

Chapter Six - Accounting for Musharaka Financing

Financial Accounting Standard N° 04 (AAOIFI)

One of the financial transactions used by Islamic banks is the participatory financing contract, which is a permissible financial transaction in Islam. It was established to facilitate the investment of funds and enable people to earn a halal livelihood. Any client intending to enter into such a transaction should familiarize themselves with its terms, its permissibility according to Islamic law, and the relevant legal and jurisprudential principles.

The term "participation/Musharaka" in Arabic, derived from the verb "to participate," signifies sharing or joint ownership. It is related to the concept of partnership, which involves combining two separate assets in such a way that they become indistinguishable.

In the context of Islamic finance, participatory financing refers to the process of combining funds for the purpose of generating profit. It is a contract between the partners who share in both the capital and the profits.

The concept of Musharaka financing:

It is a financial agreement between two parties, in which each party contributes a share of the necessary capital for an economic project or business transaction. The project is managed by both parties or one of them, as agreed upon. Each party receives a share of the profits, proportionate to their capital contribution.

Sharia-compliant of Musharaka Financing:

The partnership contract refers to the partnership between several parties in terms of money, work, and management. All parties have the right to share in the results and returns generated by the partnership process. Jurists have included a group of contracts that fall within the partnership process, such as the Mudarabah company, the Anan company, the Mufawwadah company, the Wujuh company, the Abadan company, the Muzara'ah company, and others. However, the jurists' interest in this issue has focused on the Mudarabah and Anan companies.

Contemporary Islamic scholars have agreed to classify par financing as a type of "Musharaka" (partnership) agreement, based on its similarities in structure and purpose, such that the legal principles governing participatory financing are derived from the legal principles of Musharaka.

The Islamic legal conditions for Musharaka financing:

The contracting parties: Both partners must be legally competent to enter into contracts and manage their assets. It is not a requirement that both partners be Muslims, as non-Muslim participation is permissible within the framework of Islamic principles.

Capital: Both parties must contribute capital, although the amounts contributed do not need to be equal. The capital must consist of a readily available currency, and its type and amount must be clearly defined.

Profit distribution: The rules for profit distribution between the partners must be clearly defined. In the event of a loss, each partner bears the loss in proportion to their share of the capital.

Implementation of Musharaka financing: The Islamic partnership contract is based on trust and agency. All parties are accountable to God, to themselves, and to their partners. Each party must understand their specific rights and responsibilities within the partnership, and both parties must agree to the terms of the contract.

Types (Methods) of Musharaka(Partnerships):

First - Permanent **Musharaka**: These take the form of an investment in joint-stock companies, ranging from 20% to 50%. The invested company is called an associate/allied/sister company.

Second - Temporary **Musharaka**: These involve the bank's participation in a specific project with the goal of making a profit for a specific period. Partnerships take two forms:

1 - **Musharaka** to finance a specific transaction: The bank agrees with the client to finance a single transaction, then they sell it and share the profits. The bank then reclaims its money in one lump sum. This is the simplest type of **Musharaka** .

2 - Diminishing Musharaka Ending with Ownership: This is a partnership in which one partner undertakes to gradually purchase the other partner's share until the buyer fully owns the project. The partnership must not require buying and selling; rather, the partner undertakes this outside of the partnership by a promise separate from the partnership.

The concept of diminishing Musharaka financing includes the following:

- The financing provided by the bank is for a specific, defined project.
- The financed project is expected to generate profitable income.
- The bank is a partner in the project through the financing it provides.
- The bank's **Musharaka** is limited to the financed project.
- The relative share of the income of each of the bank and the other partner is determined according to their respective share of the capital.
- The duration of the **Musharaka** is linked to the other partner's ownership of the entire project.

Implementation of Musharaka Operations:

1 - Accepting customer requests for financing in the Musharaka form, accompanied by supporting documents, evidence, and economic feasibility studies.

2 - The Islamic bank reviews the application from a Sharia, banking, and financial perspective, including a statement of cash payments, profitability, and all requirements that demonstrate the project's success and ability to repay.

3 - The results of the study are presented to the relevant higher authorities for necessary approval in accordance with agreed-upon procedures.

4 - Upon financing approval, the customer fulfills the commitments (not to neglect, default, or transgression), concludes the Musharaka contract, and outlines the agreed-upon operating and payment systems and controls.

5 - Follow-up, oversight, and performance evaluation, as well as the continuity of accounting and Murabaha on Musharaka activities, business results, and profit distributions.

Requirements included in Standard No. 4 issued by AAOIFI:

Standard No. 4, published by AAOIFI, has the following requirements:

1. If the payment is made in kind, the bank must record a gain or loss in relation to the cash value, and the amount paid is calculated at fair value.
2. The difference is shown as a gain or loss in the profit/loss statement. The historical value is recorded less the historical value of the sold share, accounting for the fair value assessment of that share.
3. The customer's portion is recorded as a receivable until it is fully collected if the Musharaka term ends and the client is unable to return the bank's share.
- 4-If the Musharaka lasts longer than a year, the bank's portion of the revenue is recorded at the conclusion of the fiscal year or when accounting for it.
5. The bank discloses the amount of the provisions it has set up to offset any drop in the value of its Musharaka stake.

The most important accounting recording according to Standard No. 4 when the partner client is the project manager:

- When contracting:

The bank, upon delivering the amount required to finance the project, measures the amount paid in cash or at fair value if the share is in kind, with the resulting difference recognized in profit or loss.

- 1- When the bank pays the share in cash, it records the following:

Dr. Musharaka Financing Transaction No....

Cr. Treasury, Partners' Current Accounts

- 2- If the bank's share is in kind (and the fair value = book value), the bank records the following:

Dr. Musharaka Financing Transaction No....

Cr. Assets Account

- 3- If the bank pays its share in kind and the fair value of the asset is greater than its book value, the difference is recorded as profit:

Dr. Musharaka Financing Transaction No....

Cr. Assets Account

Cr. investment profits

4- If the fair value of the asset is less than its book value, the difference is recorded as a loss.

Dr. Musharaka Financing Transaction No....

Dr. investment Loss

Cr. Assets Account

B- After contracting

The share is recorded at its historical value, less the historical value of the share sold at fair value. The difference between the two values is recorded as a gain or loss in the income statement.

-Value of the share sold = book value (historical). The bank records the following:

Dr.Means of Receipt

Cr. Musharaka Financing Transaction No....

-Value of the share sold > book value

Dr.Treasury

**To the afore mentioned
Cr. Musharaka Financing
Cr Investment Profits**

-Value of share sold < Book value

Dr.Collection Method

Dr. Investment Losses

Cr. Musharaka Financing Transaction No...

Second: Recognizing the Bank's Share in Musharaka 's Profits or Losses

1- If the partnership has ended or been liquidated and the Bank's share in the partnership's capital has not been recorded after full accounting, the Bank's share is recorded as a liability on the partner as follows:

Dr. Musharaka receivable (Partner)

Cr. Musharaka Financing Account, Transaction No.

2-The bank's share in **Musharaka** profits is recorded as a liability on the partner if they are not collected, as follows:

Dr.Musharaka receivable

Cr. Investment Profits/Musharaka

3- If the partnership profits are due but the partner does not receive them, they are recorded as uncollected profits due as follows:

Dr.Accrued Investment profits

Cr. Investment Profits/Musharaka
