Islamic Corporate Finance through Diminish Musharakah Financing Mode

Dr. Ahcene Lahsasna*

Abstract

Corporate finance as form of a business organization includes entrepreneurship, sole proprietorship, partnership and corporation. One of the challenges faces by the modern firm corporate is the working capital and financial support to their gradual business expansion in the market, therefore the financial aspect is always consider as crucial impediment for the business growth of corporate firm. In this context this paper is addressing the above issue and providing one of the financial solution to the issue from Islamic perspective by discussing the scheme of diminish musharakah financing mode as an Islamic financial approach to support the corporate firm in the industry, this approach is a form of partnership which was developed recently by the Islamic financial industry in order to meet the requirement of the corporate finance need. In this financing model the Islamic banks or the Islamic financial institutions agree as financier to transfer gradually to the corporate firm shares in the musharakah structure, so that the Islamic bank’s share declines and the client (corporate firm) share increases until the latter becomes the sole proprietor of the venture. According to this concept, a financier and the corporate firm participate either in the joint ownership of a property or an equipments such as machines, or in a joint commercial enterprise. The share of the financier is further divided into a number of units base on the mutual agreement of the two partners, and it is understood that the corporate firm will purchase the units of the share of the financier one by one periodically according to the scheme of diminish musharakah, thus increasing corporate firm own share until all the units of the financier are purchased by corporate firm so as to make him the sole owner of the property or the commercial enterprise. This scheme is very useful for the industry and consider very stable mode in corporate finance which support the financial needs of the corporate firm at large.

Key terms of the research: Corporate finance, partnership, musharakah, diminish musharkah.

---

1 Paper to be presented at the National Conference On Islamic Economics 2009 on 10th-11th February 2009 at Universiti Malaya.

* Lecturer INCEIF University, the Global University in Islamic finance, Kuala Lumpur, Malaysia.
1. Definition of Musharakah

1.1. Literal definition

The word *musharakah* in Arabic is derived from *sharaka* or to share. *Al Shirkah* covers in its meaning *shirkah al-mulk* which is a joint ownership of a common property and *shirkah al-aqad* which is a contractual partnership in a business according to a mutual consent. (Al Mawusua Al fiqihiah, 2004).

1.2. Technical definition:

scholars define *musharakah* as a contract between partners on both capital and profit. The Shafi’i scholars define it as the confirmation of the rights of two or more people over a common property. Hanbali scholars, it is the amalgamation of rights and freedom to use. Malikis define it as permission to transact where each of the partners permits the other to transact with the partnership property while at the same time retaining his own right to transact with the same property. (Al Mawusua Al fiqihiah, 2004). According to AAOIFI Musharakah It is the commingling of funds for the purpose of sharing in profit. (AAOIFI, 2004. p.175).

In the light of the above definition of musharakah we can conclude the following remarks.

- Musharakah is partnership on capital and profit.
- The concept of musharakah suits the modern concept of partnership.
- Musharakah or partnership is one of the contracts recognized by shariah.
- In musharakah or partnership the profits is shared according to agreed ratio whereas the losses is born according to the ratio of capital/ investment of each partner.

2. Categories and types of musharakah

Partnerships are of two types: holding partnership (sharikat al mulk) and contract partnership (sharikat al aqad). (Al Mawusua Al fiqihiah, 2004). Holding partnership is created by means of inheritance or wills or other circumstances resulting in the holding by two or more persons of an asset in common. In a holding partnership two or more persons share in a real asset and in the returns arising therefrom. A contract partnership is created by means of an agreement whereby two or more persons agree that each of them contributes to the capital of the partnership and shares in its profit or loss. (AAOIFI, 2004. p175).

*Musharakah* contractual partnership is divided into two types: sharikat al *inan* which is unequal-shares partnership and sharikat al *mufawadah* which is equal-shares partnership, these two types are explained below.

2.1. Sharikat al Inan: Unequal Shares Partnership

2.1.1. Concept and definition:

Sharikat al inan means that two person or more people agree to establish a business whereby every member of the group commit him self to pay a specified amount to form a capital. The capital will be invested in business and trade to generate profit which will be distributed among the partner according to a specified ratio agreed upon by them. (Al Mawusua Al fiqihiah, 2004). According to AAOIFI It is a contract between two or more persons. Each of the parties contributes a portion of the overall fund and participates in work. Both parties share in profit or
loss as agreed between them, but equality is not required either in the contribution to the fund or in work or in sharing of profit (these being subject to agreement between the parties). (AAOIFI, 2004. p. 175).

2.1.2. Features of sharikat al inan

The main characteristic and feature of inan as follows:

- This type of partnership does not require equality in capital investment amount.
- The distribution of profit generated is subject to mutual agreement, and it does not require equality in profit distribution.
- The members of the sharikat considered partners are the business organization.
- Each partner in the business organization considered as an agent in acting on matters concerning the capital of the company and trade transactions.
- The partner in Sharikat al inan partnership is not acting as sureties. Each of the partners will not guarantee the liabilities of the other partners.
- Each partner in the business organization is allowed to transact in accordance with the terms and conditions stipulate in the partnership agreement.
- The partners in the business organization are required to serve the best interest of the company.
- The contract of sharikat is not binding; it means that all partners have the right to cancel the contract; however they have the right to stipulate terms and conditions which govern the partnership.

2.2. Sharikat al Mufawadah: Equal-Shares Partnership

Sharikat al Mufawadah is an equal-Shares Partnership whereby each partner in the business organization has a share equal in capital, profit and liabilities. This type of partnership is the opposite of inan whereby equality in investment, personal status and distribution of profits and liabilities are required. According to AAOIFI It is a contract between two or more persons. Each of the two parties contributes a portion of the overall fund and participates in work. Both parties equally divide profit or loss. It is a condition of this type of partnership that contributed funds, work, mutual responsibility and liability for debts be equally shared by the parties. (AAOIFI, 2004. p.176).

2.2.1. Features of sharikat mufawadah

There are some important characteristic and feature in mufawadah partnership should be observe which area as follows:

- Each partner in this business partnership has a status of equal authority to transact with capital.
- Each partner considered as an agent for the partnership business and stands as guarantor for the other partners in the business organization.
- This type of partnership is permissible in the view of the Hanafis School of law, whereas the majority of scholars don’t allow it.
- The Hanafi approach is appropriate and applicable for the current business partnership modern provided that the rights and obligations of each partner are well specified and stipulated in the contractual agreement.
3. Category of partnership

3.1. Shirkah al-amwal: The subject matter of sharikat al amwal s in the form of money, whereby all the partners cash capital into the account of the business partnership.

3.2. Shirkah al-amal: The subject matter of sharikat al amal is in the form of labour, whereby all the partners in the organization jointly undertake to provide some services or work to the relevant customers. The income generated from the business will be distributed among the partners according to the agreed ratio. AAOIFI define it as a contract between two persons who agree to accept work jointly and to share the profit from such work. For example, two persons of the same profession or craft may agree to work together and to divide the profit arising from such work on an agreed basis. It is sometimes called abdan or sanae' partnership. (AAOIFI, 2004. p176). An a'maal partnership is considered permissible by Hanafis, Malikis, Hanbalis). It is considered valid within the same profession or otherwise. Its permissibility is based on much evidences including explicit approval thereon by the Prophet, prayers and peace be on him. In addition, it is based on agency which is permissible. This type of partnership has been used throughout without being disapproved of. (AAOIFI, 2004. p.176).

3.3. Shirkah al-wujuh: the subject matter of sharikat al wujuh is the reputation and creditworthiness of the partners, whereby the partners purchase commodities on a deferred payment and sell them again on the spot in the market. The profit generated from transaction will be distributed among the partners on an agreed ratio. AAOIFI define it as a contract between two or more persons who have good reputation and prestige and who are expert in trading. Parties to the contract purchase goods on credit from firms, depending for that on their reputation, and sell the goods for cash. They share profit or loss according to the guarantee to suppliers provided by each partner. Accordingly, this type of partnership does not require capital since it is based on credit backed by guarantee. Hence, it is sometimes called a "receivables partnership". A wujuh partnership is considered permissible by Hanafis and Hanbalis. Those who support its permissibility argue that it includes an agency guarantee which is also acceptable. It has been used throughout without being disapproved of. (AAOIFI, 2004. p.176).

The basic rules of musharakat

There are some rules of musharakat should be mentioned here in order to be observed in documentation and implementation.

1: Distribution of Profit

1. The proportion of profit to be distributed between the partners must be agreed upon at the time of affecting the contract.

2. The ratio of profit for each partner must be determined in proportion to the actual profit accrued to the business and not necessarily in proportion to the capital invested by him.

3. It should not be fixed as a lump sum amount for any one of the partners or any rate of profit tied up with his investment.

4. The distribution of profit is whether it is necessary that the ratio of profit for each partner to conform to the ratio of capital invested by him?

   o The Malikis and the Shaafi’is view that it is necessary for the validity of musharakah that each partner gets the profit exactly in the proportion of his investment.
However, the Hanbalis view that the ratio of profit may differ from the ratio of investment if it is agreed between the partners based on free consent. The Hanafis opined that the ratio of profit may differ from the ratio of investment in normal conditions. However, if a partner has put an express condition in the agreement that he will never work for the musharakah and will remain a sleeping partner throughout the term of the musharakah, then his share of profit cannot be more than the ratio of his investment. (AAOIFI, 2004 & Siddiqi, 1985).

2: Sharing of Loss
All Muslim jurists are unanimous on the point that each partner shall bear the loss exactly according to the ratio of his investment.

3: Management of Musharakah
In a musharakah venture, all partners have a right to take part in its management and to work for it since all of them contributed capital for such an enterprise.

4: Termination of Musharakah
The musharakah can be terminated in any one of the following instances:
1: Every partner has a right to terminate musharakah at any time after giving his partner a notice to this effect, whereby the musharakah will end.
2: If any one of the partners passes away.
3: If any one of the partners becomes insane or incapable of effecting commercial transactions. (AAOIFI, 2004, AL Zuhaili, 5: Termination of Musharakah without Closing the Business
If one of the partners wants termination of the musharakah, while the other partner or partners would like to continue with the business, this purpose can be achieved by mutual agreement.

The partners who want to run the business may purchase the share of the partner who wants to terminate his partnership.

In this respect, one of the pertinent questions is whether the partners can agree, while entering into the contract of musharakah, on a condition that the liquidation or separation of the business shall not be effected unless all the partners or the majority of them wants to do so.

In addition, a single partner who wants to come out of the partnership shall have to sell his share to the other partners and shall not force them to liquidate or separate.

Most of the classical literature of fiqh seems to be silent on this question. However, it appears that there is no objection on such an agreement from the Shariah point of view provided that the partners agree to such a condition at the beginning of the musharakah agreement.

Musharakah financing mode
Musharakah which is base on equity financing mode has a different mode of finance in the modern financing as follows:
1: Project Financing
Musharakah project financing is one of the modes implemented in the financing by the Islamic banks. This mode of financing can be used particularly if the investment comes from different parties.

2: Financing of a Single Transaction
Musharakah financing for a single transaction for individual or corporate depend on the type of banking product subject to the musharakat contract, the financing mode suite the home financing and suite the trade financing as well in import and export whereby the LC is opened base on musharakah concept with some margin. The expected profit is shared between the financial institution and the client.

3: Financing of the Working Capital
Musharakah can be used in financing the working capital of a business in company. The financing of the working capital is based on partnership. The form of financing here is base on the value of the business of the client who is looking for business and investment whereby the financial institution can provide cash for the investment and accordingly the partnership is formulated according to agreed profit ratio. The mode of financing in musharakah is very flexible base on the nature of the business and the mutual agreement of the contracting parties. The financing can be base on the transaction or base on particular period such as one year or less or more depends on the project or the types of the project.

Diminishing musharakah financing
Importance of diminishing musharakah
Diminishing musharakah or musharakah mutanaiqisah is one of the promising modes of finance that promote equity financing, this mode of financing is still new in the industry and it is not implemented very widely. Diminishing musharakah is developed concept from the ordinary musharkah which gives opportunity to investors and clients in getting financial assistant from the Islamic financial institution and suit the position of the Islamic banks in the transaction.

Concept of diminishing musharakah.
The concept of diminishing musharkah is base on gradually transfer of the ownership of the asset from the Islamic financial institution to the relevant client, whereby the Islamic bank’s share
declines and the relevant partner’s share increases until the latter becomes the sole proprietor of the asset (the subject matter of the business partnership). According to AAOIFI it is a Musharaka in which the Islamic bank agrees to transfer gradually to the other partner its (the Islamic bank's) share in the Musharaka, so that the Islamic bank's share declines and the other partner's share increases until the latter becomes the sole proprietor of the venture. (AAOIFI, p.187). The aim of diminishing musharakah is to enable the client to possess the property by purchasing it gradually due inadequate funds.

**Mechanism of diminish musharakah as mode of financing**

According to the concept of diminishing musharakah, the Islamic financial institution as financier and the client participate jointly enter into a musharakah partnership as joint ownership either in a property, assets, equipments, or a joint venture business.

- The function of diminishing musharakah require that the share (the subject matter of musharakah) of the Islamic financial institution financier to be divided into a number of units in order to enable the client to purchase gradually the units of the share of the Islamic financial institution.
- This ongoing process of the facility will increase the shares of the client and decrease the shares of the financier.
- The process will maintain till the full purchase of the outstanding units and make the client the sole owner of the property (the subject matter of musharakah).

**Diminishing musharakah**

![Diminishing Musharakah Diagram](image-url)
Illustration of the mechanism of diminishing musharakah

Diminishing musharakah can be offered by the Islamic banks for single commercial transaction such as home financing for one individual, and convey also the commercial transaction for investment.

A: Illustration of diminishing musharakah for single commercial transaction (Home financing):

This mode of financing can be illustrated as follows:

- An agreement of partnership is concluded between the financier and the client with ratio of 20% and 80%, both agree to purchase an apartment which is the subject matter of musharakah with value of RM 100,000.00, both they the owner of the property. According to the agreement the Islamic financial institution owns 80% of the property, whereas the client share is only 20%.
- The share of the financier is divided in eight equal units (example), each unit is representing 1/8 ownership of the apartment.
- The client agrees to buy the financier’s units on monthly or three months basis according to their mutual consent subject to the financial profile of the client.
- The ongoing process of the facility will reduces the share of the financier from 80% to 70%, 60%, 50% according to the periodical and regular payment by the client. Meanwhile the share of the client will increase accordingly.
- This process of payment will continue according to the terms of the agreement and the duration stipulated in the contract till full purchase of the outstanding units from the financier.
- This process and its duration is related to the terms and conditions of the contract agreement, it can be 5 years, 10 years, and the units of the financier can be divided into 8 units of 80 units depends on the mutual consent of the partners in musharakah, and base on the financial profile of the client.
- At the end of the contract agreement and stipulated period the client purchases the whole share of the financier and will be entitle for the full ownership of the property (apartment).
- The diminishing partnership or diminishing musharkah allows the financier to get a periodical rent according to his proportion of ownership in the property, because his partner is fully utilizing the house, and at the same time allows him periodical returns from sales of the units of his share.
B: Illustration of diminishing musharakah for commercial transaction (investment):

This mode of financing can be illustrated as follows:

- If a company wants to purchase 100 taxi services to be used in the city, the value of one car is RM 100,000.00, with a total amount of RM 10,000,000.00.
- The purpose of buying the cars is to offer a transport services to passengers and generate profit.
- The financial profile of the company does not enable it to invest in this business.
- The company approaches the financier to be a partner in the investment. The Islamic bank agrees to participate in the partnership and be partner in the investment, and accordingly they establish a partnership base on ratio of 20%, 80%.
- Both of them purchase 100 taxis with capital of RM 10,000,000.00 according to the agreed ratio.
- After the purchase is concluded the expected return of the business by one taxi service RM 1000 earned on a daily basis, which make the value of 100,000.00 monthly.
- The profit is distributed according to the ration of investment whereby RM 80,000 goes to the financier, and RM 20,000 goes to the company.
- The company wants to purchase the share of the financier; therefore the share of the financier is divided into 8 units.
- The company will start buying the units of the financier every one month or tree months according to the terms of the agreement between the two partners.
- As result of this process the share of the financier will reduced to 80, 70, 60, etc. Whereas the share of the company will increase to 20, 30, 40, etc.
The process continues until the end of the agreement and expiry of period stipulated in the contract, 2, 3, 5, or 10 years according to the agreement. By the end of the period the company will have possession and ownership of the property (100 cars).
Mode of diminishing musharakah in banking

Mode of Diminishing musharakah in banking

Mode of diminishing musharakah in banking

Conclusion
The study concludes with the following result:

- Musharakah is one of the important equity financing in Islamic finance.
- There are some important rules in Musharakah must be observe in order to ensure shariah compliance in financing.
- Diminishing musharakah is one of the innovated products in Islamic finance; the concept has been derived from murakaha concept.
- The diminishing musharakah can be used in finance for single financial transaction for individual and for financing corporation.
- The study did not address the issues of the musharakah, because the focus was on the model on diminishing musharakah as a mode of financing.
- There are a few models in implementing diminishing musharakah may vary from one financial institution to another, depends on mutual agreement of the two parties.
- The aim of the diminishing is to provide a financial assistance and realise the benefit and interest to both parties.
- The diminishing musharakah is governed by the rules of musharakah.
- The diminishing musharakah is ending by full ownership transfer to the client.
SEMINAR EKONOMI ISLAM PERINGKAT KEBANGSAAN 2009 (SEIPK ’09)
“KE ARAH PENGUKUHAN DAN PEMAHAMAN APLIKASI SISTEM EKONOMI ISLAM DI MALAYSIA”