

Chapter Five - Accounting for Speculative Transactions

FAS 03 (AAOIFI)

Mudarabah financing is considered the most important contract in Islamic banks, particularly in mobilizing savings.

In the Arabic language, mudarabah means "traveling or seeking livelihood," and it is derived from the word "qard" (loan), meaning "to cut off" or "to separate," because the capital provider relinquishes a portion of their capital and a share of the profit to the mudarib (agent).

In Islamic financial terminology, mudarabah is a partnership contract, similar to other forms of partnership. One party provides the capital, while the other provides their labor or expertise. The capital provider is called the "owner of the capital" (the bank), and the one who provides the labor is called the "mudarib" (the client). Mudarabah can be either unrestricted or restricted.

The definition of mudarabah : »mudarabah is an agreement between two parties in which one party provides the capital while the other provides their effort and expertise. The profit is then shared between them according to their agreement. The loss, however, is borne solely by the capital provider, while the mudarib only loses their effort and labor, provided this loss was not due to negligence or misconduct ».

Types of Mudharaba

First - Based on Conditions:

1- Unrestricted Mudharaba : This type of **Mudharaba** is not subject to any restrictions regarding time, location, type of goods, or the identity of the buyer or seller. Although this type of Murabaha is permissible according to Islamic law, Islamic banks currently do not use it, as they prefer to safeguard their funds.

2- Restricted Mudharaba: This type of **Mudharaba** is subject to restrictions regarding time, location, or the type of goods, and the sale or purchase can only be made with a specific person or under conditions determined by the capital provider (the bank) for the implementation of the **Mudharaba** agreement. Islamic banks use this type of **Mudharaba**

urabaha because it is more regulated than unrestricted **Mudharaba** , and the bank can monitor its investment more effectively through the conditions of the restricted **Mudharaba** agreement.

Secondly, based on the number of parties involved:

1- **Bilateral partnership:** This is a partnership between only two parties, one being the capital provider and the other the agent (or partner).

2- **Collective partnership:** This type of partnership has several forms:

a) Multiple capital providers and a single agent.

b) Multiple agents and a single capital provider.

c) Multiple parties involved in the partnership, with a bank acting as an intermediary.

The principles and conditions of financing through speculation:

Speculation involves several key elements:

- The two parties (the capital provider and the partner),
- The agreement (offer and acceptance),
- The capital (the amount provided by the capital provider to the partner for use in the business venture),
- The profit (the surplus earned beyond the initial capital, which is the essence of partnership financing),
- And the work (the effort and expertise provided by the partner in exchange for the capital).

Among the fundamental conditions governing the elements of Murabaha financing, regarding the agreement, is that the offer and acceptance must be mutually agreed upon, and that the agreement can be made verbally, in writing, by correspondence, or through modern means of communication. As for the conditions regarding the capital, it must be clearly defined in terms of amount and type, and can consist of cash or assets whose value is determined at the time of the agreement or based on their historical cost. Furthermore, the capital must be tangible and readily available, not merely a debt owed, and must be transferred to the partner by granting them possession or control over it.

Accounting Standard for Mudharaba Financing No. 3:

This standard aims to establish the accounting principles governing the recognition, measurement, and disclosure of mudharaba financing transactions undertaken by Islamic banks and financial institutions. It also includes the Sharia-based principles upon which the proposed accounting treatments and various alternative accounting methods for murabaha financing are based.

Accounting treatment for Mudharaha financing (FAS 03)

Standard No. 3 addresses the accounting procedures for **Mudharaba** financing transactions in the books of the financial institution (the capital provider). However, it does not cover the accounting treatment in the books of the client (the investor), nor does it address the issue of zakat (charitable tax) on investment funds, or the bank's receipt of investment funds (investment accounts)

First – Recording Mudharaba capital at the time of the contract: The investment financing transaction is recorded when the capital is provided, either in cash or in kind (paragraph 3).

- **Valuation of the investment capital at the time of the contract:** If the bank provides the investment capital in cash at the time of the agreement, it is valued at the amount paid or made available to the investor. If the bank provides the investment capital in kind, it is valued at the fair value of the asset (agreed upon between the bank and the investor). Any difference between the fair value and the book value of the asset is recognized by the bank as a **gain or loss** (paragraph 8).

a- **When the capital is transferred to the trader in cash:** The bank records:

	Debit	Credit
Mudaraba Financing	xxxx	
Treasury/Current Account of Mudareb		xxxx

b- **When the capital is transferred to the trader in kind (permitted):**

	Debit	Credit
Mudaraba Financing	xxxx	
Assets/Goods Delivered to Mudareb		xxxx

Secondly – In cases where there are differences between the fair value of the asset and its book value, these differences must be recognized by the bank.

- **In case of a profit (fair value > book value)**

Statement	Debit	Credit
Mudaraba financing	xxxx	
Assets entrusted to mudharib		Xxxx
Profits		xxxx

- **In case of Loss (book value > fair value)**

Statement	Debit	Credit
Mudaraba financing	Xxxx	
Loss	xxxx	
Assets entrusted to mudharib		xxxx

Thirdly – Measuring the investment capital after contracting at the end of the financial period:

The investment capital after the agreement is measured as described above, and any amount recovered by the bank from the investment capital is deducted from this value (paragraph 10).

- a- **In the event that the Mudharaba period ends:** The full investment amount, including the principal and the net profit, is remitted by the investor to the bank. This transaction is recorded as follows:

Statement	Debit	Credit
Cash	Xxxx	
Mudharaba financing		xxxx

- b- **if there are outstanding receivables from speculative trading clients,** :the following accounting entry should be recorded.

Statement	Debit	Credit
Mudharaba debtors N°....	Xxxx	
Mudharaba financing		xxxx

Fourth – Distribution of profits between the bank and the investor: This is done as follows :

- **If the investment results in a profit**

Statement	Debit	Credit
Mudharaba financing	Xxxx	
Current Account(Mudharib)		Xxxx
Investment profits (the bank's share of the profits)		xxxx

Fifthly – If the balance of the speculative financing account is a debit balance (the amount deposited by the client is less than the financed amount): this represents a loss that the bank bears alone (provided that no negligence, misconduct, or breach of contract by the client is proven). The following entry is then made to close Mudaraba financing account:

- a- **If the result of the speculative transaction is a loss (without any fault on the part of the speculator)**

Statement	Debit	Credit
Mudharaba Loss	Xxxx	
Mudharaba financing		Xxxx

- b- **- If the result of the speculative transaction is a loss (due to negligence or fault on the part of the speculator)**

Statement	Debit	Credit
Mudharaba debt to N°....	Xxxx	
Mudharaba financing		Xxxx

- c- **The speculative loss account is closed by transferring the balance to the bank's profit and loss account as follows:**

Statement	Debit	Credit
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Profit/Loss	Xxxx	
Mudharaba Loss		Xxxx

Sixthly – If the speculative transaction continues beyond the bank's financial year-end, any profits realized are recorded, and any losses incurred are deducted from the speculative capital. The bank will then record the following accounting entry:

a-Generating speculative profits during the financial period

Statement	Debit	Credit
Mudharaba financing	Xxxx	
Current Account(Mudareb)		Xxxx
Mudharaba income (bank's share)		xxxx

c- Speculative trading resulted in losses during the financial period.

Statement	Debit	Credit
Investment losses (Mudharaba)¹	Xxxx	
Mudharaba financing		Xxxx

¹ From jurisprudential apoint of view, losses should not be recognized immediately; rather, a risk reserve should be set aside until the speculative period has ended.