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INTERNATIONAL ISLAMIC UNIVERSITY MALAYSIA
بِسْمِ اللَّهِ الرَّحْمَنِ الرَّحِيمِ

**AN EXPLORATORY STUDY OF IJARAH
ACCOUNTING PRACTICES IN MALAYSIAN
FINANCIAL INSTITUTIONS**

BY

ROS ANIZA BT. MOHD. SHARIFF

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ABSTRACT


Prior studies on *Ijarah* were mainly focusing on the economics, legal and financial aspects but there was, however, no in-depth study on accounting for *Ijarah* that have previously been carried out. Therefore, this study is a contribution towards a better understanding of accounting issues on *Ijarah*. The main objective of this study is to explore the nature of accounting practices as practiced by Malaysian financial institutions. First, the study makes comparison between the International Accounting Standard on leasing (IAS 17); the accounting standard for *Ijarah* (FAS 8) as developed by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI); and the Malaysian Accounting Standard Board (MASB 10). The study found that there are major differences as to the nature of leasing and *Ijarah*, and as a result accounting principles that have driven all the three standards as well as accounting techniques developed for leasing and *Ijarah* are significantly different. Secondly, the study examines the level of acceptability of the AAOIFI's FAS 8 among the Malaysian financial institutions. The result of the questionnaire survey shows a low level of acceptability of FAS 8 and the result from the interview survey further confirms this finding. First, this study indicates, subject to further study on other Islamic financial instruments and other Islamic countries, that the effort to harmonise the accounting practices on Islamic financing practices by financial institutions internationally may be a difficult task. Secondly, until and unless the AAOIFI standard is adopted by the regulatory agency as in the case of Malaysia, Bank Negara Malaysia, AAOIFI standards will remain only as a reference but do not have the legal authority. Consequently, the quality and comparability of accounting information of Islamic financing such as *Ijarah* will be seriously at a stake.

ملخص البحث

إن أكثر الدراسات التي أجريت حول مبدأ الإجارة تنحصر في الجوانب الاقتصادية والقانونية والمالية , دون أن تكون هناك دراسات متعمقة لها في مجال الحسابات ولهذا السبب فإن هذا البحث يساهم في إزالة الغموض في الإشكاليات الحسابية حول الإجارة. ومن الأهداف الرئيسية لهذا البحث الإطلاع على طبيعة العمليات الحسابية التي تقوم بها المؤسسات المالية بماليزيا, وذلك في مرحلتين. ففي المرحلة الأولى يقوم البحث بالمقارنة بين المعيار العالمي للحسابات في الإجارة (IAS 17) , ومعيار الحسابات للإجارة (FAS 8) الذي طورته منظمة التدقيق الحسابات للمؤسسات المالية الإسلامية (AAOIFI) ومعيار هيئة الحسابات الماليزية (MASB 10) . وقد توصل البحث إلي أن هناك فروق واضحة فيما يتعلق بطبيعة الإجارة , ويترتب علي ذلك الاختلاف الكبير بين المبادئ الحسابية التي تولدت منها تلك المعايير الثلاثة وكذلك بين الأساليب الحسابية المطبقة في الإجارة. ثم يقوم البحث في المرحلة الثانية باختبار مدى قبول المؤسسات المالية بماليزيا لمعيار الحسابات للإجارة (FAS 8) , حيث أثبتت الدراسة الميدانية التي قام بها البحث أن هذا المعيار لم يلق نسبه عالية من القبول لدى هذه المؤسسات. وقد أكدت المقابلات الشخصية التي أجريت على ما يلي : أولا : يشير هذا البحث , الذي قد يمتد إلى دراسات تفصيلية حول المجالات المالية الإسلامية الأخرى في مختلفه الأقطار الإسلامية , إلي أن تحقيق الانسجام عالميا بين العماليات الحسابية في الشؤون المالية الإسلامية من قبل المؤسسات المالية قد لا يكون أمرا يسيرا. ثانيا : وإلا أن يتم تطبيق معيار منظمة التدقيق والحسابات للمؤسسات المالية الإسلامية (FAS 8) من قبل الوكالات النظامية كما هو الحال في ماليزيا, حيث يقوم البنك الوطني بهذا الدور , فإن هذا المعيار سيظل نظاما ومرجعا دون أن تكون له أي سلطة قانونية. وبناء علي ذلك فإن إجراء المقارنة بين المعلومات الحسابية للمؤسسات المالية الإسلامية , كالإجارة مثلا , وقياس جودتها يكون أمرا مرهونا.

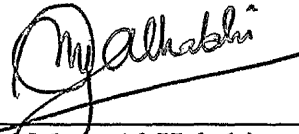
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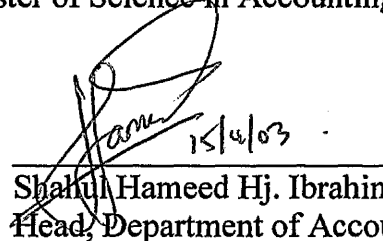
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Syed Musa Al-Habshi
(UNITAR)
Examiner

This dissertation was submitted to the Department of Accounting and is accepted as partial fulfillment of the requirement for the degree of Master of Science in Accounting.



15/4/03

Shahul Hameed Hj. Ibrahim
Head, Department of Accounting

This dissertation was submitted to the Kulliyah of Economics and Management Sciences and is accepted as partial fulfillment of the requirement for the degree of Master of Science in Accounting.



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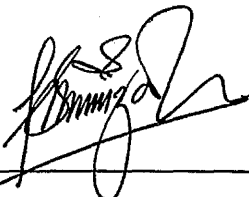
Wan Sulaiman Wan Yusof
Acting Dean,
Kulliyah of Economics and
Management Sciences

DECLARATION

I hereby declare that this dissertation is the result of my own investigation, except where otherwise stated. Other sources are acknowledged by footnotes giving explicit references and a bibliography is appended.

Name: ROS ANIZA BT. MOHD. SHARIFF

Signature



A handwritten signature in black ink, appearing to read 'Ros Aniza Bt. Mohd. Shariff', written over a horizontal line.

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LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organization for Islamic Financial Institutions
AITAB	<i>Al-Ijarah Thumma Al-Bai'</i>
BAFIA	Banking and Financial Institutions Act
BIMB	Bank Islam Malaysia Berhad
BNM	Bank Negara Malaysia
IAS	International Accounting Standard
IBA	Islamic Banking Act
IDB	Islamic Development Bank
MASB	Malaysian Accounting Standard Board
UK	United Kingdom
US	United States

CHAPTER ONE

INTRODUCTION

Ijarah has been conceptually understood as a contract of exchange where one party enjoys the benefit arising from employment by another party in return for a consideration for the services rendered and from the use of an asset. Scholars of the four schools of jurisprudence (Shafi'ie, Maliki, Hanbali and Hanafi) have cited various definitions of the contract of *Ijarah*. In brief, these definitions agree on the fact that the contract of *Ijarah* is a contract on using the benefits or services in return for compensation (Kharofa, 1997).

This classical definition has been the basis of many of the contracts of exchange even before the times of the Prophet Muhammad peace be upon him (p.b.u.h.) and was popular amongst *fuqaha* as documented in much of the literature. After that, the operation of these contracts developed to a higher level of sophistication during the period of the companions of the Prophet Muhammad (p.b.u.h.). However, the basis of operation remained confined to simple *Ijarah* contracts.

In the context of Islamic financing schemes, *Ijarah* can be defined as a process by which the "usufruct of a particular property is transferred to another person in exchange for a rent claimed from him/her" (Hairetdinov, 1998). In many respects, *Ijarah* resembles leasing as it is practiced in today's commercial world. Nevertheless, leasing has become an increasingly important method of financing capital investment in recent years (Martin, 1997).

1.1 BACKGROUND OF THE STUDY

Ijarah receives very little attention in the literature. Most of the periodicals that report on the current issues on the area of Islamic banking and finance fail to mention any significant issue regarding *Ijarah*. With regards to the online databases, a search using the key word *Ijarah* finds not a single match in Proquest and Emerald. Despite the hopeless situation, there are several pieces of literature that include *Ijarah* as part of their discussion.

Ijarah began as trading activity in Islam. It was not until much later that it became a mode of financing (Al-Hathal, 1997). The Islamic leasing industry has been growing at a faster pace in many countries because the product is able to meet certain demands, which are not covered in conventional leasing with an alternative mode to traditional bank loans. *Ijarah* has many advantages for any investment project, as it provides the required financing for buying machines or assets without offering any guarantee. Hence, the *Ijarah* instrument makes it possible for any project to prevent the freezing of capital when purchasing assets.

There are some basic differences between conventional leasing and *Ijarah* (Al-Hathal, 1997). Furthermore, unlike their western counterparts, Islamic bankers share in the risk of their transactions (Martin, 1997). For example, under Islamic real estate finance rules, the lender buys the property and then leases it to the purchaser in what is known as an *Ijarah Wal-Iqtina* or hire purchase. The two parties share the risk. If real estate prices go up, the lease payments and final prices rise. If property values decline, the lease payments and final price also fall. In addition, *Ijarah* recognizes the fluctuation in the rent (Martin, 1997; Abdullah, 2000). An *Ijarah* agreement should also address the basis of rent calculations (whether it is using fixed or floating rates) and the commencement of the rent calculations (whether from the date of delivery or from the date of commissioning of the leased asset) (Abdullah, 2000).

In addition, the risk and liability of ownership in *Ijarah* lie with the lessor (Hairetdinov, 1998). The leased asset shall remain the risk of the lessor throughout the lease period. Any loss or harm caused by factors beyond the control of the lessee shall be borne by the lessor. However, the lessee is liable to compensate the lessor for any harm to the leased asset caused by any misuse or negligence on the part of the lessee.

Nevertheless, the lessee shall always bear the maintenance expenses to keep the leased assets in good working order and be responsible for replacing any worn or damaged parts (Hairetdinov, 1998; Abdullah, 2000). However, in other examples the parties to the lease agreement agree that the main maintenance work must be the responsibility of the lessor and the periodical and partial maintenance is to be assigned to the lessee as it is considered regular and may be considered part of the rental. Nonetheless, the responsibility of the maintenance of the leased asset in *Ijarah* should be shared by both parties (lessee and lessor).

1.2 MOTIVATIONS FOR AND OBJECTIVES OF THE STUDY

There is a considerable body of research on the Islamic financial system in general. However, literature that specifically discusses the *Ijarah* contract is limited. Hence, this is an indication for the need to embark on further research in this area. The researcher is motivated to study accounting issues in *Ijarah* due to the lack of accounting studies on *Ijarah* reported by academic journals.

The scarce availability of literature written on the topic of *Ijarah* is due to several possible reasons. The most fundamental reason is the infancy stage of Islamic banking and finance as compared to conventional finance. The idea of Islamic finance was inspired by the first conference on Islamic economics in 1976. Obviously, *Ijarah*, which is part of Islamic finance, is very much in its early stages of development.

The development of Islamic banks today has led to the creation of a financing structure, which reflects substantial divergence from the basic features of the *Ijarah* contract. *Ijarah* is considered as one of the Islamic banking instruments that is in compliance with the *Shari'ah Islami'ah*.

The first objective of this study is to examine the nature of *Ijarah* financing and its differences with conventional lease financing from the legal and accounting perspectives. This is considered as important because without a proper understanding on the nature of *Ijarah* and the differences compared to conventional leasing, the conceptualization of the accounting implications for *Ijarah* may not be complete.

Al-Hathal (1997) argues that there are some differences between conventional leasing and the *Ijarah* contract. Hence, it is assumed that the accounting treatment for *Ijarah* is expected to be different from that in conventional leasing. The AAOIFI, as the standard setter for the Islamic financial institutions, has addressed accounting standards for *Ijarah*. Thus, it is believed that to have a better comparison between the *Ijarah* standard with that of conventional leasing, it is necessary to study the standard of *Ijarah* recommended by the AAOIFI and compare it with conventional leasing standard set by the International Accounting Standard (IAS) and the Malaysian Accounting Standard Board (MASB).

The second objective of this study is to determine the level of acceptability of AAOIFI's standards on *Ijarah* in Malaysia using questionnaire survey. According to Hairetdinov (1998), a number of Islamic financial institutions have adopted leasing as carried out by conventional financial institutions without making any modifications that really conform to the *Shari'ah Islami'ah*. From the above argument, it is believed that it is crucial for us to have a clear understanding about the current practices of the *Ijarah* contract in Malaysia.

In order to confirm the findings of the questionnaire survey, telephone interviews were conducted to get some feedback from the *Ijarah* practitioners regarding the main issues on *Ijarah*. It is considered crucial for the researcher to conduct the interviews to assure the level of validity of the results of the questionnaire survey.

Hence, the outcome of this research may provide some insight for several parties such academicians, banking practitioners, accountants and the public at large. It is hoped that one of the contributions of this study is to provide a better picture of the process and procedure of *Ijarah* and its accounting practices in Malaysia. The fulfillment of the aim of this research will also add to the accounting literature as well as to the literature on the Islamic banking system in Malaysia.

1.3 ORGANIZATION OF THE STUDY

The content of this thesis is organized into seven chapters. Chapter One gives an overview of the thesis, including the identification of the research problems, the reasons for undertaking this research, the objectives and the significance of the study. Chapter Two reviews literature on Islamic financing schemes. This chapter highlights the general objectives of the Islamic financial principles and the development of Islamic financing schemes. It will also discuss four of the Islamic financing contracts in general (*Musharakah, Mudharabah, Murabahah and Ijarah*).

Chapter Three proceeds with a discussion of the need for accounting standards for *Ijarah* financing. This chapter presents the nature of *Ijarah* financing, the importance of accounting in Islam and the need for an accounting standard for *Ijarah*. It will also discuss the AAOIFI as the standard setter for Islamic financial institutions and the AAOIFI's standards on accounting for *Ijarah* as well as accounting standards for leasing set by the IAS and the MASB.

Chapter Four outlines the research methodology. This chapter will explain the research question used in this study. In addition, the method of data collection and the description of the sample and the mechanics of sampling selection will also be identified. Finally, the method of data analysis will also be outlined. Chapter Five focuses on a comparative study of AAOIFI FAS 8, IAS 17 and MASB 10. A comparative study between the AAOIFI's standards for *Ijarah* and the leasing standard set by the IAS and the MASB will be presented.

Chapter Six presents the results of the questionnaire survey and interview of practitioners about their accounting practices related to *Ijarah*. The descriptive analysis of the accounting practices in Malaysia will be discussed as well as the findings of the semi-structured interviews conducted with five selected financial institutions. Finally, some conclusions are offered in Chapter Seven. This chapter also discusses several limitations of this study and concludes with suggestions for future research.

CHAPTER TWO

DEVELOPMENT OF ISLAMIC FINANCING SCHEMES

The era of Islamic resurgence in almost all Muslim countries in the late 19th and early 20th centuries is widely believed to have been a significant factor in the change in the system of banking and finance in those Muslim countries. Since *riba* (usury) is prohibited in Islam, its elimination in business dealings has become one popular item on the agenda discussed by the contemporary scholars (Haron, 1997).

The main objective of this chapter is to provide an overview of the Islamic financial principles. It is important to establish an overview of the Islamic financial principles for two reasons. Firstly, it is important to understand the principles underlying the Islamic financial system. Secondly, it is essential to discuss the main principle governing Islamic financing transactions, which is strict compliance with the *Shari'ah Islami'ah* (Islamic law) such as the prohibition of *riba* and *gharar* (uncertainty).

This chapter will also discuss the development of Islamic financing schemes in general and discuss in greater detail four of the Islamic financing contracts (*Musharakah*, *Murabahah*, *Mudharabah* and *Ijarah*). Finally, an introduction to Malaysian banking system will be presented.

2.1 ISLAMIC FINANCIAL PRINCIPLES

Islamic finance is an ethical, indigenous and equitable mode of finance, which derives its principles from the *Qu'ran* (The revealed book of Muslims), the traditions of the Prophet Muhammad (peace be upon him), and the *Shari'ah Islami'ah* (Islamic law), which is based on the *Qu'ran* and *Sunnah*.

There are clear distinctions between Islamic finance and 'conventional' finance (Qureshi and Millet, 1999). These differences are derived from four main prohibitions by the *Shari'ah Islami'ah*. The first prohibition is against *riba* (usury). This prohibition is intended to prevent exploitation and to maximize social benefits. Secondly, Islam prohibits *gharar* (uncertainty) in activities. *Gharar* is considered as not Islamic because it can cause injustice to another party. The third prohibition is against *maisir* (gambling). This is because it can lead to immorality and other social evils (poverty). And finally, Islam prohibits the use of certain products such as pork and liquor. It is important to understand certain principles of Islam that underpin Islamic finance (De Belder et al, 1993).

One of the most important principles of Islamic finance is the scriptural injunction against *riba* and there is now a general consensus among Muslim economists that *riba* is not restricted to usury but encompasses interest as well. The prohibition of usury is ordained in Islam in all forms and intent. This prohibition is strict, absolute and unambiguous. The Holy *Qur'an* in verse 278 of Surah Al-Baqarah states: "O ye who believe! Fear Allah and give up what remains of your demand for *riba*, if ye are indeed believers", and verse 2: 279 says " If you do it not, take notice of war from Allah and His Messenger, but if ye turn back, ye shall have your capital sums. Deal not unjustly and you shall not be dealt with unjustly".

Riba can be defined as predetermined payment over and above the actual amount of the principal. It is prohibited because while profit is legitimately allowed, the parties cannot predetermine a guaranteed profit. This is based on the principle of “uncertain gains” which, on a strict interpretation, does not even allow an undertaking from the customer to repay the borrowed principal plus an amount to take into account inflation.

Riba is also prohibited as it leads to injustice (*zulm*) and Islam is against all forms of injustice and exploitation and pleads for an economic system, which aims at securing extensive socio-economic justice. The Islamic law of prohibition of *riba*, which includes interest, was originally not based on economic theory but on Divine Authority, which considers the charging of usury is as an act of injustice.¹

According to Islamic law, it is a sin to lend money and charge for it. A lender must share the rewards and the risks faced by the borrower (Hall, 1994). If a loan attracts a huge profit then the lender receives a portion of it. But if the loan makes a loss, the lender should lose a portion of the principal. Thus, if money cannot be lent without charging interest, it can be increased through making investments as long as the investor participates in the risk of the investment. Theoretically, Islamic lending suggests that an Islamic deposit could decrease as well as increase. Nonetheless, underlying this view of finance is the concept that money must not be treated as a commodity. Islamic financiers say that money must be used productively and not feed on itself.

Islam encourages Muslims to invest their money and to become partners in order to share profits and risks in the business instead of becoming creditors (De Belder et al, 1993). Following this line of argument, some Muslim jurists consider money as potential capital

¹Siddiqui, S. H. Islamic Banking: True Modes of Financing. http://www.islamic-banking.com/ibanking/ibanking_aom/sh_siddiqui.php

rather than capital, meaning that money becomes capital only when it is invested in business. Accordingly, money advanced to a business as a loan is regarded as a debt of the business and not capital and, as such, it is not entitled to any return (i.e, interest).

The principle, which thereby emerges, is that Islam encourages investments in order that the community may benefit (De Belder et al, 1993). However, it is not willing to allow a loophole to exist for those who do not wish to invest and take risks but are rather content to hoard money or deposit money in a bank in return for receiving an increase on those funds at no risk. Accordingly, under Islam, either people invest with risk or suffer loss through devaluation by inflation by leaving their money idle. Islam encourages the notion of higher risks and higher returns and promotes it by leaving no other avenue available to investors. The objective is that high-risk investments provide a stimulus to the economy and encourage entrepreneurs to maximize their efforts.

From the above discussion, it is clear that Islam forbids all commercial transactions that involve injustice. This includes not only *riba* but also *gharar* activities. *Gharar* is from the Arabic word which means risk, peril and uncertainty. It is a kind of *sak*, which involves giving an undertaking, which the seller is not certain to fulfill such as the sale of fish before they are caught. The prohibition of *gharar* is because it affects both the subject-matter and the price, which can generate unearned profit or an unacceptably huge loss. Hence, the motive behind the prohibition of *gharar* is the avoidance of risk in sale.

Another rationale behind the prohibition of *gharar* is that, it depends not on the existence or non-existence of the goods, but on the vendor's obligation to deliver the subject-matter of the sale. If he is not in a position to do so, because, for example the contract contains an element of *gharar* risk, the transaction will be void according to the degree of *gharar* involved.

For instance, the rules laid down to prevent uncertainty in the contract of sale have been applied by analogy to the sale of *salam* (a sale with advance payment for future delivery), *istisna'* (contract of manufacture) and *Ijarah* (lease contract). These contracts ought to be considered invalid, but because of economic needs and the public interest, these contracts are treated as legitimate transactions on condition that they fulfill certain requirements, despite the non-existence of the goods at the time of delivery (Nawawi, 1999).

2.2 DEVELOPMENT OF ISLAMIC FINANCING SCHEMES

The desire of enlightened Muslims to seek the moral equivalent of Modern Capitalism goes back to Egypt in the early 1960s. The pioneering effort, in Egypt, took the form of a savings bank based on profit-sharing in the town of Mit Ghamr. The Organisation of Islamic Conference (OIC) established the Islamic Development Bank (IDB) in 1975, but it was primarily an intergovernmental bank aimed at providing funds for development projects in member countries. The IDB now also extends to the private sector for project and trade finance facilities.

In the mid-seventies, Islamic banks came into existence in Saudi Arabia and the United Arab Emirates. Since then, Islamic financial institutions have emerged in a large number of Muslim countries including Kuwait, Bahrain, Qatar, Turkey, Pakistan, Indonesia and a belt of other IDB member countries. These institutions have taken the form of commercial banks, investment banks, investment and finance companies, insurance companies, etc.²

Islamic banking today is an industry that is still evolving. The industry manages approximately \$180 billion dollars today, growing at approximately 15 % per annum.³ The growth of Islamic finance is a result of economic growth in the Islamic world, fuelled primarily by oil wealth. This growth created a growing middle-wealth segment and hence

²Khan, I. Issues and Relevance of Islamic Finance in Britain. http://www.islamic-banking.com/ibanking/ibanking_aom/ia_khan.php

³Khan, I. Issues and Relevance of Islamic Finance in Britain. http://www.islamic-banking.com/ibanking/ibanking_aom/ia_khan.php

made banking a necessary service to the larger segment of the population rather than a service for the few, as had been the case some 10 to 15 years earlier.⁴

Since the international banking system is rooted in interest-based transactions, the Islamic finance system could easily be dismissed as a technique only used among devout Muslims (Cunningham, 1994). What has changed in recent years is that the application of Islamic financial structures has become more widespread and cooperation between Islamic and interest-based institutions much more common. Furthermore, there has been an enormous diversification of products by Islamic bankers and growing competition from interest-based commercial banks that have watched the growth in Islamic Funds.

In the early years, investments and products used by most Islamic financial institutions were driven by the concept of *Mudharabah* (referred to as trust financing) and focused on short-term investments. During this period, *Murabahah* (cost-plus finance) emerged as the instrument most widely used by Islamic banks, accounting for over 80 percent of a portfolio of an Islamic bank.⁵

During the 1990s, Islamic financial institutions became increasingly more innovative, developing more complex instruments and structures to meet the demands of modern day business. The use of instruments such as leasing and construction finance became far more widespread. Islamic finance trenches were also structured into big-ticket syndications.

Equities have only recently opened up as an asset class to Islamic investors, following approval from the Islamic *Fiqh* (Islamic jurisprudence) Academy in Jeddah, one of the major legal bodies in the Muslim world. Islamic investors are now able to invest in equities

⁴Khan, I. Issues and Relevance of Islamic Finance in Britain. http://www.islamic-banking.com/ibanking/ibanking_aom/ia_khan.php

⁵Khan, I. Issues and Relevance of Islamic Finance in Britain. http://www.islamic-banking.com/ibanking/ibanking_aom/ia_khan.php

subject to certain criteria. Over 100 Islamic equity funds have now been launched since 1995 with assets under management in excess of \$7 billion. Some of these funds are being sold in the UK.⁶

The last few years have seen a growth in the number of conventional banks, which offer Islamic banking products (Cunningham, 1994). Indeed, conventional banks have also begun to realize that offering Islamic products is a way of capturing deposits. Many investors keep most of their money in a conventional account, but like to place part of their funds in Islamic accounts. A conventional bank with an Islamic finance division can capture all of such a client's business rather than just a limited part.

2.3 ISLAMIC FINANCING CONTRACTS

De Belder et al (1993) argue that some of the most common forms of Islamic financing instruments are: *Musharakah* (partnership), *Murabahah* (cost-plus margin financing), *Mudharabah* (trust financing) and *Ijarah* (leasing).

1) *Musharakah*.

Musharakah (partnership) is one of the important modes of investment in the Islamic commercial system, wherein people can share both in capital financing and management. Muslim jurists define partnership as a “contract between two or more parties, with the capital or in labour on contribution of labour or skill or in credit on understanding that they shall share the profits, in specified proportions, as well as the losses” (Nawawi, 1999).

However, the *musharakah* transactions which involve the Islamic financial institutions predominantly use “*Inan Sharikat Maa'*” or finance-limited investment partnership, whereby money is the main investment. Thus, the Islamic institution funds the working

⁶Khan, I. Issues and Relevance of Islamic Finance in Britain. http://www.islamic-banking.com/ibanking/ibanking_aom/ia_khan.php