

Profit and Loss Sharing – The Shariah Preferred Investment Modes

By S M Wasiulah

The preferred form of investment or financing in *Shariah* is profit-and-loss-sharing (PLS). References can be found in favor of PLS modes in *Quran* and *Ahadith*. However, a quick review of the current progress of Islamic finance industry indicates that while on the one hand, the volume of Islamic finance transactions has grown with a swift pace, on the other, the volume of PLS transactions in the total volume continues to be quite minor. This implies that while the industry as a whole has been targeting a high growth and expansion, it has deviated from its initial objective of promoting banking on an equitable (PLS) basis.

The reasons could be poor ethical standards prevailing in business, the absence of tax shields for equity financed transactions and the cost-intensive nature of record-keeping and audit required for ascertaining and assuring correctness of reported results. The reasons mentioned above do pose serious problems for the successful adoption of PLS based investment arrangements in business, especially in environments such as India. But our experiences shows that if these issues are addressed wisely after engaging in thorough research and study and taking a calculated risk, then it is possible to practice PLS based investment arrangements in a wide range of situations.

It is to be noted that TESIS is the only institution in India which has been providing *Shariah* Compliant Product structuring services for the past decade to corporate firms, SMEs, microfinance institutions and individual investors to cater their fund mobilisation, financing and investment requirements.

In Islamic Finance *Musharakah* and *Mudarabah* are two basic contracts using which PLS based investment arrangements can be designed. According to Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI), *Musharakah* is a partnership of ownership in the combination of the assets/funds of two or more persons in a manner that creates a state of sharing the realised profit or income or benefiting from an increase in the value of the partnership assets.

An extension of *Musharakah* is Diminishing *Musharakah* in which one of the partners promises to buy the equity share of the other partner gradually until the title to the equity is completely transferred to the buying partner. It is necessary that this buying and selling should not be stipulated in the partnership contract. In other words, the buying partner is allowed to give only a promise to buy. This promise should be independent of the partnership contract. It is also preferable that the offer price should be linked to the prevailing market price.

Mudarabah is a partnership in profit whereby one party provides capital (*Rab-al Mal*) and the other party provides labour (*Mudarib*). It can be considered as a limiting case of *Musharakah* in which one partner provides the entire capital and the other the labour. According to AAOIFI, in both contracts, the profit to be shared should be in a ratio of the actual total profit realised and not as a predefined rate or a lump-sum amount linked to capital or on expected profit basis. The losses in case of *Musharakah*, should be shared between the partners only in capital contribution ratio whereas in case of *Mudarabah* the losses should be borne only by the party who is contributing the capital.

Scope of PLS in Indian Context:

Normally, when a PLS arrangement is mentioned, there is a tendency to automatically assume that it implies a thorough-going full-fledged long-term partnership in the commercial transactions and results of an enterprise. But actually this need not be the case always. Profit sharing can assume many forms depending on the extent of risk that the investor is willing to assume and/or the closeness of the monitoring of transactions he wishes to undertake. There can be many kinds of PLS arrangements, right from vanilla equity at one end to Islamic preference shares and the quasi debt of waterfall type of structures used in project finance at the other.

PLS in the Indian context, especially in the current discussion, refers to short to medium term finance accessed as *Shariah* compliant finance modes by small and medium size enterprises (SMEs). Such type of finance is mostly characterized by financing for short periods ranging from a few months to a couple of years, at times with the possibility of rolling over the investment for further contracted periods.

Structuring the PLS based Investments for SMEs:

There are four key areas that need to be taken care while structuring the PLS (*Musharakah* & *Mudarabah*) based investments for SMEs. They are as follows:

1. Capital Structure,
2. Fund Mobilisation,
3. Profit (Returns) Sharing Mechanism and
4. Loss Sharing Mechanism

Capital Structure:

Generally, the capital structure for a business can either be based on 100% equity or on 100% debt. In the first case, the funds flow into the business is as equity from the investor. The investor becomes a partner in the business in proportion to his/her investment and shares the profit and loss accordingly. *Shariah* does not have any objection to this capital structure. Hence, this fund mobilization model is *Shariah* compliant.

Debt is generally, inducted against a predefined return linked to the investment. A predefined return linked only to the investment and independent of the results of the business is 'interest' (*Riba*), which is prohibited in Islam. Hence, this structure is *Shariah* Non-compliant. The debt-based capital structure can be termed

as *Shariah* compliant only if the debtor does not seek or is paid (explicitly or implicitly) any contracted return on the loaned fund (*Qard Hasan*) unconnected with the results of the business.

In addition to the above mentioned two basic capital structures, TESIS has developed a '**TESIS Hybrid Capital Structure**' (THCS). The objective of THCS is to create operational efficiency in fund mobilization, and mitigate risk of the investors while complying with both, local regulations and *Shariah* stipulations.

The THCS structure is a combination of both equity and debt. The debt inducted into the business is linked to equity in such a way that the equity to debt ratio remains same for all the partners. In this case, each partner effectively is loaning to himself in relation to his equity in the business. The investors are paid returns on account of their debt as well as equity. The return on debt, can be either predefined and fixed or return on debt can be linked to the actual profit made by the business, while the return on equity is obviously linked to the residual profit after the return to debt.

It is to be noted that as the debt to equity ratio for all the partners is constant and the giver and the receiver of the interest amount (return paid on debt) is the same person (partners). Hence, the interest paid in this case will not come within the purview of the definition of interest (*Riba*) given in the *Shariah*.

The salient features of THCS are:

- Investment is treated as either Equity or Equity-linked-Debt.
- In compliance with the prevalent tax regime,
- *Shariah* Compliant
- Operationally efficient
- If the major portion of investment comes in as Debt, the overall impact of tax is reduced (benefit of Tax Shield due to Debt).

Fund Mobilisation:

Fund Mobilisation is the process of flow of funds from the person who has an excess to the person who needs them. It can be done either directly or through consultancy. Both the ways have their merits and demerits based on the investment requirement, nature of the business and the market conditions.

Funds can be mobilized directly if the investors are fully aware of the investee and his business. Investors like people from core groups, family members, close friends and associated businessmen can finance one another directly. In this type of financing the level of due diligence, record keeping and other formalities tend to be much lower as compared to the other type. One of the drawbacks of this type of mode is that it has very limited scope in terms of investors as well as funds. There is always heavy risk in case of transparency, correctness of information and dispute resolution.

If fund mobilization is done through consultancy, then the consultants take responsibility of due diligence, investors' relations, project/business information, regulatory

compliance, *Shariah* compliance and regular monitoring. It will also increase the scope in terms of investors as well as mobilization of funds. In this type of financing the level of due diligence, record keeping and other formalities will be much higher which will help in transparency, correctness of information and efficient dispute resolution.

Profit (Returns) Sharing:

Profit (P), in simple terms, is the difference of the Selling Price (SP) of the goods and the Cost of the Goods (C) or services. Let us assume the business has a single product then the profit can be represented as $P = S - C$, where P is profit, S is selling price and C is cost of goods/services.

In case the business has a single product but various costs are segregated either activity wise or nature-wise, then the total cost 'C' can be further identified as $C_1 + C_2 + C_3 + \dots + C_n$, then the total cost can be represented as $C = \sum (C_1, C_2, C_3, \dots, C_n)$, where C_1 to C_n are costs of type '1' to type 'n'.

In case the business has various products and costs segregated product-wise, then the total cost 'C' can be identified as $C_a + C_b + C_c + \dots + C_n$ and the total cost can be represented as $C = \sum (C_a, C_b, C_c, \dots, C_n)$, where C_a to C_n are the costs related to the products 'a' to product 'n'.

In the second case, as the cost varies from product to product, so too does the profit. Therefore, the total profit 'P' can also be identified as $p_a + p_b + p_c + \dots + p_n$. And, the total profit can be represented as $P = \sum (p_a, p_b, p_c, \dots, p_n)$, where p_a to p_n are the profits related to the products 'a' to 'n'.

As per *Shariah* the parties cannot stipulate a lump sum amount or a percentage of the capital as the profit share. Instead, a profit sharing ratio should be stipulated between the parties. Suppose, the parties agree to share profit in the ratio of say x:y, where 'x' is the sharing ratio of partner 'A' and 'y' is the sharing ratio of the partner 'B' then the profit share of 'A' can be represented as $P_A = P * x$ and profit share of 'B' can be represented as $P_B = P * y$.

Misconceptions related to Profit Sharing:

While the *Shariah* insists on sharing profits with investors on the basis of actual profitability, unlike what is generally assumed, such a system does not necessarily imply the need for the investors to share in the overall profitability of the business. From a *Shariah* perspective,

- It is not necessary that profit should be shared only on the completion of the project or winding up of the business. Profit can be shared on account during the business period (say monthly, quarterly, and half-yearly) and a final settlement can be done at the end of the business period. But it should be done only after deducting the interim expenses in calculating the interim profit, keeping the initial investment intact.
- It is not necessary that the sharing be based on the after-tax profitability. As agreed between investors and the business (promoters) the sharing can also be based on pre-tax profits. A clear understanding needs to be reached regarding this aspect between

the investors and the business – ideally – before the start of the financial period / the investment itself.

- It is not necessary that the sharing be based on the entire operations of the business. The parties can mutually decide at the start itself, the scope of operations in the profitability of which the investors would be participating. Thus, the restriction could be defined in terms of geography, in terms of products, in terms of customers, in terms of type of processing (for instance in case of a textile process house, only goods which are accepted for, say, dyeing or printing), in terms of credit terms (cash/credit), and so on. Of course, depending on the scope of participation, the expenses and income which will need to be considered will be different and only those germane to the scope of participation will need to be factored in.
- It is not necessary that all the expenses related to the participation should be considered on actuals down to the last paisa. It is acceptable that a host of minor expenses, amounting in aggregate to a small proportion of the total cost could be considered on the basis of fixed estimates or estimates linked to a measure of activity or some other major relevant cost head such as direct labour, direct material, electricity, etc. Alternatively, such minor expenses could be merged with the promoters' managerial responsibility in return for a fixed or variable compensation to them on account of such expenses.
- In the absence of sufficient data to begin with, certain estimates can be resorted to at the start and the system refined over a period, so long as there remains a reasonable extent of variability in the returns calculated, as a result of variation in external business and market conditions.
- While deciding on the profit-sharing ratio, the promoters can be considered to be bringing to the table, apart from their working capital and their entrepreneurship and expertise, also certain fixed productive assets and their profit share could be based on their bringing this entire package of inputs to the participation.
- It is wrong to fix the profit-sharing ratio on the basis of the Sales. Such a method is not Shariah-compliant, though it may be more transparent and easier in operation. The reason it is not Shariah compliant is that a profit-sharing based on Sales implies that there is next to no possibility of incurring a loss as sales cannot normally be negative. But on the other hand, sales is an ever-present possibility in business.

Loss Sharing Mechanism:

Loss (L), in simple terms, is the difference of the Selling Price (SP) of the goods and the Cost of the Goods (C) or services where the resultant figure is less than zero. It means that the selling price of the goods/services is less than its Cost. Let us assume the business has a single product, then the loss can be represented as $L = S - C < 0$ or $C > SP$, where L is loss, S is selling price and C is cost of goods/services.

As per *Shariah* the losses in case of *Musharakah*, should be shared between the partners only in capital contribution ratio.

Loss sharing in *Musharakah* can be represented as follows:

Equity of A = a

Equity of B = b

Total *Musharakah* Capital = (a + b)

Total Cost = C = K,

Loss = L = SP-C, if SP < C.

Loss Share of A = $(a / (a + b)) * L$,

Loss Share of B = $(b / (a + b)) * L$,

It is to be noted that in case of *Mudarabah* the losses should be borne only by the party who is contributing the capital. The other party who is managing the business will lose his efforts.

Prerequisites of Efficient PLS Practices:

The efficient practice of PLS modes of Islamic Finance relies on the following factors which can be termed as prerequisites of efficient PLS practices.

1. **Shariah Compliance as an Objective:** Investors should be clear that one of the primary objectives of adopting the PLS modes is to make the earnings/income from investments *Shariah* compliant (*Halal*). If the investors have this objective focused in their mind then all the difficulties and hurdles in adopting the PLS model can be solved. Else, despite its benevolent features, a few small difficulties in operational structure or environment would lead the investors to deviate from *Shariah* compliant to *Shariah* non-complaint avenues.
2. **Supportive Regulations:** In a broad sense, the financial regulations in India are not very supportive for the practice of Islamic Finance. However, within the existing regulations, there are certain options available and by utilizing such options PLS can be practiced. The investors and consultants need to constantly do R&D on this aspect to remain in compliance with the local regulations.
3. **Book-keeping and Maintenance of Records:** To ascertain the costs, profits and sharing ratios investors and promoters need to maintain books as per the standards required by the concerned authorities. This will lead to accuracy and correctness of the information on which abovementioned parameters are based.
4. **Business Transparency:** Transparency is required in any business. It becomes more important in case of PLS practices as the crux of these modes is 'ethics' and any ambiguity in the information, calculations, record-keeping, facts and figures can lead to unethical practices, which are against *Shariah*. Hence, investors and promoters should ensure transparency in transactions to enable efficient practice of PLS modes.
5. **Information Sharing:** If the parties involved in PLS business do not share the information related to the accounts and transactions with one another or with the consultant then the whole PLS practice becomes very risky. Information-sharing is the

backbone of any successful business model. Without required information, none of the parties can take decisions related to investment, services, model, etc. This would lead to conflicts among the parties leading to business failure.

6. **Costing System and Cost Management:** It has to be noted that to be able to calculate correct profit the business needs to know exact costs incurred on manufacturing the products or providing services. It becomes more important when the profit needs to be ascertained for different products, activities and periods. Moreover, especially in the PLS business model there is a need to put in extra efforts in terms of human resources, stationary, reporting, etc. to manage the model. These extra efforts bring additional costs which may affect overall profitability of the PLS business. Hence, to tackle all these issues, it is advised that the business should implement scientific costing system. The scientific costing system on the one hand will enable to keep track of the costs incurred product and activity-wise and on the other hand it will also help in identifying the cost centres where the cost has to be controlled.

If the abovementioned prerequisites are taken care of, then the chances of major issues creeping into the implementation of PLS model will become lower. Even if certain issues arise due to unforeseen circumstances, they can be addressed effectively.

Conclusion:

From the discussion above, it can be said that in spite of the difficulties, it is still possible for the investors to successfully and effectively use PLS investment arrangements. For this however, they need to clearly understand the dynamics of PLS arrangements, including the manner and extent to which such arrangements can be simplified without compromising essential *Shariah* compliance and regulatory compliance.

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