

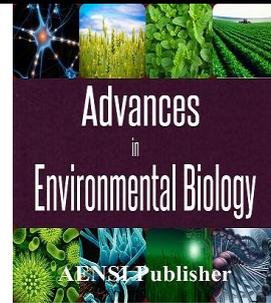


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# From Conventional to Islamic Muamalat Procurement Contract: A Fundamental Approach in the Construction Industry

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### ABSTRACT

The project development can be carried out based on various types of procurement contracts. Discussions and comparison of conventional procurement contracts as it is being presently practiced in Malaysia propose that there is a need for an enhancement in this sector. A comprehensive study of the Islamic procurement contract could endow with a significant solution to the various subjects that face the industry. Examples from the aspect of the Islamic Muamalat contract practiced in the banking and insurance sector in Malaysia, indicates the option for the building sector to move from the existing conventional contract to an Islamic contract in order to bring about the upgrading and sustainable industry practices. Though, the development of the Islamic Muamalat contract requires a major smart revolution and willingness of all parties in the industry. Thus, this paper discusses the potential of the construction industry in Malaysia moving from conventional to Islamic Muamalat procurement practice for an expansion in the industry.

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## INTRODUCTION

Commonly, contract can be defined as a provision and a balanced allocation between responsibilities, rewards, and risks [1]. Gould [2] defined procurement contract as an agreement between two or more parties who agree to provide goods or services. Procurement contract differs in the determination of payment for the involved parties [3].

In should be pointed out that the procurement of manufactured goods is clear-cut, while that of buildings or construction projects requires different procurement contracts depending on each task type, monetary value, and complexity. In every development project, the construction stage is the most critical because it realizes the actual building from a blueprint. Each building construction is unique and involves various parties. The contract signed before construction is subject to changes due to the inability of clients and consultants to foresee project suitability and buildability. Among the project uncertainties are design changes, design failures proven during construction, unanticipated site, unforeseen environmental conditions, and changes in government regulations [4]. These changes could disrupt the main construction schedule and affect the earlier contract signed between the main contractor, supplier, and sub-contractor. If the contractor was given a certain date of completion during the earlier stage, the changes will certainly have a domino effect throughout the completion of the project because each of the construction activities is highly correlated.

Fixed price (FP) is the most dominant contract used for public-sector projects in the industry, but the need to use cost plus (CP) contracts remains while incentive contracts are increasingly being employed [4,5,6]. However, most private-sector practices are also governed by public procurement contract. The FP contract is dominant in the Malaysian construction industry based on the prevalent use of traditional and design-and-build procurement systems. However, the use of FP contract has brought several problems to the industry [7]; [8]; and [9]. This paper discusses the move from conventional contract practices to an Islamic Muamalat contract in the construction industry in Malaysia.

*Literature review:*

(i) *FP Contract:*

Bajeri and Tadel [4] defined FP contract as the action of buyers to offer a seller a pre-specific price for the completion of the project. The client agrees to the terms and contract signed and their representative has no

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control on the costs, detail methods, programming, and expenditures. The contractor enters a risky involvement because they must construct the building with the price agreed in advance [1]. Ordinarily, this contract tends to be awarded by competitive bidding. When a public or private agency decides to procure goods or services, they look for the lowest tender and use their bargaining power. Manelli and Vincent [10] argue that even if the benefits of the selection of the lowest tender has been generally agreed upon by economists because of competition, the quality, which is guided by inefficient and incomplete contracts, enables the other party to maximize the profit.

*(ii) CP contract:*

Bajeri and Tadelì [4] defined CP contract as the price reimbursement for the actual cost of the contractor plus a stipulated fee. In actual practice, the employer pays the contractor for the actual costs of work in addition to a management fee, which includes the overhead charges, supervision costs, and profit of the contractor. Based on the contract, the contractor agrees that all his expenditure of labour and materials, among others, will be met by the client, and the contractor will only charge a fee on an agreed basis [5]. Turner [1] justifies that this contract will be used when the sum of the contract is derived based on actual costs of labor, plants, and materials used in the work, in addition to an agreed allowance for overheads and profit. Usually, the customer agrees to reimburse the contractor in full.

*From conventional procurement contract to Islamic approach:*

Jaafar [11] identifies the following rationales on shifting from conventional to Islamic contract in the construction industry:

- i. The Islamic law of contract has been widely used in banking and insurance sector in Malaysia. The Malaysian Islamic finance industry has been in existence for over 30 years under the enactment of the Islamic Banking Act of 1983.
- ii. In Islamic principle, the contract is the core of the Islamic Shariah. The contract must be free from *riba*, *gharar* or uncertainty, any gambling element, deception and other unethical issues, danger, unfairness, and must be based on mutual consent. The local construction industry is based on a conventional procurement system where the practiced contract is solely guided by Western philosophy.
- iii. Contracts emerged from the British colonial period wherein the local construction industry used the FP contract, which is embedded in the dominant procurement system. High dispute originated from the arrangement together with contract manipulation and the demand for a more serious, genuine, and pure contract to safeguard all the parties affected.

*Methodology of the concept of contract with Islamic law:*

With reference to the Committee of Islamic Fiqh, the *al-Muqawalah* contract is a contract wherein only one of the contracting parties agree to manufacture a product or conduct work that is equal to the payment promised by the other party. Fiqh scholars refer to this contract as *al-Istisna'* (manufacturing contract). The act of the contractor to advance the work in this contract is referred to by Fiqh scholars as *al-Ijarah* (lease) on the work [Resolution No. 129 (14/3) on The Council of the International Committee of Islamic Fiqh of the Organisation of Islamic Conference, 2003].

*(i) Al-Istisna' contract:*

In Arabic, the term *Istisna'* means making, manufacturing, or constructing a product. An *Istisna'* contract is therefore defined as “a contract with a manufacturer to make something as demanded by the client using his own materials...” [12] In other words, it is a contract of sale of specified items to be manufactured or constructed with an obligation on the part of the manufacturer or contractor to be delivered to the customer upon completion [13] and [14]. Nevertheless, to ascertain the validity of *Istisna'*, the price must be determined with the consent of the parties and necessary specification of the commodity (intended to be manufactured) should be fully resolved between them. The *Istisna'* contract creates a moral obligation on the manufacturer to produce the goods, but before they begin the work, any of the parties may cancel the contract after giving a notice to other parties [15] cited in [16].

*(ii) Al-Ijarah contract:*

“*Al-Ijarah*” is a term in Islamic Fiqh. Lexically, it means “to give something on rent.” In Islamic jurisprudence, the term “*Al-Ijarah*” means “to employ the services of a person on wages given to him as a consideration for his hired services.” The employer is called *musta'jir* and the employee is called *ajir*. This type of *Ijarah* includes every transaction in which the service of a person is hired by somebody else. *Al-Ijarah* is a contract in which the contractor performs a certain work only with the materials to be supplied by the customer. The administration and the supervision are done by the other contracting party who is the owner of the project. In this contract, the project owner is the one who provides the materials, whereas the contractor only owes them

duty to use the materials in performing the work in accordance with specifications [17]; cited in [18]. According to [18] in Al-Ijarah construction contract, the contractor is not liable to any loss of materials because these were not kept under their custody. More importantly, the contractor in Al-Ijarah contract does not buy the raw materials.

#### Discussion:

The Western approach on contracts specified by [5] and [1] has a similar background and concept as that of the Islamic law of contract. However, the "FP" or "*al-Istisna*" contract poses a high risk to contractors, whereas the cost reimbursement or "*al-Ijarah*" contract places a high risk on the client.

A large number of projects in the Malaysian construction industry today practice the "FP" or "*al-Istisna*" contract. In a typical scenario for public projects, the primary contractor can earn up to a 10% profit (depending on the type of negotiation with the client), allowing them to further subcontract the project to subcontractors. In most cases, the multilayered subcontracting practiced in the industry resulted in a large number of disputes and problems, including unfair and delayed payments to the subcontractor. These issues seem to pose a major effect on the operations of contractors and subcontractors and are strongly linked to the high rate of business failure in the industry.

In contrast, "cost plus" or "*al-Ijarah*" contract only allows contractors to be paid based on their work, with an acceptable allowance for profit and attendance in the case of direct sub-labour. For large projects, the management contract system allows the involvement of professional advisors to manage all suppliers and expert subcontractors who are hired for a particular project and who do the work based on their specialties. This type of contract does not allow the hiring of an inexperienced management contractor and the utilization of multilayered subcontracting. This practice will enhance the advancement of the construction industry in terms of skillful workers, higher expertise of subcontractors and also minimize related unallowable practices to enhance fairness, which also benefits all industry players.

#### Conclusion:

Considering the negative issues such as corruption, integrity and low quality, delay, and cost uncertainty, revisiting the procurement contract applied in the construction industry is a timely concern. Based on the definition of the agreement of two parties, the transparent contract will help address the industry problems. The construction industry may also borrow a leaf from the successful practice of the Islamic procurement in the banking and insurance sectors. One approach is to create a respective body and employ an expert in Islamic Muamalat to work with industry participants in developing Muamalat contracts. This action will enhance the future development of construction industry towards the trustworthiness, integrity, and sustainability of various stakeholders. However, the growth of Islamic contract for better industry practice may require a long time and willingness of both government and the industry participants.

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