

25. WORKING CAPITAL FINANCING

Where finances are required for the working capital of a running business, the instrument of Musharakah may be used in the following manner:

1. **The capital of the running business may be evaluated with mutual consent:** The value of the business can be treated as the investment of the person who seeks finance, while the amount given by the financier can be treated as his share of investment. The Musharakah may be affected for a particular period, like one year or six months or less. Both the parties agree on a certain percentage of the profit to be given to the financier, which should not exceed the percentage of his investment, because he will not work for the business. On the expiry of the term, all liquid and non-liquid assets of the business are again evaluated, and the profit may be distributed on the basis of this evaluation.

Although, according to the traditional concept, the profit cannot be determined unless all the assets of the business are liquidated, yet the valuation of the assets can be treated as “constructive liquidation” with mutual consent of the parties, because there is no specific prohibition in the Shariah against it. It can also mean that the working partner has purchased the share of the financier in the assets of the business, and the price of his share has been determined on the basis of valuation, keeping in view the ratio of profit allocated for him according to the terms of the Musharakah.

For example, the total value of the business of A is 30 units. B finances another 20 units, raising the total worth to 50 units; 40% having been contributed by B, and 60% by A. It is agreed that B shall get 20% of the actual profit. At the end of the term, the total worth of the business has increased to 100 units. Now, if the share of B is purchased by A, he should have paid to him 40 units, because he owns 40% of the assets of the business. But in order to reflect the agreed ratio of profit in the price of his share, the formula of pricing will be different. Any increase in the value of the business shall be divided between the parties in the ratio of 20% and 80%, because this ratio was determined in the contract for the purpose of distribution of profit.

Since the increase in the value of the business is 50 units, these 50 units are divided at the ratio of 20:80, meaning thereby that B will have earned 10 units. These 10 units will be added to his original 20 units, and the price of his share will be 30 units.

In the case of loss, however, any decrease in the total value of the assets should be divided between them exactly in the ratio of their investment, i.e., in the ratio of 40/60. Therefore, if the value of the business has decreased, in the above example, by 10 units reducing the total number of units to 40, the loss of 4 units shall be borne by B (being 40% of the loss). These 4 units shall be deducted from his original 20 units, and the price of his share shall be determined as 16 units.

2. **Sharing in the gross profit only:** Financing on the basis of a Musharakah according to the above procedure may be difficult in a business having a large number of fixed assets, particularly in a running industry, because the valuation of all its assets and their depreciation or appreciation may create accounting problems giving rise to disputes. In such cases, Musharakah may be applied in another way.

The major difficulties in these cases arise in the calculation of indirect expenses, like depreciation of the machinery, salaries of the staff etc. In order to solve this problem, the parties may agree on the principle that, instead of net profit, the gross profit will be distributed between the parties, that is, the indirect expenses will not be deducted from the distributable profit. It will mean that all the indirect expenses shall be borne by the industrialist voluntarily, and only direct expenses (like those of raw material, direct labor, electricity etc.) shall be borne by the Musharakah. But since the industrialist is offering his machinery, building and staff to the Musharakah voluntarily, the percentage of his profit may be increased to compensate him to some extent.

This arrangement may be justified on the ground that the clients of financial institutions do not restrict themselves to the operations for which they seek finance from the financial institutions. Their machinery and staff etc. is, therefore, engaged in some other business also which may not be subject to Musharakah, and in such a case the whole cost of these expenses cannot be imposed on the Musharakah.

Let us take a practical example. Suppose a ginning factory has a building worth Rs. 22 million, plant and machinery valuing Rs. 2 million and the staff is paid Rs. 50,000 per month. The factory seeks a financing of Rs. 5,000,000 from a bank on the basis of Musharakah for a term of one year. It means that after one year the Musharakah will be terminated, and the profits accrued up to that point will be distributed between the parties according to the agreed ratio. While determining the profit, all direct expenses will be deducted from the income. The direct expenses may include the following:

1. The amount spent in purchasing raw material.
2. The wages of the labor directly involved in processing the raw material.
3. The expenses for electricity consumed in the process of ginning.
4. The bills for other services directly rendered for the Musharakah.

So far as the building, the machinery and the salary of other staff is concerned, it is obvious that they are not meant for the business of the Musharakah alone, because the Musharakah will terminate within one year, while the building and the machinery are purchased for a much longer term in which the ginning factory will use them for its own business which is not subject to this one-year Musharakah. Therefore, the whole cost of the building and the machinery cannot be borne by this short-term Musharakah. What can be done at the most is that the depreciation caused to the building and the machinery during the term of the Musharakah is included in its expenses.

However, in practical terms, it will be very difficult to determine the cost of depreciation, and it may cause disputes also. Therefore, there are two practical ways to solve this problem.

In the first instance, the parties may agree that the Musharakah portfolio will pay an agreed rent to the client for the use of the machinery and the building owned by him. This rent will be paid to him from the Musharakah fund irrespective of profit or loss accruing to the business.

The second option is that, instead of paying rent to the client, the ratio of his profit is increased.

3. **Running Musharakah account on the basis of daily products:** Many financial institutions finance the working capital of an enterprise by opening a running account for them from where the clients draw different amounts at different intervals, but at the same time, they keep returning their surplus amounts. Thus the process of debit and credit goes on up to the date of maturity, and the interest is calculated on the basis of daily products.

Keeping in view the basic principles of a Musharakah the following procedure may be suggested for this purpose:

- A certain percentage of the actual profit must be allocated for the management.
- The remaining percentage of the profit must be allocated for the investors.
- The loss, if any, should be borne by the investors only in exact proportion to their respective investments.
- The average balance of the contributions made to the Musharakah account calculated on a daily product basis will be treated as the share capital of the financier.
- The profit accruing at the end of the term will be calculated on a daily product basis and will be distributed accordingly.

If such an arrangement is agreed upon between the parties, it does not seem to violate any basic principles of the Musharakah. However, this suggestion needs further consideration and research by the experts of Islamic jurisprudence. Practically, it means that the parties have agreed to the principle that the profit accrued to the Musharakah portfolio at the end of the term will be divided on the capital utilized per day, which will lead to the average of the profit earned by each rupee per day. The amount of this average profit per rupee per day will be multiplied by the number of the days each investor has put his money into the business, which will determine his profit entitlement on a daily product basis.