

## CIFE02, 03, 04: UNDERSTANDING MUSHARAKAH – ISLAMIC BUSINESS PARTNERSHIPS

You have heard of joint-stock companies. Now learn about the Islamic variation. We look at Musharakah, the Islamic business partnership where partners pool together capital, expertise or goodwill to conduct business or trade. We look at the basic features of a Musharakah and its types, their mode of operation, duration and the various forms of capital contribution. We discuss the management of the Musharakah



business and take you through some practical applications of how Islamic banks use Musharakah. We also look at profit and loss sharing ahead of the subsequent module's profit calculation exercises. We complete our discussion on general aspects of Musharakah, including how banks handle negligence, termination, and constructive liquidation. We round our discussion with some practical examples of Musharakah calculation, a quick review of financial statements and how exactly profit gets calculated.

A Musharakah is a partnership that is set up between two or more parties usually to conduct business or trade. It is created by investing capital or pooling together expertise or goodwill.

Partners share profit based on ownership ratios and to the extent of their participation in the business and share loss in proportion to the capital they invest.

Profit cannot not be fixed in absolute terms such as a number or percentage of invested capital or revenue.

### Types of Musharakah:

- Shirkah tul Aqd
- Shirkah tul Milk

Shirkah tul Aqd is a partnership to enter into a joint business venture and trade. Partners enter into a contract to engage in a defined profit seeking business activity.

Shirkah tul Milk is a partnership in the ownership of property or assets for personal use.

Every Shirkah tul Aqd has a Shirkah tul Milk imbedded in it, namely joint ownership of assets and property.

### Differences between Shirkah tul Aqd and Shirkah tul Milk

1. Shirkah tul Aqd is a direct contract of partnership in a business or income generating activity whereas Shirkah tul Milk comes indirectly through contracts or arrangements unrelated to production or income generation.
2. Shirkah tul Milk is a partnership of joint ownership as opposed to a commercial venture (Shirkah tul Aqd). It may serve as source of income for one party but not for both.
3. In a Shirkah tul Milk ownership proportions cannot be specified however a Shirkah tul Aqd cannot be formed unless the respective capital contribution shares of the parties are specified.

### Types of Shirkah tul Aqd:

- **Shirkah tul Wujooh:** Partnership where subject matter is bought on credit from the market based on a relationship of goodwill with the supplier.
- **Shirkah tul Aa'mal:** Partnership in the business of providing services. There is no capital investment, instead partners enter into a joint venture to render services for a fee.
- **Shirkah tul 'Amwaal/Shirkah tul 'Inaan:** Partnership between two or more parties to earn profit by investing in a joint business venture.

### Musharakah Duration

*Ongoing Musharakah:* Most common form also referred to as open-ended or permanent. Partnership where there is no intention of terminating or concluding the business venture at any point for instance equity participation.

Partners may exit the business at any point they want. This is usually done by the remaining partner(s) purchasing the share of the individual exiting the Musharakah.

*Temporary Musharakah:* Partnership created with the intention of terminating it at a given time in the future at which point Musharakah assets are sold and distributed along with any remaining profit on a pro-rata basis.

It is used to meet working capital needs of businesses, other examples being private equity followed by planned exit.

### **Musharakah Capital**

All Shariah-compliant items of material value may be used as capital in a Musharakah.

It may be in the form of cash or it may be in kind, for instance contributing assets to the business in which case it is necessary to ensure the assets are valued at the time of Musharakah execution.

Partners' capital investment ratio must be determined at Musharakah inception or before the business generates profit.

In case of a Musharakah investment in different currencies, partners must agree upon the numeraire, i.e. one particular currency to serve as the standard of value in the business which is usually the currency of the country where the business is located.

Debt may not constitute Musharakah capital.

### **Musharakah Management**

All partners possess the right to be involved in the administration of the business.

Partners who opt for limited partnership are silent partners. Since they do not participate in the business unlike the working partners, according to Shariah, they cannot be allocated a profit share greater than their capital contribution ratio.

The working partner is responsible for running the Musharakah but cannot receive separate remuneration for his services although he may receive an increased profit share as a reward for his management role.

Unlike for the silent partner, the working partner's profit share may exceed his capital contribution ratio.

In case an individual who is not a business partner serves as business manager, he is paid a fixed wage for his services but does not share business profit or loss.

The business manager is liable for loss in case of his proven negligence.

If the business manager invests in the Musharakah business by means of a separate contract, his capacities of manager and partner are independent of one another. He earns remuneration for his managerial role and shares profit and loss based on his business partnership.

## **Musharakah Profit and Loss**

It is important to remember that profits are not fixed in absolute terms, such as a number, or as a percentage of the invested capital or the revenue.

For instance, \$1,000 of profit cannot be stipulated as a fixed number at the time of the contract's execution because the profit itself is not yet known.

Or, for instance, if a person invests \$100,000 and their profit is guaranteed to be 10% of their investment amount. This would result in an absolute positive number, or \$10,000, regardless of whether the business gains or loses money.

Similarly, profit rates cannot be set as a percentage of the revenue either as if there's no revenue; how can there be any profit? And what if the revenue is unexpectedly high; why should investors be denied higher profits?

In a Musharakah:

- Profit may not be guaranteed or fixed in absolute terms for any of the Musharakah partners.
- Profit may not be set as a percentage of capital.
- Each partner whether minority or majority shareholder must be allocated a profit share.
- One partner cannot guarantee any part of the profit or capital of another partner.
- Silent partner's profit ratio may not exceed his investment ratio.
- During the Musharakah, a partner may surrender all or part of his profit share to another provided doing so is not agreed at the time of Musharakah execution.
- Profit sharing mechanism and profit ratios must be clearly determined at Musharakah inception.
- Musharakah may only announce an expected return for the business; actual returns are declared only after they are known.

## **Profit Calculation**

Profit is calculated by subtracting costs and expenses from revenue.

Loss can only be shared by capital contribution ratios.

## **In Practice**

Many Islamic banks base profit and loss sharing investment or savings accounts on Musharakah. The bank is the working partner and the account holders are silent partners.

Modern ijtehad has enabled a profit calculation system based on a combination of tiers of investment amounts, investment duration, minimum and average balance.

Many businesses need running finance, but are unwilling to opt for finance on interest. In a conventional running finance facility the bank offers credit to a client over a certain period and charges interest. To address this, the bank and its client enter into a temporary Musharakah.

In a Shariah-compliant running Musharakah facility:

1. The bank and the client agree to a financing limit.
2. The bank opens a current account to hold the client's sale proceeds and also to allow him to utilize the finance facility.
3. The client's contribution to the Musharakah is the business he owns, while the bank's contribution to the Musharakah are the running facility funds.
4. After a certain period, the client and the bank share the business's operating profit based on a predetermined ratio.
5. Eventually, one partner, the bank, sells shares to the remaining partner, the client, and exits the Musharakah.

Unlike interest-based financing, where the bank is only interested in the repayment of a debt, in a running Musharakah, the bank has actual equity ownership in the client's business.

### **Negligence in Musharakah**

Negligence refers to loss resulting from the violation of contract conditions or willful or intentional damage to the Musharakah.

### **Musharakah Termination**

If partners have not agreed on a Musharakah term, one of them may terminate his partnership unilaterally at any time.

Alternatively, a condition may be stipulated at contract execution that no partner can terminate the contract without the consent of the other partners.

In case of Musharakah termination, if assets are realized as cash, they are distributed based on partnership ratios. In case a profit has been earned, it is distributed based on predetermined profit ratios.

Tangible assets may be liquidated by granting them to existing partners in exchange for the profit they have earned or they may be sold in the market and the income from them distributed.