

The difference between islamic musharkah and conventional equity investments essa...

[Business](#), [Company](#)



This paper compares the differences between Islamic Musharaka and Conventional equity investments. It contains a detailed discussion on both financial models accompanied with a brief comparison of the two at the end. The following aspects of the Musharaka and Conventional equity financing contracts have been covered.

1. Introduction to Islamic and Conventional financing systems
2. Brief over view of both modes of financing
3. Types of both modes of financing
4. Commencement of agreement
5. Contract terms and conditions
6. Termination of contract
7. Risk of loss
8. Ownership provision
9. Expense consequent to ownership
10. Future aspects

Islamic Finance: A financing system that is in consonance with the principles of Islamic law (Shariah). The prime principle of this system is an interest free financing. It promotes sharing of risk among the investor and the entrepreneur by promoting investment and discouraging loans. Islamic financing system focuses on generating returns from investment tools that are Shariah compliant. Islamic law associates the gains on investment with its performance. Operating within the range of Islamic law, the base of operations of Islamic financial models is the sharing of risk which may arise through investment activities using the tools of Islamic modes of finance.

Alike conventional system; the rates of returns are aimed at maximization, provided Sharia principles are followed. Islamic financing system ensures that all parties that are involved contribute equally in both the profitability or in any losses incurred. The status of customers is of contributors or partners in any business deal or any financial transaction.

On the other hand Equity Financing is a method that is applied in order to raise share capital through external investors, provided the share capital being issued in lieu of company shares.

Equity investments are made aiming to achieve medium to long term returns.

The major advantage to such financing is that the business is not liable to payback the money. Rather, the investors expect to claim their investment out of future returns.

Need for Financing:

There could be many reason for which a person or a business needs financing, for example, in order to start a business, acquisition or merger, moving to new premises, to pay for the day to day running of business, house building etc. Certain modes of financing have been developed by financial institutions, as for example debt financing, equity financing and taking in to account the Islamic banking; they offer musharkah and mudarbah financing. Discussed below are a few aspects and comparison of musharkah and conventional tools of financing.

Musharkah:

The word Musharaka literally means sharing. According to Islamic law, Musharaka refers to a joint partnership where two or more persons combine either their capital or labor, forming a business in which all partners share the profit according to a specific ratio, while the loss is shared according to the ratio of the contribution (Usmani, M. I. 2002, p. 87).

Types of Musharkah

Musharaka can be a partnership that is equal, unrestricted and unlimited, in which the partners have equal authority in the areas of management and capital, also they enjoy a right of disposition. Each partner is the guarantor as well as the agent of the other.

Another type of investment partnership is quite limited. In this type of partnership contribution is done to the capital fund, this could be done either via money, contributions in labor, or kind. The partners are not the guarantors in this case; they only act as the agent of the other partner.

For both types, profit sharing is done in an agreed upon manner and the losses are born in proportion to the size of their investment.

Another form of Musharkah is Diminishing Musharaka it is a type of co-ownership where two or more partners share the ownership of a tangible asset in a proportion that is agreed upon at the time of contract. One of the co-owners buys out the proportionate share of the other co-owner in periodic installments till the title to the asset is fully transferred to the purchasing partner / co owner.

Terms and Conditions

Since the base of Musharkah is a mutual contract, it therefore, needs to fulfill all the necessary requirements of a valid contract. For example, the capability of the parties to enter the contract, like age and mental compatibility. Mutual consent of the parties entering the contract without any fraud, duress or misrepresentation. Any missing element shall turn the contract void. Contract must take place with free consent of the parties without any duress, fraud or misrepresentation, etc.

Distribution of profits

In Musharaka, every partner has a right to be a part of the management. The partners may however come to an agreement according to which the management is maintained by one of them, and other partners shall not work for such a contract. In such situation the " sleeping" partner is entitled to the returns only from his invested capital, also the proportion of profit allocated to the sleeping partner shall not exceed the relative ratio of his investment.

However, if all the partners agree to work for the joint venture, each one of them shall be treated as the agent of the other in all matters of business, and work done by any of them in the normal course of business shall be deemed as being authorized by all partners.

Source: (Usmani, M. I. 2002, p. 92).

If a certain percentage of the profit to the investment has been agreed among the partners, it must be explicitly mentioned in the agreement.

Fixing a lump sum amount for the partners is not allowed in any case, neither any rate of profit could be tied up with the capital. However a management fee can be paid to the managing partner.

Imam Abu Hanifah says 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 musharkah and will remain a sleeping partner throughout the term of musharkah, then his share of profit cannot be more than the ratio of his investment”.

Sharing of Loss

In the case of loss, each partner shall bear the loss according to the exact ratio of his invested capital. Hence, if a partner has invested 20% of the capital, he must bear 20% of the loss, no more, no less, violation of this condition shall render the contract void.

Termination of Musharkah

The partnership/ Musharkah contract is terminated if any of the following events take place:

1. Any of the partners terminates the contract / partnership.
2. Any of the partners expires (the heirs have the option, whether to continue the partnership or to liquidate and retract their shares from the partnership).
3. Any of the partners becomes insane or otherwise becomes incapable of commencing any transactions.

If the remaining partners wish to pursue the business under any of the above situations, it could be done by signing another mutual agreement. These partners would now have to buy the share of the out-going person.

Future Prospects:

Presence of 'Interest' or Riba predetermines a fixed rate of return on a debt advanced by the investor irrespective of the returns or the losses incurred by the debtor, whereas Musharaka does not fix the rate of return. Instead, the profit in Musharaka is based on the real profit earned by the joint venture. In Musharkah the presence of risk confirms it as an Islamic financing instrument. The demand for Musharaka as compared to other Islamic financial instruments is comparatively low, however it is expected that in the future in order to defend the Islamic financial system; more contracts will be introduced using Musharaka as an option of financing.

Conventional Equity Investments

Equity financing, or equity investments, is trading shares or a percentage of ownership of a business for certain amount of money. Through this form of financing a business can raise the capital needed without undertaking any debt. In business language it is the money generated for business activities through selling preferred or common stock to an institutional investors or an individual. As a return, the shareholders receive ownership interests in the company. It is also called "share capital". Equity finance comes in numerous forms and is mainly provided by business angles and venture capitalists.

Private Equity Financing

Private equity financing means that a business, obtains money via private sources, trading up an ownership stake of the business. The investors in this case are engaged with the governance and management of the business, aiming for financial returns either from dividends or capital appreciation. Venture Capital is a special type of private equity financing. Its focus is on the companies that are new. Normally, the VC is involved closely in the monitoring and governance of the company, till the time it ultimately cashes out via selling its stake completely or partially.

Public Equity Financing

The alternative to generating funds from private equity sources would be to raise finance by investing publically through listing the company on the stock exchange. The company seeking investment 'lists' a big percentage of its shares sale. In effect, it is just like sale of goods and services, as a similar process of marketing, branding, marketing, accounting and distribution is involved.

Terms and Conditions

There are no specific criteria to regulate the private equity market.

Therefore, in that respect, any company can qualify. However, it must be kept in mind that the private financier (in any form) is taking on a big amount of risk by financing an unquoted company without any market valuation. Therefore, the investors would also expect higher returns to invest with the assumed higher risks. Companies that need financing through private equity financiers are normally beginners with a valid business model,

or such companies that have established a significantly sized operation just recently and seek financing for expansion. In short, mainly these are SMEs with solid foundation and great potential. Such companies are expected to appreciate faster in value and are attractive targets for investors like VCs.

Associated Risks

Obtaining private or public equity financing comes with quite a few risks.

Some of the risks include:

Being a co owner equity financier may exploit the company to force the company into supplying materials to some other business at below-market prices.

Performance-oriented equity financiers may retract their investments if the company does not do well or in compliance with the required returns.

AS there is no proper formula for the market valuation for the stake in the business' shares, the business might be 'under-valued' by the financiers through strong bargaining.

Autonomy in making decisions is lost.

The terms and conditions may turn Stringent

The demand for profit in any case can hinder business progress as financier has nothing to do with the business his only concern is his invested capital.

When it comes to public equity the compliance with rules and regulations can cost the company.

The company needs to disclose its competitive information.

Sharing of Profits and Losses

The profits are distributed among the shareholders in form of dividends, upon agreed percentage whereas in case of any loss the investments of the financiers are returned by selling out the company's assets. The financier in no case bears any kind of losses if the company incurs any loss.

Termination of the Contract

The shareholders can terminate their contract and withdraw their investment whenever they wish to by selling their share to any other investor. Provided this sale is brought in to prior notice of the company.

Summing up: Brief comparison of the two modes of financing

Musharkah and conventional equity, both the models are some what same in the real sense, the only difference between these two is compliance with the Islamic law, that restricts the investor to enter in to any such agreement or investment that involves interest and uncertainty in any form. It also compels the sharing of losses as well whereas in conventional practice, losses are not shared.

Musharkah as a model Islamic finance system and important instrument of Islamic Banks for house financing, plant machinery & commercial premises and agricultural financing, follows the full Islamic laws and ethics. The difference between Musharkah and conventional financial system can be seen in the general difference between conventional and Islamic financial

system. Islamic finance is differed in many aspects with convectional finance system since it follows the Islamic laws on transactions.

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