

# Comparison and Analysis on Shariah Standards of AAOIFI & BNM For Mudarbah Product

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## Abstract

There are two main international standard setting bodies which provide shariah, accounting and auditing standards for global Islamic financial industry. These two institutions are the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Bank Negara Malaysia (BNM). The objective of the current study is to provide an analysis of Mudarbah financing by comparing the standards of the AAOIFI and BNM. Qualitative method of research is used to analyze the content from archival sources. It is established that there are a lot of clauses between the two standards which need to be highlighted for the development of a comprehensive and uniform Islamic financial system. This study will help to achieve this goal by minimizing the gap between AAOIFI and BNM.

**Keywords:** Mudarbah financing, AAOIFI, BNM, Shariah Standards

## 1. Introduction

Islamic banks of the whole world in which GCC<sup>1</sup> countries are also included, they either adopted the Shariah standards issued by the AAOIFI<sup>2</sup>, the violation of which is entitled to penal actions by the central authorities of banks of the related countries except Malaysia, as they have their own shariah standards issued by Shariah Advisory Council. In Pakistan, for the Islamic Banks<sup>3</sup>, it is made compulsory by the SBP to adopt AAOIFI Shariah Standard No:(13)<sup>4</sup> on Mudarbah financing deteriorating which subject to punitive action under the provision of Banking Companies Ordinance, 1962 while following AAOIFI Shariah standards is not essential for Islamic banks in Malaysia because Islamic banking industry in Malaysia is governed by the rulings of Shariah standards set by SAC<sup>5</sup> of the BNM<sup>6</sup>.

<sup>1</sup> Gulf Cooperation Council (GCC), political and economic alliance of six Middle Eastern countries —Saudi Arabia, Kuwait, the United Arab Emirates, Qatar, Bahrain, and Oman

<sup>2</sup> Accounting and Auditing Organization for Islamic Financial Institutions

<sup>3</sup> State Bank of Pakistan

<sup>4</sup> ("IBD Circular- State Bank of Pakistan," 2010)

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AAOIFI Shariah Standards have attained great importance and familiarity in global Islamic finance industry due to its increasing adoption in different jurisdictions. BNM guidelines pertaining to Islamic finance modes are also of worth importance and this is because Malaysia is the leader in Islamic finance industry and other jurisdictions follow the footprints of Malaysian Islamic financial institutions.

The aim of this paper is to compare and analyze the Shariah standards issued by the AAOIFI and BNM on Mudarbah financing i.e. AAOIFI Shariah Standard No: 13 titled, ‘Mudarbah A partnership in profit’ is compared and analyzed with the Shariah Standard on Mudarbah issued by BNM. This study aims to help AAOIFI and BNM minimize the gap between two Shariah standards to develop a comprehensive and standardized financial system worldwide.

## 2. Literature Review

There are plenty of studies on the AAOIF Shariah Standards and BNM guidelines separately but the comparative studies of both standards are very few.

Saleem and Mansor (2020) examined the accordance of Ijarah Financing practiced by Islamic banks in Malaysia with AAOIFI Shariah Standard on Ijarah financing. The study was based on qualitative methodology and used semi-structured interviews. The study found that there is a gap between the practices of BNM and AAOIFI Shariah Standards regarding Ijarah financing. Moreover, it was also highlighted that there is need of further research on other Shariah standards and guidelines issued by BNM and AAOIFI.

In another study by Vinnicombe (2012), the compliance between accounting standards by AAOIF and practices of Islamic Banks of Bahrain was analyzed. The study was based on quantitative methodology and it also highlighted the shortcomings in the adopted methodologies in previous studies. The study found a positive link and compliance between AAOIFI accounting standards and practices of Islamic banks in Bahrain.

AAOIFI has also issued Governance standards that are adopted by different jurisdictions. In a study, Albarrak and El-Halaby (2019) tried to identify the level of transparency in compliance by Islamic banks of selected countries with AAOIFI Shariah and Governance standards. They used quantitative methodology and also analyzed the effect of compliance on the performance of Islamic banks by applying statistical tests. The study found that adoption of AAOIFI Shariah standards and compliance with them has positive effect on the financial performance of Islamic banks. Further, it also highlighted that there was need to

check the compliance between AAOIFI Shariah standards and standards or guidelines issued by other institutions such as BNM in Malaysia.

Mohammed, Fahmi, and Ahmad (2015) studied the Mudarbah and Musharakha regarding accounting mechanism with reference to AAOIFI, MFRS and IFRS. They used quantitative methodology and secondary data from the annual reports of Malaysian Islamic banks. The study found that both Mudarbah and Musharakha were less attractive modes for Islamic banks in Malaysia due to their high-risk nature. Moreover, the study suggested that Islamic banks in Malaysia had also incorporated AAOIFI accounting and Shariah standards that were more inclusive and exhaustive than BNM guidelines.

In a study, Aswer, Jalil, and Muhamed (2019) made an attempt of proposing a new product named as Adapted Mudarbah Model (AMM). According to the authors, the product was proposed as an alternative to *Bay' Bithaman Ajil* (BBA) and *Musharakah Mutanaqisah* (MM) for home financing. Authors cited the BNM Shariah standard for Mudarbah in formulating the legal and Shariah guidelines for the proposed product. This is done due to the flexible nature of BNM Shariah standard and limited scope of AAOIFI guidelines on Mudarbah.

The matter of Dana Gas's Mudarbah Sukuk exposed the legal and Shariah loop holes in the structure and documentation of that sukuk. In a study, Hekmatyar and Parkar (2018) investigated the case of Dana Gas Sukuk and highlighted the Shariah and legal issues pertaining to that case. The study found that there was clear Shariah issues in the scheme and the stipulated conditions were deviated from the AAOIFI Shariah standard.

### 3. Problem Statement

Islamic banks have given products in the whole world which have now emerged as not only viable but also competitive modes of financing against conventional interest based financial system, however; a lot of obstructions exist still on the way forward to the growth of Islamic banking system (Ouerghi, 2014). There is a lack of standardization in legal documentations and Shariah interpretations of the products of Islamic banks which becomes one of the main sources to make people not only doubtful but also makes investors feel reluctant to invest in Islamic banking and urges them to choose the conventional system of finance (Islamic Finance Outlook, 2019).

Standardization of shariah standards means the establishment of universal shariah standards which are agreed upon after the consultation with every school

of fiqh. It also eliminates the need for individual shariah scholars at bank level or at the national level and it also helps to fulfill the shortage of shariah scholars. According to Ghoul (2011), standardization means the establishment of universal Shari'ah standards which would eliminate the shortage and the divergence of Shari'ah interpretation. According to McMillen (2011) standardization means the establishment of universal shariah standards by flexible codification of shariah principles which would ultimately reduce the shortage of shariah scholars and also help to promote unity among different school of fiqh. This signifies that a universally recognized Islamic manuscript or standard is important to harmonize the differences in fiqh opinions concerning Islamic finance in order to further enhance the product development and reduce the *Shariah* noncompliance risk (Oakley, 2010).

In this respect, with the determination of standardization in the rulings of Islamic banking products worldwide, the objective of this study is to compare and analyze the AAOIFI and BNM Shariah standards pertaining to Mudarbah financing so that the aim of standardization may be realized. Therefore, the study answers the question: What are the differences between the AAOIFI and BNM Shariah standards pertaining to Mudarbah financing?

### **3.1 Shariah Standards on Mudarbah**

#### **3.1.1 AAOIFI on Mudarbah**

The AAOIFI team in its meeting held in Al-Madina tul Munawwarah on May 11-16, 2002 developed the Shariah Standard No: 13 on Mudarbah financing with the title, 'Mudarbah A partnership in profit'. This standard is comprehensively divided into ten (10) sections and each section is further divided into different sub-sections which encompass the important aspects of Mudarbah transaction and its various steps in detail. Requirements before the execution of Mudarbah contract and their details are also covered. However, to secure the loss in capital by Mudarib negligence, the permission of guarantees etc. is also discussed in brief. This standard is applicable to both kinds of Mudarbah financing whether it is restricted or unrestricted type of contract. The concept of sukuk based on Mudarbah transaction is not discussed in this standard, as it is covered in a separate standard of Investment Sukuk. Moreover, Shariah Standard No: 13 on Mudarbah financing also covers the rights and duties and the relationship between the Mudarib i.e. the institution and Rab ul Mal i.e. the client.

#### **3.1.2 BNM on Mudarbah**

In order to develop harmony within different Islamic banks in Malaysia and to comply with the requirements of Shariah, Bank Negara Malaysia (BNM) was

given the authority by the Islamic Financial Services Act (IFSA) to develop and issue Shariah Standards for the Islamic banks in Malaysia. As of now, BNM has already issued twelve (12) Shariah Standards including Mudarbah which was issued by BNM on 23<sup>rd</sup> December, 2013. The Shariah Standard on Mudarbah is broadly divided into four (4) parts: Part (A) gives an overview of the standard whereas Part (B) of the standard outlines the Shariah requirements and practices that contain thirteen (13) sections comprising seventy-six (76) sub-sections. Moreover, Part (C) discusses the operational requirements while in the last Part (D), specific operational requirements are given for the Islamic financial institutions when they are capital providers which are followed by twelve (12) appendices on legitimacy of Mudarbah contract.

Moreover, clauses under Part (B) & (C) are categorized as either Standard (S), the non-compliance of which is subject to penal action, or Guidance (G) which contains the information, advice and/or recommendation that help Islamic financial institutions in Malaysia for the implementation of sound industry practices.

#### **4. Methodology and Data Collection**

The main commitment of the study is to explore the differences between the AAOIFI and BNM Shariah standards through archival data, therefore, the study is qualitative in its nature which uses archival research strategy using inductive approach as according to Saunders, Lewis, Thornhill and Wilson (2009), inductive approach initiates with collecting data to explore a phenomenon. Furthermore, the study's main intent along with research question had never been inquired before; thus, the study is exploratory also. Furthermore, this study collected archival data from the AAOIFI and BNM Shariah standards as prescribed by Bryman (2012). Under the qualitative methodology, the content analysis method is applied to do an in-depth analysis of gathered documents and for the extraction of useful insights from them. This method is adopted as the research objective is to make comparative analysis of AAOIFI and BNM Shariah standard on Mudarabah financing.

Following table shows the list of sources from where we have gathered the archival data.

**Table 4.1: List of Archival Data Sources**

Bank/Institution	Document	Source	Year of access
AAOIFI	Mudabah A partnership in Profit	Bank Personnel	2018
Bank Negara Malaysia	Shariah Standard on Mudabah	Bank Website	2019

This table is constructed by the researcher which reveals the secondary sources of data collection

#### 4.1 Analysis and Discussion

After having the callous content analysis and comparison between the clauses of the AAOIFI Shariah Standard and BNM Shariah Standard on Mudabah financing, it was revealed that the clauses covered in all the six (6) sections of Mudabah framed by AAOIFI are also comprehensively covered in the BNM Shariah Standard on Mudabah in its eleven (11) sections. However, certain differences in the content of the clauses of both the standards have been found

#### 4.2 Comparison of AAI OFI Standard (Clauses; 5/1, 5/2) with BNM Standard (Clauses; 11.3, 11.4) on Types of Mudabah

Mudabah contract is of two types: Un-restricted and Restricted mudabah. They are based on the sense of permission of Rab ul Mal (Capital Owner). if capital owner permits Mudarib to manage capital in a defined and determined way, it is called Restricted Mudabah while if capital owner allows him to use the capital in his own way without any specific cautions, it is called an Un-restricted Mudabah as defined in both standards: AAI OFI and BNM. but BNM adds a situation that both the parties can switch their type of Mudabah from one to another by the consent of both parties. So, clause 11.4 of BNM shariah standard clarifies that there is no need to renew the whole content of the contract.

#### 4.3 Comparison of AAI OFI standard (Clause; 4/2) with BNM Standard (Clause; 12.2) on Legal Capacity of Contracting Parties

In AAI OFI shariah standard, the legal capacity of contracting parties is affixed with the legal capacity of a person who can appoint an agent or can have the capacity to become an agent, the reason to accompany it with agent is that Mudabah contract is a sort of bi-lateral agency contract where each party is

called the agent of other (Febianto, 2009). And when we compare it with the BNM shariah standard, the legal capacity of the parties is defined in the footnote which is an overall capacity of the contracting parties given by shariah. This description on legal capacity of the parties describes merely the capacity of a human being and of a legal entity to enter in any contract while the legal capacity in AAI OFI clauses describes the apprehension of the nature of the Mudarbah contract.

#### **4.4 Comparison of AAI OFI Standard (Clauses; 4/1, 4/2, 4/3, 4/4) with BNM Standard (Clauses; 12,13, 14, 15, 16, 17) on Components of Mudarbah**

A contract is always designed with all its necessary components for its successful completion (Derigs & Marzban, 2008). In AAOIFI shariah standard, components of a Mudarbah contract are not mentioned separately which could describe a brief introduction of all elements of the contract, and which could determine the rights and obligations of the contracting parties also. This deficiency is covered by the BNM shariah standard of Mudarbah, the clauses are designed in such a way that after a heading of Components of Mudarbah, each section and every clause demonstrate, in sequence, the structure of the whole contract.

#### **4.5 Comparison of AAI OFI Standard (Clause; 8/2) with BNM Standard (Clause; 14.4) Standard on Agency**

According to the AAI OFI Shariah standard, to appoint an agent other than custom practices of the contract is not allowed during the contract of Mudarbah; however, it is allowed to construct a separate contract which must not affect the Mudarbah contract, if any term of this separate contract is not fulfilled. In comparison of it, BNM Shariah standard compromises with the situation and gives permission to the Mudarib to assign a task to another Mudarib or an agent with the permission of Rab ul Mal who may charge a fee for his services too but AAI OFI did not allow, unconditionally, to hire an agent or charge a fee.

#### **4.6 Comparison of AAI OFI Standard (Clauses; 6) with BNM Standard (Clauses; 15.10) on Permission to take Guarantee on Capital**

Guarantee is an assurance (Afkar, 2017) which is obtained for the security of the capital (Jaffar, 2010), and it is given to the capital provider before any play up with his capital. So, AAI OFI shariah standard allows Rab ul Mal to take guarantee for the security of his capital from Mudarib but it must be according to the capacity of Mudarib. The guarantee is taken prior to the enforcement of the

contract (Htay & Salman, 2013) so that when there occurs breach of any condition, guarantee can participate actively. But in BNM shariah standard, a guarantee for capital is not permissible, and in exceptions, it is written that in case of breach of any term of contract, the guarantee can be taken. Now the question is that if it is not permissible at initial stage of contract, how deficit would be compensated if any misconduct or breach of any condition occurs in the mid of the contract.

#### **4.7 Comparison of AAIOFI Standard (Clauses; 9, 9/1, 9/2, 9/3, 9/4, 9/5, 9/6, 9/7) with BNM Standard (Clause; 15.18) on Defaulting Rab ul Mal**

As it is discussed earlier that BNM has explained fantastically the components of Mudarbah, so inverse to the AAIOFI, BNM has also elaborated the rights, obligations, and penalties of the parties upon breach of any term where all the standards fix the penalties of Mudarib upon breach of any condition. BNM has also discussed the conditions: what will happen if Rab ul Mal fails to provide capital or some part of the capital.

#### **4.8 Comparison of AAIOFI Standard (Clauses; 8, 8/1, 8/2, 8/3, 8/4, 8/5, 8/6, 8/7, 8/8) with BNM Standard (Clauses; 16.9, 16.10) on Profit**

AAIOFI and BNM shariah standards have a detailed pattern to fix the profit and they applied many regulations to fix, earn, and distribute the ratio of profit so that nobody can claim for his exploitation because profit is the main focus (Hilman, 2016) of binding parties in financial contracts or profit generating contracts. So, to generate profit, many of the strategies are adopted to convince the other party. After comparing a different clause of BNM standard, it came into view that, no doubt, conventional banking system fixes a ratio of capital as profit is not permissible but this standard gives a way to Islamic financial institutions to translate the ratio of profit yielding capital of last years to share as an experience or to have an estimate of the profit earned to the customer so that this tool of motivation may inspire the customer to refrain from Haram transactions.

#### **4.9 Comparison of AAIOFI Standard (Clauses; 10, 10/1) with BNM Standard (Clauses; 22, 22.1) on Dissolution of Mudarbah**

A contract may be dissolved due to many reasons which both standards tried to explain thoroughly but comparatively BNM shariah standard is more



comprehensive and describes in its clauses that dissolution can also be occurred unilaterally due to the negligence, misconduct or termination of any condition by any party, the other has the right to terminate unilaterally. Moreover, BNM has also mentioned the death of Rab ul mal while AAOIFI standard writes about Mudarib only. In the last, another reason for dissolution, loss of legal capacity is added by BNM which AAOIFI has not took into its consideration.

Following table summarizes the dissimilarities between the clauses of the AAOIFI and BNM Mudarbah standards.

**Table 4.2 Comparison of AAOIFI and BNM Shariah Standards on Mudarbah Financing**

AAOIFI Shariah Standard	BNM Shariah Standard	Difference
Clauses 5/1 and 5/2 on Types of Mudarbah	Clauses 11.3 and 11.4 on Types of Mudarbah	Minor
Clause 4/2 on Legal Capacity of contracting parties	Clause 12.2 on Legal Capacity of contracting parties	Major
Clauses 4/1, 4/2, 4/3, 4/4 on Components of Mudarbah	Clauses 12, 13, 14, 15, 16, 17 on Components of Mudarbah	Major
Clause 8/2 on Agency	Clause 14.4 on Agency	Minor
Clause 6 on Guarantee	Clause 15.10 on Guarantee	Major
Clauses 9, 9/1, 9/2, 9/3, 9/4, 9/5, 9/6, 9/7 on Duties and Powers of Mudarib only	Clause 15.18 on Defaulting Rab ul Mal	Major
Clauses 8, 8/1, 8/2, 8/3, 8/4, 8/5, 8/6, 8/7, 8/8 on Profit	Clauses 16.9, 16.10 on Profit	Minor
Clauses 10, 10/1 on Dissolution	Clauses 22, 22.1 on Dissolution	Major

This table is constructed with the help of sections 4.2 to 4.9

## 5. Discussion

An exhaustive and in-depth comparison of AAOIF and BNM Shariah standards on Mudarbah financing raised various concerns. It clearly shows the absence of uniformity and harmony between two mainstream Shariah standards pertaining to a single product. The above comparison shows that the most of the differences between AAOIFI and BNM are of major in nature. It is also unveiled that BNM is more comprehensive and encapsulates detailed conditions and covers more scenarios than AAOIFI Shariah standards, as it is highlighted in the clauses pertaining to duties of Mudarib and Dissolution of contract. These results are somehow different from previous studies. For example, Saleem and Mansor (2020) clearly enumerated the importance and inclusivity of AAOIFI Shariah standards and the study also recommended Islamic banks in Malaysia to follow the AAOIF Shariah standards vis a vis BNM guidelines. This may be justified by saying that these differences between AAOIFI and BNM might be only found in case of Mudarbah financing. Therefore, it is pertinent to mention that future research and comparative analysis should be carried on other standards of AAOIFI and BNM.

There is no doubt that AAOIFI Shariah standards are more famous in terms of adoption than BNM. This may be due to authenticity of AAOIFI Shariah standards as it is claimed that the AAOIFI Shariah standards are formulated and devised by a committee of top notch Shariah experts who belong to all major school of fiqh. Contrarily, BNM guidelines and Shariah standards are in accordance with only one school of fiqh. In different studies such as Tahrir et al. (2018) highlighted that there is need to revise the BNM guidelines on Islamic modes of finance. This is also one of the reasons that the major differences are found in the comparative analysis of AAOIFI and BNM standards on Mudarbah financing.

## 6. Conclusion & Recommendations

After having done the rigorous analysis of the clause-wise comparison between the AAOIFI and BNM Shariah standards on Mudarbah financing, it was revealed that, there are five (5) major and three (3) minor differences between the two Mudarbah standards. In Mudarbah contract of both the AAOIFI and BNM Shariah standards, the clauses in which major differences were analyzed include the clauses pertaining to (1) legal capacity of contracting parties (2) components of Mudarbah (3) guarantee (4) defaulting Rab ul Mal and (5) dissolution of Mudarbah whereas minor dissimilarities exist in the clauses pertaining to (1) types of Mudarbah (2) agency and (3) profit.

On the basis of the findings of the study, we recommend to competent authorities of both the AAOIFI and BNM to minimize, if not eliminate, the gap between AAOIFI and BNM Shariah Standards which is also recommended by the Islamic Finance Outlook Report-2019 edition by Standard & Poor's (S&P) Global Ratings as the plurality in the Shariah contracts and its interpretation across different regions may reap benefits in the short run by designing innovative state of the art products. However, in order to meet the objectives of Maqasid e Shariah across the globe and to attain a comprehensive financial system in the long run, standardization in the Islamic banking contracts along with its interpretation are of utmost importance. Furthermore, standardization in the contracts of Islamic banking industry of Malaysia with the AAOIFI Shariah Standards also helps resolve the problem to not only operate globally but also make integrated financial deals with the regions that follow AAOIFI Shariah Standards.

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