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The Functioning and Accounting of Musharakah Financing in Participation Banks and Firms; Problems and Recommendations*

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Abstract

Main income source of participation banks is loans. Participation banks keep the loans they generate in their balance sheet and distribute the income generated by these loans into participation pools and into their equity. The loan processes of participation banks are unique and not evaluated enough for literature. Musharakah financing as a unique financing model of non-interest financial institutions is currently in the foreground. Describing the process of musharakah financing is important to understand the difference between conventional and participation banks. This research evaluates the process of musharakah financing of participation banks for the first time. Accounting of musharakah and the problems are also included in the research. Moreover, with this research, it is included in the results that there is no difference between accounting of normal loans and musharakah financing.

Key Words: Musharakah, accounting, Islamic banking, Islamic finance

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Introduction

The interest-free financing types are applied in a wider spectrum in the world than in our country. Although interest-free financing provides horizontally different financing types in the world scale, it has more sub-financing types in vertical manner. The sub-types of modaraba, usury, musharakah and leasing financing, which are the basic units in this context, have been developed and applied in the world.

There are several reasons for the narrow development of interest-free financing types in Turkey. These reasons are similar to those that exist in the world scale. Interest-free financing types generally emerge with the modification of conventional banking products and freeing them from interest (Hasan, 2008; 272). Interest-free financing model has developed in the way that followed the conventional banks since the very first day it was born (Sıddiqi; 1983; 86). Financing types that are suitable for the spirit of interest-free banking cannot be developed (Hasan, 2005; 22). Right at this point, there is a strategic disadvantage that follows the conventional banking. In addition to this, and depending on this, when the economy types in which interest-free financing types are more developed are analyzed it is observed that conventional banking systems in such economies are strong and developed and conventional activities are made use of in product development processes.

It is possible to understand that there is a close relation between the development level of conventional banking in Turkey and the development level of participation banks. Another factor in this context is the slow-down of the conservative management concept of participation banks in product development process. Another factor that feeds this problem is the inactive status of counseling boards and the lack of senior counseling boards. In addition, Turkey, which provides a secular economy model, has not established a binary system that would encourage the interest-free financing.

The recent forthcoming financing type of participation banking is the *musharakah*. Musharakah Financing attracts attention with its positive contribution to profitability and balance sheet structure. In this study, international debates on the functioning of Musharakah Financing, the accounting, and the basic problems in participation banks in Turkey are investigated. Understanding the functioning of Musharakah loans is important in that it will make a distinction between participation banks and conventional banks.

This study is important in that it provides data on the functioning of Musharakah Financing and its accounting for further studies and performance research.

1. Musharakah Financing in the World Practice

Several loan types have been developed all over the world in interest-free financing models parallel to the economic development levels of countries. Usury, modaraba, Musharakah and leasing, which are basic interest-free financing types, are used widely all over the world. More products and services are also provided under these basic units by

differentiating them. One of the financing types for which the most differentiated methods are developed is the *Musharakah*.

The name *Musharakah* does not exist in Islamic law books, and has been developed in modern terminology (Usmani, 2004; 21). *Musharakah* means the partnership established by two or more people by providing a certain amount of capital to do business together and to share the profit or the loss that might incur (Hammad, 1996; 318). The certain amount mentioned above may be equal or different (Sarker, 1999; 5). The partnership in *Musharakah* is formed with capital and effort. The parties of *Musharakah* may provide their active efforts in addition to the capital partnership or it is also sufficient that some of the parties may also contribute to the partnership with their efforts (Parlakkaya, Çürük, 2015; 70). Participating with effort may be at administrative level or it may also be in functional terms (Sarker, 1999; 4). *Musharakah* is also called as the “*partnership in capital*” (Bayındır, 2005; 140). It is called as *profit loss sharing* in the world to mean the partnership in profit and loss (Sarker, 1999; 5) or sometimes it is also called as *joint venture*. *Musharakah* is a method for collecting funds, and it has also evolved as making others use these funds. The conditions of making the funds be used by clients have been determined by discussing the changes, conversions, disintegration and termination in *Musharakah* (Bayındır, 2005; 140).

Musharakah has a form that may be applied as *Normal Musharakah*, and it has also some other application types. One of these types is the *Musharakah-i mütenakısa* (Bayındır, 2015; 24). *Musharakah-i mütenakısa* is also called as *Musharakah-i tanazoleya*. It is called as *Digressive* or *Diminishing Musharakah* in the world. It may be translated into Turkish as the *Decreasing Musharakah* (Dinc, 2016, 1). It is also called as the partnership that ends with the transfer of the ownership (Bayındır, 2015; 145). In this context, the rights in the established partnership ends with the transfer of these rights after some time and after a project is realized and the profit/loss is shared between the bank and the project owner (Bayındır, 2015; 24).

Other financing types are also developed in *Musharakah*. In general, knowing the functioning of *Musharakah* is determinant on the other *Musharakah* types.

1.1. The Functioning of *Musharakah* Financing in the World

Modaraba and *Musharakah* may be observed as the most suitable financing types for the spirit of the interest-free financing model. There is a clear distinction between the loan and investment in Islam (Yasserı, 2000; 157). Focusing on this distinction does not make any difference for the job model in conventional banking. These two financing types are important in terms of their direct contribution to economy and their core activities as intermediaries in interest-free financing bodies.

Although *Modaraba* and *Musharakah* are the financing types in the center of the interest-free financing sector, their applicability is not so widespread. Four factors may be mentioned about the dissemination of *Modaraba* and *Musharakah*. These are *the lack of*

healthy balance sheet conditions, the unconformity between the collected funds and the maturity structure (Gafoor, 2001;5), the limited status of the project on which investments may be made, and the lack of expertise of the interest-free bodies in the field of projects. The inability in the spread of these two financing types makes it difficult to discriminate between interest-free bodies and conventional banks. This may be considered as a problem for interest-free finance bodies, because one of the reasons of the lack of the spread of interest-free financing model is the similarity in the processes with the conventional banks. According to Bach, the biggest obstacle for the development of Modaraba and Musharakah is the hybrid structure that has been formed with the merger of financing with conventional spirit (1997; 3).

The spread of Modaraba and Musharakah, which are the specific models for interest-free finance bodies, and the spread of Interest-free financing model may be considered as the cycles that feed each other. There are very few differences between Modaraba and Musharakah Financing, which are determinant for the interest-free model. Modaraba is known as the partnership for profit and losses. Collecting funds is the passive side of Modaraba in terms of the interest-free body (Rachmawati, Syamsulhakim, 2004; 2). There are two parties in Modaraba. The interest-free financing body of these parties, which is known as *Rab'ul Mal*, provides capital; and the party, which is called as the *Mudarip* and which obtains the capital, which is also responsible for the realization of the project by presenting its entrepreneurship and effort (Bacha, 1997;3). *Rab'ul Mal* participates in the profit or loss with its capital. In principle, the rate of participation of the *Rab'ul Mal* in the profit-loss in Modaraba is defined in the contract stage. For example, the profit and loss is shared among the parties over a sharing rate of 50-50, 60-40, 70-30. The *Musharik* takes part in Musharakah instead of *mudarip*. Modaraba is not realized in Turkey in financing, but Musharakah financing has been realized.

Malaysia has been examined in the models in the world, and it was observed that there are two types of Musharakah agreement. In this context, two types of Musharakah proceedings are realized, which are Musharakah Financing and Musharakah Investment (Bank Negara Malaysia, 2010; 18-19).

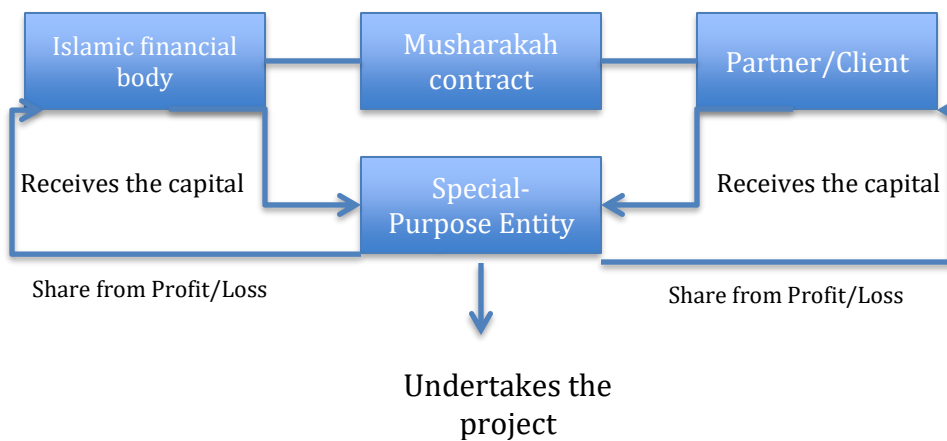
Firstly, the basic functioning of the Musharakah Financing has been defined.

- Both partners must participate in the investment capital though not in equal amounts. The capital may be in the form of cash or assets that have monetary values.
- Both partners may participate in the administration. It is acceptable if one of the partners do not participate, or transfer his/her responsibility in administration to 3rd parties in the context of Musharakah Contract.
- The job or the project must be legalized in terms of Islamic laws.
- The rate of the profits to be distributed among the partners must be determined at the beginning of the contract.
- The loss is distributed among the partners in direct proportion with their shares; however, if the loss is incurred due to a faulty behavior of a partner responsible

for the administration, it is the basic principle that the relevant partner is involved in the loss.

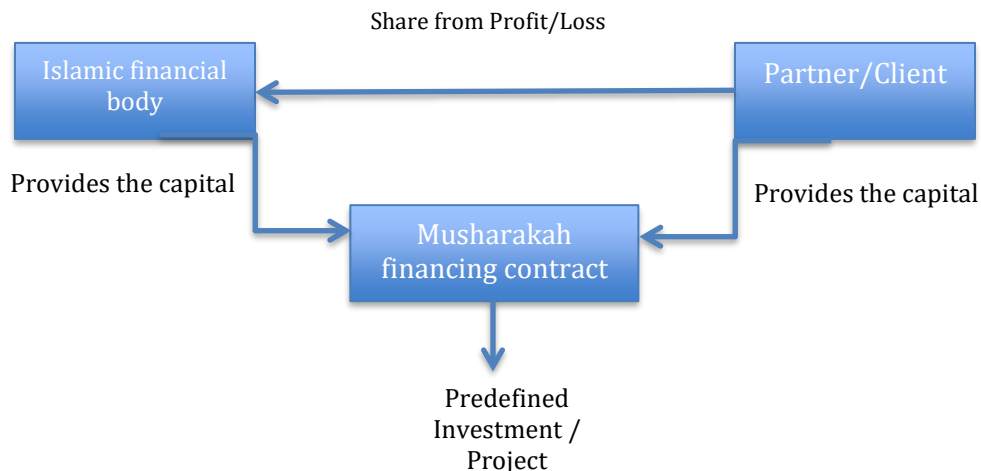
In this context, the characteristics of Musharakah investment have been defined. Musharakah investment occurs when interest-free financing body is a partner of the newly-established or existing company. In the Musharakah investment, the interest-free financing body purchases the shares of an independent and legal business, which is in a legalized activity in terms of Islamic laws, in the context of Musharakah contract. Musharakah investment may also appear in the form of holding the shares of another body by the interest-free financing body for the purpose of investment, or obtaining the shares of another body to distribute the risks. The structure is shown in Figure 1.

Figure 1. Musharakah Investment



Musharakah financing is provided in the scope of the partnership that appears in the context of the contract of Musharakah Financing in the interest-free financing body. The partners participate in the capital in the context of a certain project. They also participate in the profit or loss that will incur due to the activities at a predefined rate. Financing may be provided partly or in total depending on the terms and conditions of the contract.

Figure 2. Musharakah Financing



Partnership may be divided into shares in case all parties agree to transfer partnership. In this context, it must be certain that the parties of the transfer give permission for the proceedings in addition to the Musharakah financing contract. The structure of such a financing is given in Figure 2.

2. Musharakah Financing Provided by the Participation Banks in Turkey

The Musharakah proceedings in Turkey are considered under the umbrella terms of Musharakah financing. Since Musharakah Investments may be dealt with under the conventional participation concept, they may not be considered as a type of financing. However, participations are naturally included in the active assets of the balance sheet of the banks. Item 48 of the Banking Law with the number 5411 regulates the banking activities under the title of Loans. According to this item, each asset included in the active assets of the bank is a type of loan in its nature.

In this context, although the participation item may be handled as a type of loan, it is considered as classical participation in terms of the accountancy logic and taxation proceedings. Musharakah investment, which is the element of interest-free financing, is not realized in Turkey in this sense.

Musharakah financing, on the other hand, is realized in a way that is similar to that applied all over the world.

2.1. The Functioning and Problems of Musharakah Financing in Turkey

The functioning of the Musharakah financing of the Participation banks is similar to that applied in the world. However, the functioning also resembles the conventional banking practices. In this context, the client or the partner, applies to the participation bank with the demand of Musharakah financing. The most important element in this application is the return time of the project. When the average terms of the participation fund in Turkey is considered, the importance of this criterion may be understood better.

As of December 2016, 18,1% of the total deposit and participation fund was undated; 15,7% was dated up to 1 month; 58% were dated up to 3 months; and 8,2% was dated up to over 3 months (Source: TCMB). Since banks open the accounts dated for 1 month over 32 days, such accounts are included in the 3-month group. In other words, in actual reality, it must be known that the share of the 1-month dated accounts is not less than 70%.

This situation generally makes it difficult for short-term funds and long-term return project to be financed with Musharakah. The problem of inconsistent dates becomes deeper when Musharakah financing is used. Another problem is that businesses are expected to have an accurate balance sheet structures. Although there is a problem right at this point, an entrepreneur, who wants to propose a project, has to provide financial

data. The business has to be established for this reason. Otherwise, the risk cannot be measured, and the amount of the risk for the owner of the participation fund cannot be explained in a certified manner.

Due to these reasons, participation banks perform their Musharakah Financing by using other resources i.e. the equity capital except for the participation funds.

In case the ability of having investments is determined with feasibility works, the participation to the capital and the shares that will be received from the profit are determined and thus the Musharakah contract is formed. The consecutive accruals are then realized when the profit starts to be received.

The accruals cannot be rediscounted, which is different from the other financing types, and therefore, this is among the prior problems in the accounting of this financing type. In this context, although accruals occur simultaneously, it is observed that they are recorded in a periodical manner in the participation banks practice.

The inability of rediscount of a returning of a financing in Turkey is a problem experienced only in Musharakah financing. This is another problem in the realization of the financing from the equity capital instead of participation pools.

When Musharakah Financing, which is a type of partnership in its true nature, is considered as a loan, there appears taxation problems. In this context, Musharakah Financing bears the Bank and Insurance Actions Taxation (BIAT) costs. The profit of the banks that occur additionally is subject to corporate tax. When considered as participation, Musharakah Financing will only be subject to corporate tax. However, this solution, which also brings a taxation advantage, gives the result of accruing of the profits in only a periodical manner.

In general, the problems in taxation and accounting about Musharakah Financing may be handled in this context.

3. Musharakah Financing Accounting

There is no literature on the accounting of Musharakah Financing in Turkey. In this context, the accounting records of a model profit-loss partnership has been formed for the first time.

In this context, let us assume that a client applies to the participation bank with the demand of TL20.000.000 financing (bank participation) in respect of profit-loss partnership. Let us also assume that XYZ Construction Building Industry and Trade Incorporated Company and ABC Building Equipment Industry and Trade Incorporated Company establish a mutual enterprise to realize a project.

3.1. Forming the Accounting Records of Musharakah Financing

The mutual enterprise AAA receives the common capital in its account from the Participation bank for the financing of the project.

The process that starts with the first accrual of the financing continues with the accrual that appears with the profit centralization. Then, the BSMV accrual is shown. After this step, the records on the follow-up of the relevant financing in case it is delays and the records on allocating counterparts are included.

XYZ CONSTRUCTION BUILDING INDUSTRY AND TRADE INCORPORATED COMPANY & ABC BUILDING EQUIPMENT INDUSTRY AND TRADE INCORPORATED COMPANY MUTUAL ENTERPRISE and AAA PARTICIPATION BANK INC.

A CAPITAL EQUITY PROJECT

As pursuant to the contract, the record on the payment of TRL20.000.000,00 contribution margin (participation share) to the deposit account of the XYZ Building Mutual enterprise by the Bank.

THP NO	THP Account No	Client. No	ACC. NO	I	PCN	AMOUNT	EXPLANATION
1401 1000	EQ.CAP. VAL.CLI.PRO.LO.PART.			B	TL	20,000,000.00	02002218-2 XYZ CONSTRUCTION BUILDING INDUSTRY TRADE
3042 1000	ANY TYPE OF PART. (EXCEPT FOR INSURANCE CO.)			A	TL	20,000,000.00	BANK PARTICIPATION AMOUNT

ACCRUAL OF THE PROFIT (Record of the accrual in favor of the Bank TL1.000.000,00 - with profit accrual 5% BSMV amount TL50.000,00)

THP NO	THP Account No	Client. No	ACC. NO	I	PCN	AMOUNT	EXPLANATION
2200 0000	TAHREES			B	TL	1,000,000.00	130-2002218-2 XYZ CONST. BUILD. PROFIT-LOSS PROJECT
5401 1000	FROM EQ. CAP.			A	TL	1,000,000.00	130-2002218-2 XYZ CONST. BUILD. PROFIT-LOSS PROJECT
2200 0000	TAHREES			B	TL	50,000.00	130-2002218-2 XYZ CONST. BUILD. PROFIT-LOSS PROJECT
3800 0500	BANK AND INSURANCE ACTIVITIES TAX			A	TL	50,000.00	130-2002218-2 XYZ CONST. BUILD. PROFIT-LOSS PROJECT

The Collection of the Accrued Profit and BSMV from the Deposit Account

THP NO	THP Account No	Client. No	ACC. NO	I	PCN	AMOUNT	EXPLANATION
3042 1000	ANY TYPE OF PART. (EXCEPT FOR INSURANCE CO.)			B	TL	1,000,000.00	130-2002218-2 XYZ CONSTRUCTION BUILDING PROFIT-LOSS PROJECT COLLECTION
2200 0000	TAHREES			A	TL	1,000,000.00	130-2002218-2 XYZ CONSTRUCTION BUILDING PROFIT-LOSS PROJECT COLLECTION
3042 1000	ANY TYPE OF PART. (EXCEPT FOR INSURANCE CO.)			B	TL	50,000.00	130-2002218-2 CONSTRUCTION BUILDING PROFIT-LOSS PROJECT BSMV COLLECTION
2200 0000	TAHREES			A	TL	50,000.00	130-2002218-2 XYZ CONSTRUCTION BUILDING PROFIT-LOSS PROJECT BSMV COLLECTION

In Case Collection is Delayed:
When delay exceeds 90 days, it is transferred
to Non-Performing Accounts.

In the follow-up of the non-performing receivable, firstly the profit written is cancelled (in this example, TL1.000.000,00). It is followed in the 54011000 account by providing 22000000 receivables for this account if it is in the same year; it is followed-up with 69900000-CORRECTION ACCOUNT OF PROFIT SHARES OF PREVIOUS YEARS if it is in a different year. The BSMV (tax amount) is added to the capital amount (since the taxation is paid to the Tax Office in the relevant period, it is added to the capital amount instead of being cancelled).

The Cancellation of the Profit Share and the Addition of
BSMV Amount to the Capital Amount
(The Same Year)

THP NO	THP Account No	Client. No	ACC. NO	I	PCN	AMOUNT	EXPLANATION
5401 1000	FROM THE EQ. CAP.			A	TL	1,000,000.00	130-2002218-2 XYZ CONSTRUCTION BUILDING PROFIT-LOSS PROJECT PROFIT CANCELLATION
2200 0000	TAHREES			B	TL	1,000,000.00	130-2002218-2 XYZ CONSTRUCTION BUILDING PROFIT-LOSS PROJECT PROFIT CANCELLATION
1401 1000	EQ.CAP.OUVD.VAL.CLI. PRO.LOSS.AVE.			A	TL	50,000.00	130-2002218-2 XYZ CONSTRUCTION BUILDING PROFIT-LOSS PROJECT BSMV AMOUNT
2200 0000	TAHREES			B	TL	50,000.00	130-2002218-2 XYZ CONSTRUCTION BUILDING PROFIT-LOSS PROJECT BSMV AMOUNT

Non-Performing Transfer Record of
the Project

THP NO	THP Account No	Client. No	ACC. NO	I	PCN	AMOUNT	EXPLANATION
1700 0000	FROM THE EQ. CAP.			B	TL	20,050,000.00	02002218-2 XYZ CONSTRUCTION BUILDING INDUSTRY TRADE TRANSFER TO NON-PERFORMING
1401 1000	EQ.CAP.OUVD.VAL.CLI. PRO.LOSS.AVE.			A	TL	20,050,000.00	02002218-2 XYZ CONSTRUCTION BUILDING INDUSTRY TRADE TRANSFER TO NON-PERFORMING

Record of Allocating Provision (Provision is allocated over the unguaranteed part in accordance with the BBDK Provision)

Regulation)

THP NO	THP Account No	Client. No	ACC. NO	I	PCN	AMOUNT	EXPLANATION
8200 0000	FROM THE EQ. CAP.			B	TL	4,010,000.00	130-2002218-2 XYZ CONSTRUCTION BUILDING PROFIT-LOSS PROJECT PROVISION
1800 0000	FROM THE EQ. CAP.			A	TL	4,010,000.00	130-2002218-2 XYZ CONSTRUCTION BUILDING PROFIT-LOSS PROJECT PROVISION

P.S.: Sharing is realized at a rate defined in contract items when profit is obtained.

In this respect, Musharakah accountancy does not have any different proceedings other than known loan proceedings in the party that demands financing. The records that will be held by the receiver of the Musharakah Financing were examined. The thing to be focused on in the Musharakah receiver's records is the contract duration being long-term or short-term. The Musharakah Financing that has a term less than 12 months is followed in 300 Bank Loans account; the resources obtained from the Musharakah contracts that have more than 12 months are followed in 400 Bank Loans account.

In this respect, the financing proceeding in our example (let us assume that a period of 12 months is foreseen for Musharakah Financing) will be as follows.

Record on the Day when Musharakah Financing is in the Bank Account

	B	A
102 BANKS	20.000.000,00	
300 SHORT-TERM LOANS		20.000.000,00

Profit and BSMV Payments

	B	A
780 FINANCING EXPENSES		1.050 000,00
153 COMMERCIAL GOODS (OR)*		
102 BANKS		1.050.000,00

Principal Payment

300 SHORT-TERM LOANS	20.000.000,00	
102 BANKS		20.000.000,00

P.S.: If the Loan was Received for Purchasing Goods or Fixtures in the First year, the Interests are Followed in the Cost of the Good not in the Financing Expenses.

Result

Musharakah proceedings in the world are realized in two forms, which are Musharakah Investment and Musharakah Financing. There are no financing methods like Musharakah Investment in Turkey. Musharakah Financing is realized in a way that is similar to that applied in the whole world. Although Musharakah Financing is an investment that is realized in the form of participation in terms of Islamic Law, it is followed as a loan type. This situation requires regulations in terms of taxation.

In general, banking system has a problem of inconsistency problem in dates. The realization of Musharakah Financing, which has a certain return duration for Interest-free finance bodies, makes this inconsistency problem become bigger.

The lack of rediscounting in Musharakah Financing may be considered as another problem. Although it may have an advantage if it is followed-up as participation, the rediscount of profit accruals may remain unsolvable.

Musharakah Financing accounting records are realized in accordance with current proceedings, it has been shown that they do not have differences from general loan records. In this respect, the records in the party that demands financing are realized with conventional methods. It has been observed that the terms of the Musharakah Contract are determinant in the financing records.

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