IAS 32 PARAGRAPH 15:

Classification of Financial Instruments	Upon initial recognition, issuer must classify financial instrument as a financial liability, financial asset, or equity instrument based on substance of contractual arrangement rather than its legal form.
Focus on Substance Over Form	The classification depends on the economic reality of the contract, ensuring that the accounting treatment reflects the underlying rights and obligations, not just the legal terminology.
Alignment with Definitions	The classification process requires adherence to the specific definitions of financial asset, financial liability and equity instrument.

CONCLUSION AND RECOMMENDATION

SUMMARY AND IMPACT

Summary:

When financial statements are prepared **under IFRS or equivalent standards, Mudaraba balances are classified as liabilities.** In contrast, under AAOIFI standards / in certain instances based on relevant Central Bank guidelines, they are presented as a separate category between liabilities and equity.

Impact:

Mudaraba balances exhibit characteristics of both liabilities and equity, making their **classification as liabilities under IFRS or equivalent standards contradictory to IFRS principles**. However, due to a lack of specific guidance, entities often default to presenting them as liabilities.

AAOIFI, FAS 45, addresses this by proposing their classification as Quasi-Equity, positioned between equity and liabilities in the financial statements.

RECOMMENDATION 1

IMPROVE IAS 32 / IFRS 9 GUIDANCE

- Current definitions of liabilities and equity do not address conditional obligations and performance-based profit-sharing in Mudaraba.
- IAS 32 provides no clear rules for profit-sharing arrangements without fixed returns or direct claims on assets.
- The standard's focus on unconditional obligations and residual interests does not suit the conditional nature of Mudaraba.
- The absence of guidance can lead to inconsistencies in financial reporting for entities practicing Mudaraba.
- IAS 32 and IFRS 9 should include specific guidance to account for Mudaraba, addressing its unique characteristics and widespread use.

RECOMMENDATION 2
USE PRINCIPLES OF IFRS 10

- IFRS 10 - Control exists when an investor can influence variable returns through its power over the investee.
- *Mudarib's Limited Control:*

Restricted Mudaraba: Rabb-ul-Mal imposes restrictions on business type, location, or fund usage, reducing Mudarib's flexibility but increasing Rabb-ul-Mal's control.

Unrestricted Mudaraba: Mudarib has broader authority but must adhere to Sharia principles, with limited Rabb-ul-Mal intervention.

- Fiduciary Responsibility: The Mudarib acts as a fund manager, not an owner, in both types of Mudaraba.

RECOMMENDATION 2
USE PRINCIPLES OF IFRS 10 (CONT.)

- Rabb-ul-Mal's capital cannot be classified as liability or equity in the Mudarib's financial statements.
- A "virtual entity" perspective is suggested, treating the Mudarib and Rabb-ul-Mal as participants of a venture.
- Similar to IFRS 10 capital invested by Rabb-ul-Mal should be shown in equity, separately from the Mudarib's equity, under a suitable heading (similar to non-controlling interests).

THANK YOU