



RUNNING MUSHARAKAH IN ISLAMIC BANKING INDUSTRY OF PAKISTAN: AN ANALYSIS OF PRODUCT STRUCTURE AND ITS PRACTICAL IMPLEMENTATION

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Abstract

This research critically examines the practical execution of the Running Musharakah (RM) product within Islamic banking industry of Pakistan. It aims to provide a comprehensive understanding of its structure and application while addressing a significant gap in the existing literature. Previous research has predominantly focused on issues related with RM, providing limited insights into its structuring, variations, and underlying assumptions. The study employs a document review methodology, complemented by case studies and literature analysis. Data were collected from product manuals, agreements, process flows, and calculation sheets of full-fledged Islamic banks. The findings reveal that while Running Musharakah adheres to the general principles of Musharakah/Shirkah, but in practice, RM is a new form of Musharakah with different underlying assumptions, maxims, and calculations from classical Musharakah/Shirkah. Unlike traditional Musharakah, RM uses adjusted Cost of Goods Sold (COGS) or Cost of Sales (COS) for business valuation, which varies by industry. For instance, the service industry includes fixed assets alongside COS, whereas the travel industry relies on net current assets. RM also introduces a unique two-tier profit-sharing method, with "above ceiling" and "below ceiling" thresholds. Profits exceeding the ceiling are minimally shared with customers, solely to align with Shariah principles while mirroring conventional debt-based returns. Additionally, RM calculates distributable profit based on gross profit, excluding key business expenses such as administrative costs, taxes, and depreciation. These innovations distinguish RM from classical Musharakah, with elements such as business valuation through adjusted COGS/COS, exclusion of certain expenses from profit calculations, and ceiling-based profit distribution warranting further research, particularly regarding Shariah compliance, accounting methods, and regulatory oversight.

Keywords: *Running Musharakah, Bank's investment, adjusted cost of Goods Sold, Provisional profit, Profit ceiling, Total average value of Musharakah investment*

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1. INTRODUCTION

Islamic Banking's core values are based on the general good of society, profit sharing and financing based on real assets. These principles enable Islamic banks to avoid interest-based transactions and aim to be a system embedded in ethical principles. However over the years Islamic banking has faced criticism on various angles, such as replication of conventional products, the use of Hiyal, unstandardized products and non-Shariah compliance in transactions (Ayub, Islamic finance crossing the 40-years milestone – the way forward, 2018) (Khan, 2010) (Butt , Ahmad , Naveed , & Ahmed, 2018). Various researchers have pointed out that practical Islamic banking often relies on debt-based contracts, such as Murabaha, Ijarah, and Diminishing Musharakah. This reliance has led to consequences similar to those of interest-based transactions. (Khan, 2010). The pioneering scholar of Islamic finance, Mufti Taqi Usmani once mentioned that debt based products are not ideal, as these are allowed only in the transitory phase of Islamic banking with the ultimate objective of Islamization of whole economy (Usmani, An Introduction to Islamic Finance , 2001). Therefore, after the initial infancy stage, it was expected that the Islamic banking system would transition toward genuine Islamic financing options such as Mudarabah and Musharakah, featuring risk sharing and equitable returns.

Islamic banking in Pakistan is now utilizing a new mix of products based on Musharakah, Istisna, Salam, and Tijarah/Karobar finance. Running Musharakah has become the most widely used product, replacing Murabaha, which once dominated the balance sheets as a major product in the Islamic banking industry of Pakistan. The latest figures from the Islamic banking industry show that Musharakah, particularly Running Musharakah (RM), is now widely used, accounting for 25% of total financing. In contrast, Murabaha constitutes only 12% of total financing, a significant decrease from 45% over the past 14 years (State Bank of Pakistan, Dec 2023). Despite the increased use of Running Musharakah, which has risen from 3% in 2010 to 25%, there is lack of literature available on this product. Comprehensive review of academic databases indicates that there are only a small number of papers (in the single digits) specifically addressing Running Musharakah as their main focus. This limited research base emphasizes the novelty of the topic and points to a significant gap in the existing literature, calling for further investigation. Additionally, existing research has primarily focused on issues related to the product, providing limited information on its structuring, variations, and underlying assumptions. This lack of comprehensive knowledge about Running Musharakah is evident in both banking and academic circles. This study aims to address this gap by providing a detailed analysis of Running Musharakah, including its underlying concepts, methodology, structures, and assumptions.

In this perspective, the study seeks to address the following research questions:

Q1: How Running Musharakah product is structured, and what are underlying concepts and assumptions?

Q2: What are the different variations of Running Musharakah in the Islamic banking industry of Pakistan?

By exploring these questions, this research aims to achieve a comprehensive understanding of the practical implementation of the Running Musharakah (RM) within the Islamic banking industry. The study will examine the various structures and methodologies employed in RM. This detailed analysis will provide stakeholders with valuable insights into the practical execution of RM, offering a clearer perspective on its application and paving the way for further research into operational and Shariah-related challenges associated with the product.

This paper is structured as follows: Section 2 provides an overview of the literature on Running Musharakah, Section 3 covers the Research Methodology, Section 4 presents a detailed analysis of the data and Section 5 presents the conclusion of this study.

2. LITERATURE REVIEW

There has been widespread criticism of Islamic banks, as over the years practical Islamic banking relies on contracts which are debt based like Murabaha, Ijarah and Diminishing Musharakah (Khan, 2010). These transactions resemble conventional interest-based financing and result in similar consequences. Debt-based products are not ideal, as they were intended only for the transitional phase of Islamic banking, with the ultimate goal of Islamizing the entire economy (Usmani, *An Introduction to Islamic Finance*, 2001). Consequently, it was a reasonable expectation for all stakeholders that, after the initial phase, the Islamic banking system would shift towards more ideal Islamic financing options, such as Mudarabah and Musharakah, which include features of risk-sharing and equitable returns. However, (Ali & others) contend that most financing requirements of customers are fulfilled through trade or rental-based modes such as Murabaha, Ijarah, Salam, Istisna and Diminishing Musharakah. These products closely resemble conventional debt-based instruments (Ali et al., 2018). Meanwhile, profit-and-loss sharing modes like Musharakah and Mudarabah are utilized minimally by Islamic banks due to the involvement of high risk. A similar assertion has been pointed by (Khan, 2010), as he mentions that despite extensive critique of the debt-based nature of conventional banking, equity participation based products do not dominate Islamic financial transactions. As instead of equity based options, products like Murabaha and Ijarah dominates Islamic banking operations. Thus he argues that given the prevalent use of non-participatory financing modes, Islamic banking cannot be considered as genuine Islamic financial system as transactions often resemble conventional collateralized debt contracts, with pricing benchmarks based on prevailing interest rates. He concluded that current practices of Islamic banking merely involves a semantic shift, by substituting terms like profit or markup rate for interest rate in what essentially remains a standard debt contract (Khan, 2010). As Islamic finance has evolved to meet contemporary needs, the application of Musharakah has been adapted into various modern forms. A significant application of Musharakah in working capital financing, where Islamic banks provide business

customers with a running financing account (over drawn facility) based on Shirkat-ul-Aqd. This arrangement enables businesses to withdraw funds as needed and deposit excess funds back into the account, paying profit based on daily average basis. The flexibility of this financing makes it a valuable facility for businesses seeking Shariah-compliant financing solutions.

The idea of Running Musharakah, or Musharakah for working capital finance, was first introduced by Mufti Taqi Usmani in his renowned book, *Introduction to Islamic Finance*. He outlined a procedure to address key issues, such as how to calculate the value of the running business and how to share profits. He further suggested that the current value of the business be considered the investment of the business owner, while the financier's contribution represents their share of the investment. The Musharakah can be established for a specific period, such as one year or less. The profit share allocated to the financier should not exceed their investment percentage, as they do not participate in managing the business. At the end of the term, both liquid and non-liquid assets are re-evaluated to determine profit distribution. Though traditionally profit determination may require full liquidation of assets, evaluating the assets can be considered a constructive liquidation with mutual agreement, as there is no specific Shari'ah prohibition against it. Constructive liquidation implies that the business partner has bought out the financier's share based on valuation, taking into account the agreed profit ratio. Further, Usmani highlighted that many businesses, particularly those in industries with significant equipment, have substantial fixed assets. Valuing and accounting for depreciation of these assets can be complex and may lead to disputes. To address this, Usmani suggests structuring Musharakah to distribute gross profits rather than net profits. This means that indirect expenses, such as machinery depreciation and staff salaries, are not deducted from the distributable profit. Instead, these costs are borne by the business partner (i.e., the customer), while only direct expenses (such as raw materials, direct labor, and electricity) are covered by the Musharakah. To compensate for the use of their assets in the Musharakah, the profit percentage allocated to the business partner can be increased. This approach recognizes that machinery and staff may be used for other business activities, and it would be unfair to allocate the entire cost to the Musharakah. Usmani's work already pointed to potential future problems, such as difficulties in calculating ownership ratios due to the large number of fixed assets in a business and issues with sharing depreciation and indirect expenses, which can lead to disputes. However, he argues that since the financier does not fund the entire operation of the business, not all expenses need to be shared. Instead, indirect costs, such as depreciation, can be borne solely by the business partner (i.e., the customer), while direct expenses can be included in the Musharakah. This approach allows Islamic banks to develop a product that resembles conventional banks' running finance method. This approach enables Islamic banks to develop a product similar to the conventional banks' running finance method. However, the Shariah compliance of running Musharakah remains questionable, as Ali et al. (2018) pointed out that the product is structured in a way that mirrors the impact of a conventional running finance (overdraft) facility (Ali, Kishwar, & Zulkhibri, 2018). While (Akram , 2019) pointed out that profit in running Musharakah (RM) is linked to KIBOR (i.e., the market interest rate), this means

that profit is essentially equal to that of a conventional interest-based loan, with negligible differences. Questions have also been raised regarding the non-fulfillment of the basic tenets of Musharakah. Principal among these concerns is the unknown shareholding of partners. The assigned limit of the bank is not considered the bank's share; instead, the amount used over time by the customer will be regarded as the bank's share, which can only be calculated at the end of the tenor. Siddique and others pointed out that the total size of the business will remain unknown for the entire year until the audited financial statements are available, which appears to be in violation of Shariah principles. (Siddique & Siddique, 2022).

However, proponents of running Musharakah (RM) argue that it is a genuine partnership contract that fulfills all Shariah requirements, rendering the criticisms unjustified and lacking a solid Shariah basis. Mufti Taqi Usmani explains that, according to Hanafi Fiqh, it is not necessary for all partners to invest in the business from day one; some partners can contribute at later dates. Thus, in his view, the known investment of capital from all partners is not an essential Shariah requirement. However, he noted that there are differing views among scholars regarding the requirement for all partners to have a known Musharakah investment at the beginning of the partnership (Usmani, *An Introduction to Islamic Finance*, 2001). Similarly, (Ali S. M., 2020) favoring RM, pointed out that within deposit pools both size of pool and share of partners constantly change, and only upon liquidation we come to know about actual size of pool and partners' share. Therefore, he favors the view of Mufti Usmani that knowing the shares of each partners at start of partnership is not a necessary Shariah requirement.

The review suggest that, while RM adheres to the core principles of Musharakah, its practical implementation has sparked debates regarding its Shariah compliance, primarily due to its similarities with conventional running finance (over-draft facility). Key concerns include profit-sharing mechanisms, asset valuation approaches, and the uncertainty surrounding partners' shareholding until the end of the financing term. Critics argue that RM resembles conventional financing, particularly given its link to market interest rates (e.g., KIBOR) and unknown shareholding of partners. On the other hand, proponents contend that RM complies with rules of Hanafi Fiqh, where the exact shares of partners need not be determined at the outset. This review highlights significant differences of opinion on the Shariah compliance of RM. However, there remains a critical gap in research regarding RM's product structure, underlying assumptions, and practical implementation methods. The lack of comprehensive literature on these aspects has resulted in a limited understanding of RM, contributing to divergent views on its Shariah compliance within both banking and academic circles. Therefore, this study aims to address this gap by providing a thorough analysis of Running Musharakah, focusing on its product structuring, variations, and potential issues to better understand its compliance with Shariah principles.

3. RESEARCH METHODOLOGY

Our research method primarily involved reviewing product manuals, agreements, and case studies related to Running Musharakah (RM) within Islamic banks. The primary methodology employed was document review, complemented by case studies and literature review. This approach aims to explore the fundamental structure of the RM product, examine its underlying methods, identify variations in its structure, and assess potential issues.

3.1 Sample

To achieve our research objectives, we gathered data from documents of Islamic banks. These documents comprised product manuals, agreements, process flows and calculation sheets. This data was collected from six full-fledged Islamic banks. The reason for choosing these banks is their industry dominance, as they contribute to 66.6% of the total assets in the Islamic banking industry, while the remaining sixteen Islamic windows contribute 33.4% (State Bank of Pakistan, Dec 2023). Full-fledged Islamic banks not only hold a significant portion of assets and financing but also drive product innovation and establish Shariah compliance standards within the Islamic banking sector. Thus, this sample ensures the external validity of the study, as the results can be generalized to the entire Islamic banking industry (Saunders, Lewis, & Thornhill, 2009).

Table 1: Islamic Banks Data Utilized

| Sr. | Name of Bank |
|------------|---------------------------------|
| 1. | Meezan Bank Limited |
| 2. | Dubai Islamic Bank |
| 3. | Al Baraka Bank Pakistan Limited |
| 4. | Bank Islamic Limited |
| 5. | MIB Bank |
| 6. | Faysal Bank |

3.2 Data Collection

We had examined the following data gathered from our sample of six full-fledged Islamic Banks.

- **Product Manuals:** The Main document highlighting product features, Shariah requirements, transaction steps and roles and responsibilities of different departments.
- **Running Musharakah Agreement:** Formal Musharakah contract signed with the customers, disclosing the entire transaction process, roles and responsibilities.
- **Transaction Process Flows and Sample calculation sheets:** These provide

insights into how transactions are processed and how calculations are performed.

The table below outlines the sources from which secondary data were collected to achieve the answers of research questions.

Table 2: Sources of Secondary Data

| Bank | Document | Source | Year of Access |
|--------|---|----------------------------|----------------|
| Bank 1 | Running Musharakah Manual, Model Agreement and Presentation on RM | Bank Personnel and website | 2024 |
| Bank 2 | Running Musharakah Manual, Model Agreement, Process Flows, Product Video & Knowledge center | Bank Personnel and website | 2024 |
| Bank 3 | Running Musharakah Manual, Model Agreement, Process Flows and Calculation sheets. | Bank Personnel | 2024 |
| Bank 4 | Running Musharakah Manual, Model Agreement & Process flows | Bank Personnel | 2024 |
| Bank 5 | Running Musharakah Manual, Model Agreement, Process Flows and Calculation sheets. | Bank Personnel | 2024 |
| Bank 6 | Running Musharakah Manual, Model Agreement & Process flows | Bank Personnel | 2024 |

3.3 Data Validation:

The validation of the data collected was carried out through two primary methods: triangulation and expert review. For triangulation, it was ensured that all data were gathered from multiple banks. Accordingly, all documents i.e. Product Manuals, Running Musharakah Agreements, Transaction Process Flows, and Sample Calculation Sheets were obtained from more than one bank and compared and analyzed to ensure the correctness and consistency of the data across the Islamic banking industry. Triangulation revealed that the core structures, principles, and processes outlined in these documents were largely consistent across the different banks, reinforcing the reliability of the data (Denzin, 2012) (Creswell, 2013).

In addition, expert reviews were conducted with Shariah scholars and banking practitioners specializing in Islamic finance. Their insights confirmed the authenticity and correctness of the analysis and findings of the study. The experts also validated the consistency of the processes across the different banks, providing assurance of the data's accuracy. The combination of cross-bank comparison and expert validation significantly strengthened the reliability and credibility of the data used in this study (Patton, 2002) (Flick, 2018).

3.3 Analysis:

The analysis involved a thorough review of product manuals, contractual agreements, process flows and calculations to understand the structure of Running Musharakah and its underlying assumptions. To answer our research questions, we conducted a detailed review of bank documents to identify and evaluate the steps and variations in Running Musharakah financing as applied by different Islamic banks. In addition to the documents review, we utilized case studies for calculations of business value and profit distribution.

4. ANALYSIS AND FINDINGS

4.1 Practical Execution of RM in Islamic Banks

To address the first research question we analyzed the practical execution of running Musharakah across six full-fledged Islamic Banks, through their product manuals, contracts and process flows. The Running Musharakah model is primarily designed for the fulfillment of working capital finance of the manufacturing and trading industries. As per our analysis Islamic banks perform Running Musharakah transaction in following steps as summarized in figure 1, we will discuss these steps in detail in subsequent sections.



Figure 1: Running Musharakah transaction

4.1.1 Computing the Customer's Facility Limit

The first step in the execution of RM is determining the customer's financing facility limit, which represents the maximum amount a bank can provide to a customer. After comprehensive analysis of the customer's creditworthiness, financial history, and industry-specific risks, banks initiate the process of the setting running Musharakah limit. This process involves taking the average of two balance sheet components: i.e., stock-in-trade and trade receivables. In our example we have taken data of two years, but it depends on the bank's policy as they can take data of more than two years. Normally these values are calculated based on the company's financial statements over the preceding four fiscal years, ensuring that the limit is reflective of the business's recent financial and operational performance. After taking the sum of averages banks normally set limit at 70% of this sum of the total value derived from the company's financial data.

For example, as below, the total Running Musharakah (RM) limit for the customer is calculated to be Rupees. 5,880 million. This amount represents the maximum financing that the bank would be willing to provide to the customer under the Running Musharakah arrangement, based on the company's historical average stocks and receivables.

Table 3: Historical Average Stocks and Receivables

| Amount in 'Rupees' (in Millions) | 2021 | 2022 | Average |
|-------------------------------------|-------------------|-------|----------------------------------|
| a) Stock in Trade | 3,000 | 5,000 | 4,000 |
| b) Trade Receivables | 2,800 | 6,000 | 4,400 |
| Total (a) Sum of average | | | 8,400 |
| Percentage Limit | Formula | | Financing limit In Amount |
| 70% | Sum Average * 70% | | (8,400*70%)=5,880 |

Note: This percentage can vary as it depends on the bank's credit policies

Islamic banks use Average Stock in Trade and Average Trade Receivables as they represent the customer's operational business. By averaging few years of stock in trade and receivables figures bank's get a clearer picture of the customer's usual business activity and providing a reliable indicator of the business's stability and performance.

4.1.2 Computing Total Average Musharakah investment/ Business Value

As Islamic banks and customers had agreed to form a partnership in operating aspect of business, therefore first step should be identification of value of current assets (i.e. assets involved in operating activities), to estimate overall size of Musharakah assets. But instead of taking balance sheet values of inventory and receivables, Islamic banks calculates value of business through Cost of Goods

Sold (COGS).

There are two steps involved in calculating the total average Musharakah investment/business value. First step is to adjust the COGS by excluding indirect costs and considering only operating expense and second step is to calculate the total average Musharakah investment /business value, as described in following section.

i. Calculate the value of adjusted Cost of Goods Sold (COGS)

Typically, COGS is computed using the following formula:

Opening Stock + (Direct Labor + Direct Raw Material + Direct Overheads) – Closing Stock

However, for Musharakah purpose, where the focus is limited to specific operating activities, the COGS for the Musharakah period is adjusted by the bank through excluding following:

- **Non-Compliant Expenses:** Expenses such as insurance that are not compliant with Islamic principles.
- **Indirect Expenses:** Costs such as travel and conveyance, vehicle running and maintenance, printing and stationery, rent, rates and taxes, employee retirement benefits, and other miscellaneous expenses.
- **Non-Cash Expenses:** This category includes depreciation, amortization, and provisions for slow-moving spares and stock, which do not directly impact the Musharakah activities.
- **Fixed Asset-Related Expenses:** Costs associated with repair and maintenance, and stores and spares consumed, which are linked to fixed assets rather than operating activities.

The above adjustments result in lower value of COGS, resulting in reduced business value and higher bank's share in Musharakah. In below example adjustment in expenses are shown, which are normally excluded in the RM contract.

Table 4: Adjusted Cost of Goods Sold

| Adjusted Cost of Goods Sold (COGS) - Include all Direct Costs | | |
|--|-------------------------|----------------------|
| Cost of Sales "Rupees" | Audited Accounts | For Musharaka |
| Raw material (Consumed) | 18,000,000,000 | 18,000,000,000 |
| Packing Material | 345,000,000 | 345,000,000 |
| Utilities | 300,000,000 | 300,000,000 |
| Salaries, wages and benefits | 450,000,000 | 400,000,000 |
| Repair and maintained | 84,000,000 | - |
| Insurance | 16,000,000 | - |

| | | |
|--------------------------------------|-----------------------|-----------------------|
| Printing and stationary | 1,000,000 | - |
| Entertainment | 2,000,000 | |
| Diminishing Musharakah Assets | 700,000 | - |
| Other Factory Overheads | 65,000,000 | - |
| Depreciation | 250,000,000 | - |
| Fuel & Power | 126,000,000 | 126,000,000 |
| Office Supplies | 1,000,000 | - |
| Total | 19,640,700,000 | 19,171,000,000 |
| Work In Process | | |
| - Opening Stock | 250,000,000 | 250,000,000 |
| - Closing Stock | -800,000,000 | -800,000,000 |
| Cost of Goods manufactured | 19,090,700,000 | 18,621,000,000 |
| Finished Goods | | |
| - Opening Stock | 1,800,000,000 | 1,800,000,000 |
| - Purchase during the year | 200,000,000 | 200,000,000 |
| Less: closing stock | 2,200,000,000 | 2,200,000,000 |
| Total Finished goods | 4,200,000,000 | 4,200,000,000 |
| Total COGS | 23,290,700,000 | 22,821,000,000 |

ii. Computing Business value

The Average Value of the Musharakah Business is calculated by taking the Adjusted Cost of Goods Sold (COGS) for the Musharakah period and factoring both the inventory turnover and the average collection period. The formula first multiplies the adjusted COGS by the ratio of the inventory turnover in days to the total number of days in the Musharakah period. Then, it adds the product of the Adjusted COGS and the ratio of the average collection period in days to the total number of days in the Musharakah period.

Formula for Average Value of Musharakah Business

Average Value of Musharakah Business = (Adjusted COGS of the Musharakah Period * Inventory Turnover in Days/ No. of Days in Musharakah Period) + (Adjusted COGS of the Musharakah Period * Average Collection Period in Days / No. of Days in Musharakah Period)

Practical Example:

To illustrate, consider the following example for calculating the business value of the Musharakah

Table 5: Average Musharakah business

| Musharakah Total Average Investment/Business Value | |
|--|----------------------|
| Figures in "Rupees" | |
| Cost of Goods Sold (a) | 23,290,700,000 |
| Net Sales (b) | 25,000,000,000 |
| Musharakah Period in Days (c) | 365 |
| Adjusted COGS (d) | 22,821,000,000 |
| Average Stock in Trade (e) referred to table 2 | 4,000,000,000 |
| Average Trade Receivables (f) referred to table 2 | 4,400,000,000 |
| Inventory Turnover in Days (g)¹ | 64 |
| Average Collection Period in Days (h)² | 64 |
| Musharakah Total Average Investment (d*g) / c + (d*h) / c | 8,016,496,000 |

Inventory Turnover in Days = Average Inventory x 365 / COGS

Average Collection Period in Days = Average of Trade Receivables x 365 / Net Sales

Rationale and assumptions for excluding financial asset & expenses in computing average value of Musharakah business:

In the RM contract, banks focus solely on the operating activities of the business rather than the entire business enterprise. Consequently, banks exclude all expenses and assets that are not directly related to the core operations. Instead, only assets and expenses that relate to the operating business are included. This approach ensures that the valuation accurately reflects the operating part of the business related with Musharakah contract. However, the exclusion of some expenses and assets may raise Shariah issues, as principally Shariah requires that all expenses should be part of the business.

4.1.3 Computation of Profit Sharing Ratio

In the RM contract, profit-sharing ratios vary, based on the profit ceiling amount. Both the bank and the customer agree that profits up to the ceiling amount are distributed in proportion to each party's investment ratio in the business. For profits exceeding the ceiling amount, profit sharing is usually set at 0.001% & 99.999% for the bank and customer respectively. This process ensures that most of time, profit received from customers up to the ceiling is equal to the bank's required profit i.e. Bank's average outstanding multiplied by the profit rate based on KIBOR.

Rationale & assumptions of two types of profit sharing ratio:

The reasoning for dividing profits based on the investment ratio up to the profit ceiling amount and charging a minimal 0.01% on profits exceeding this ceiling is that the bank's expected profit is fully realized up to the ceiling amount, which is the target return for the bank. The bank does not seek additional profit beyond this

ceiling because the product is designed as an alternative to conventional running finance. Islamic banks aim to earn only as much profit as normal debt based running finance. Therefore, for any profit above the ceiling amount, the banks charge a negligible percentage to comply with Shariah principles and to ensure that the customer incurs only a minimal additional cost beyond the agreed profit ceiling.

4.1.4 Determination of Profit Ceiling

The profit ceiling sets a limit on profit distribution. Profits up to this ceiling are shared according to investment ratios, while profits beyond the ceiling are distributed based on predetermined ratios.

4.1.4.1 Profit Sharing Ratio below the Profit Ceiling Amount:

Profits up to the ceiling are allocated proportionally to each partner’s investment. The profit ceiling is calculated by multiplying the total average Musharakah investment by the target profit rate, which is agreed upon and linked to benchmark rate.

4.1.4.2 Profit Sharing Ratio above the Profit Ceiling Amount:

For profits exceeding the ceiling amount, the standard practice is to allocate 0.001% profit to the bank and 99.999% to the customer.

Formula for computing of Profit Ceiling amount

Profit Ceiling Amount = Total Average Musharakah Investment * Rate of Profit (i.e. KIBOR + Spread)

Table 6: Computation of Profit Ceiling Amount

| Total Average Musharakah Investment | Rate per year + Spread | Profit Ceiling Amount |
|-------------------------------------|------------------------|-----------------------|
| 8,016,496,000 | 10.74% | 860,971,670 |

4.1.5 Loss Sharing

It is the requirement of the Musharakah that the loss borne by each partner must be commensurate with the proportion of their investment in the Musharakah. Furthermore, it is not permitted to hold any partner liable for the entire loss or percentage of loss greater or lower than their investment ratios.

4.1.7 Provisional Profit Booking

The Banks charge provisional profit on monthly, quarterly, or semiannually basis. The purpose of charging provisional profit by the bank is to recover its receivable which accrue on daily basis. Provisional profit will be calculated by below given formula:

Bank’s average investment for the period * (KIBOR+ Spread)/365 * No. of days in the period

4.1.8 Completion of Musharakah and distribution of final profit

The final settlement involves two key processes. First, the business profit is calculated, and then the final settlement is carried out. The detailed steps of profit calculation and distribution are mentioned below.

- **Computation of business profit**

At the end of the Musharakah period, the bank and the customer will share the profit at the gross profit level as appearing in the financial statements after adjusting for indirect costs and direct expenses. Since the Musharakah isn't executed on the entire business, thus expenses like freight, bad debt, diminution in value of stock, sale of waste stock and export costs are left out from computing the profit calculation. These costs are not considered, because these are not deemed as direct part of the Musharakah business. Instead, only the costs directly related to manufacturing or selling goods are deducted from net sales. Therefore in the below table 4, Musharakah shows higher profit than the actual business profit.

In below the table 4, the Musharakah profit is calculated as 3,327 Million, which is to be shared as per the agreed terms, i.e. as per investment ratio till the ceiling amount and for above the ceiling as per the agreed ratios.

Table 7: Profit Computation of Musharakah

| Musharakah Profit | | |
|--|----------------------|----------------------|
| Income Statement | | |
| PKR "Rupees" | | |
| | Audited Accounts | For Musharakah |
| Net Sales | 25,000,000,000 | 25,000,000,000 |
| Adjusted Cost of goods sold (Includes all direct expenses) value referred to Table 2 | 23,290,700,000 | 22,821,000,000 |
| Gross profit (a) | 1,709,300,000 | 3,327,701,838 |
| Other Expenses | | |
| Export Expenses (b) | 100,000,000 | - |
| Freight (c) | 150,000,000 | - |
| Profit (d)=a-b-c | 1,459,300,000 | 3,327,701,838 |

Distribution of Musharakah Profit:

For distribution of the profit first the shareholding of partners has been ascertained, as profit is to be shared as per the investment ratio till the ceiling amount. The resulting calculation shows bank earning profit of Rs. 18.346 (mil) profit till the ceiling amount and Rs. 33,170 over the ceiling.

Table 8: Distribution of profit

| Description | Amount |
|--|-------------------|
| Total Musharakah Investment/Business Value | 8,016,496,000 |
| Bank's share in Musharakah | 100,000,000 |
| Customer's share in Musharakah | 7,916,496,000 |
| Bank's share in Musharakah in % (a) | 1.25% |
| Customer's share in Musharakah in (%) | 98.75% |
| Total Profit Earned by Business | 3,327,701,838 |
| Ceiling Amount (b) | 860,971,670 |
| Bank's Profit till ceiling amount at investment ratio i.e. (a * b) | 10,740,000 |
| Remaining Profit above ceiling | 3,316,961,838 |
| Bank Profit above ceiling amount @ 0.001% | 33,170 |
| Total Bank Profit | 10,773,170 |

- **Final Settlement**

As the Islamic banks receive provisional profits, by applying KIBOR-based rate on the average outstanding amount, the banks will compare the received provisional profit to the actual profit of Musharakah and adjust accordingly. If the provisional profit received is higher than the actual profit, then banks will refund the excess to the customer. Conversely, in cases where the provisional profit is lower than the actual profit, the banks will charge the difference to the customer. Furthermore, if customers do not settle the bank's portion Musharakah capital and carry over the transaction; then the outstanding exposure beyond the Musharakah Period will be considered a drawdown under the next Musharakah Period.

4.1.9 Summary of Practical execution of RM

For answering the first research question, we explored the practical execution of the Running Musharakah (RM) model by analyzing the product manuals, contracts, process flows and calculation sheets of six full-fledged Islamic banks. The RM model is primarily designed to meet the working capital needs of businesses through providing cash, under a Musharakah contract. The RM process starts with determining the customer's financing limit, which is the maximum amount the bank can provide. This limit is calculated by averaging the customer's stock-in-trade and trade receivables over several years. Islamic banks typically set the financing limit at around 70% of this averaged value, though the percentage may vary based on the bank's policy. The next step, involves computing the total value of Musharakah investment or business value. This is achieved by adjusting the cost of goods sold (COGS) to exclude indirect, non-compliant, and non-operational expenses such as insurance, depreciation, and fixed-asset-related costs. The rationale behind these exclusions is to focus solely on the operating activities of the business, as the Musharakah contract is designed to finance these activities specifically. In next step, banks calculate total Musharakah investment/business value through following formula:

Average Value of Musharakah Business = (Adjusted COGS of the Musharakah Period * Inventory Turnover in Days/ No. of Days in Musharakah Period) + (Adjusted COGS of the Musharakah Period * Average Collection Period in Days / No. of Days in Musharakah Period)

The above method decreases business value while increasing bank's share in total Musharakah. In the RM model, there are two profit-sharing ratios one is up to ceiling amount and other ratio is above ceiling amount. Profits below the ceiling amount are distributed according to the investment ratio of the bank and the customer. For profit exceeding the ceiling, the bank takes a minimal share, usually 0.001%, while the customer retains the majority of the excess profits. The rationale for this two-tier profit-sharing structure is to ensure that profits determined in RM contract should match with the conventional running finance product, though adhering to Shariah principles.

Customers are authorized to withdraw funds up to the agreed limit, while Islamic banks charge provisional profit on their average outstanding amount based on KIBOR rate during Musharakah period. The final settlement involves calculating the actual business profit at the end of the Musharakah period, which is then distributed between the partners according to the agreed ratios. The banks' share of profit will be adjusted against the provisional profit already received.

4.2 Variations in Running Musharakah

In this section we will explore two variations of RM financing. The generic Running Musharakah model, which we have described above is normally performed with manufacturing and trading businesses. The model needs changes when performed in service industry and travel/ tour operators. Though procedural steps remain consistent, the methods for calculating the financing limit and average Musharakah investment differ according to the unique financial characteristics of these sectors.

Below section will explain these variations, by highlighting how the financing limit and average value of Musharakah investment are determined for the above mentioned sectors. The specific methodologies, along with illustrative examples, will be presented in the subsequent sections.

4.2.1 Computing Financing Limit

4.2.1.1 Structure of Service Industry

For service-oriented businesses, the facility limit under Running Musharakah is determined by analyzing the company's annual expenses and average collection period. Islamic banks usually take the sum of the average adjusted cost of sales and adjusted selling and administrative expenses, as reported in the company's financial statements over the previous two fiscal years. This sum is then multiplied by the average collection period, which is calculated by dividing the average net receivables by the average net sales over the same period. Finally, the result is multiplied by 70% to determine the appropriate facility limit.

The formula for calculating the facility limit is as follows:

Facility Limit = (Sum of Average of Adjusted Cost of Sales and Adjusted Selling and Administrative Expenses of last two years) * Average Collection Period * 70%

Whereas: **Average Collection Period** = Average of Net Receivables of last two years/ Average of Net Sales of last two years

Calculation Example:

To demonstrate the calculation of the financing limit for a service industry business, the following example is provided:

Table 9: Average Collection Period Calculation

| Financial Years | 2022 | 2023 | Average |
|--|--------------|-------------|------------|
| Average Net Receivables (a) | 50,000,000 | 14,000,000 | 32,000,000 |
| Average Net Sales (b) | 80,000,000 | 110,000,000 | 95,000,000 |
| Average Collection Period in Year (a/b) = c | 0.337 | | |

Table 10: Sum of Average Adjusted Costs

| | 2022 | 2023 | Average |
|---|------------------|-----------|-----------|
| Average Adjusted Cost of Sales (d) | 3,000,000 | 6,000,000 | 4,500,000 |
| Average Adjusted Selling and Administrative Expenses (e) | 2,000,000 | 4,000,000 | 3,000,000 |
| Sum of Average Adjusted Costs (d + e) = f | 7,500,000 | | |

Table 11: Facility Limit Calculation

| | |
|--|------------------|
| Sum of Average Adjusted Costs (f) | 7,500,000 |
| Average Collection Period in Year (c) | 0.337 |
| Percentage Limit (g) | 70% |
| Facility Limit (f*c*g) | 1,768,421 |

In the above example, the total Running Musharakah (RM) limit for the customer is calculated to be 1,768,421. This figure represents the maximum amount of financing the bank can offer under the Running Musharakah arrangement, taking into account the company's historical financial performance and the average duration for receivables collection.

4.2.1.2 Structure of Travel Agencies and Tour Operators

For Running Musharakah financing within the travel agencies and tour operators the facility limit is determined through the net difference between the average trade receivables and the average trade payables, based on the company's financial data over the past eight quarters and multiplied by the limit percentage.

Formula for Calculating Facility Limit:

Facility Limit = (Average Trade Receivable – Average Trade Payable) * Financing limit (e.g.70%)

The Average Trade Receivable and Average Trade Payable are derived from the financial statements of the company for the specified periods. The difference between these averages reflects the company's net working capital tied up in trade receivables versus trade payables. This difference is then multiplied by the predetermined percentage limit to establish the maximum financing limit.

Calculation Example:

To illustrate the calculation, consider the following example for a travel agency:

Table 12: Calculation Illustration

| Financial Year | June 2022 | Dec 2022 | June 2023 | Dec 2023 | Average |
|------------------------------|----------------------------------|-----------|-----------|-----------|-----------|
| Trade Receivables (a) | 8,100,000 | 9,450,000 | 1,968,453 | 5,200,000 | 6,179,613 |
| Trade Payables (b) | 500,000 | 425,477 | 803,453 | 790,920 | 629,963 |
| Difference a-b = c | 5,549,650 | | | | |
| | Percentage Limit (d) | | 70% | | |
| | Financing Limit (c*d) = e | | 3,884,756 | | |

In the above example, the calculated Running Musharakah (RM) limit for the customer amounts to 3,884,756. This value signifies the maximum financing amount that the bank can provide under the Running Musharakah facility. The calculation is based on the company's average trade receivables and trade payables, reflecting the bank's assessment of the company's financial position and its ability to manage liquidity effectively. The limit is determined through a benchmarking process that applies a percentage to the net difference between trade receivables and trade payables, ensuring that the financing aligns with the company's operational cash flow and financial health.

4.2.2 Computing average value of Musharakah Business

4.2.2.1 Service Industry

In the service industry, calculating the total average Musharakah investment involves multiplying cost of sales by the average collection period and added to book value of identified fixed assets. While some adjustments are made to include

relevant expenses and exclude non-compliant, indirect and non-cash expenses. In following sections, we will discuss these in detail:

- **Adjustment of Service Costs and Expenses:**

The initial step is to refine the service costs and expenses by removing non-compliant expenses according to Shariah and other indirect and non-cash expenses. Furthermore, depreciation and maintenance expenses of physical assets will be made part of the total expenses, as in the RM model of service industries fixed assets are made part of Musharakah as opposed to the pervious model of manufacturing/trading where fixed assets are excluded.

- **Incorporation of Physical Assets:**

The next step involves incorporating the current book value of physical assets, such as buildings or office equipment, into the investment calculation. These assets contribute to the Musharakah and their value should be recognized as part of the total investment.

- **Calculation of Adjusted Expenses:**

Then total adjusted expenses are calculated by adding the revised service costs, administrative expenses, and selling expenses. This adjusted figure provides a more accurate representation of the costs associated with the Musharakah.

- **Final Calculation:**

For computing the total average Musharakah investment, adjusted expenses are multiplied with average collection period (converted to a fraction of the year) and divided by 365 days. The resultant figure is added to the current book value of the physical assets to obtain the total average value of the Musharakah business.

The formula used for calculating the Total Average Musharakah Investment is:

Total average value of Musharakah business = (Adjusted Musharakah Expenses* Average Collection Period) + (Current Book Value of Identified Fixed Assets)

Table 13: Value of Musharakah Business

| | |
|---|------------------|
| Adjusted Musharakah Expenses | 6,785,283 |
| Average Collection Period ³ | 0.34 |
| Book Value of Identified Fixed Assets | 5,600,000 |
| Average value of Musharakah business | 7,885,569 |

The computed average Musharakah investment for the service industry example is 7,885,569. This value was derived by adjusting the service-related expenses to exclude non-compliant, indirect, and non-cash costs, incorporating the depreciation and maintenance of physical assets, and adding the current book

value of these assets. This calculation ensures a fair representation of the Musharakah business's value, aligning with Islamic finance principles and facilitating accurate profit and loss sharing.

4.2.2.2 Travel Agencies and Tour Operators

In the travel and tourism sector, calculating the total average Musharakah investment involves evaluating the business's financial components, particularly focusing on trade receivables, trade payables, and the value of operating assets. This method ensures an accurate reflection of the business's financial standing and its alignment with Musharakah principles.

Calculation Process:

- **Assessing Trade Receivables and Payables:**

The calculation begins with determining the average trade receivables and trade payables. These figures are typically obtained from fortnightly or monthly data provided by the customer. The average trade receivables represent the amount expected to be collected from customers, while the average trade payables denote the amounts owed to suppliers.

- **Incorporating Fixed Assets:**

Next, the current book value of identified fixed assets, such as office equipment or property used in the operations of the travel agency, is included in the calculation. This value reflects the contribution of these assets to the Musharakah investment.

- **Applying the Formula:**

To compute the total average Musharakah investment, subtract the average trade payables from the average trade receivables and then add the book value of the identified fixed assets.

Formula for Total Average Musharakah Investment:

$$\text{Total Average Musharakah Investment} = (\text{Average Trade Receivables} - \text{Average Trade Payables} + \text{Book Value of Identified Fixed Asset})$$

Table 14: Average Musharakah Investment

| | |
|---|------------------|
| Average Trade Receivables | 6,179,613 |
| Average Trade Payables | 629,963 |
| Book Value of Identified Fixed Asset (2013) | 900,600 |
| Total average value of Musharakah business | 6,450,251 |

For the travel agencies and tour operator's example, the total average Musharakah investment is calculated to be Rs.6,450,251/-. This amount is derived by first subtracting the average trade payables from the average trade receivables and then

adding the current book value of the fixed assets. This approach provides a comprehensive view of the business's investment value, ensuring that the Musharakah arrangement accurately reflects the financial realities of the travel industry. This method aligns with Islamic finance principles, facilitating transparent and fair investment practices.

4.2.3 Summary of Variations in Running Musharakah:

The execution of Running Musharakah (RM) in Islamic banking has variations in service and travel industries. Although the steps in overall process are consistent with the general model of RM but the calculation of financing limits and the average total Musharakah investment value differs based on each sector's financial characteristics.

For the service industry, the financing limit is determined by analyzing the company's annual expenses and average collection period. Islamic banks calculate the facility limit by combining the average adjusted cost of sales and adjusted selling and administrative expenses over the last few years, dividing the average net receivables by the average net sales, and multiplying by 70% (or another percentage as specified by the approving authorities). In contrast, the financing limit for travel agencies and tour operators is determined through the company's trade receivable and payables of past quarters or half-yearly data for several years. This is performed through taking difference between the average trade receivables and average trade payables, and resulted value is multiplied by a predetermined percentage limit to establish the maximum financing limit. Predetermined percentage is typically set at 70% (but it can vary depending on the banks' policies).

The approach to determine the value of Musharakah investment/business value also varies, as this process includes adjusting service costs, selling and administrative expenses as to exclude unrelated services and expenses. After adjusting these expenses, the resulting sum of these figures is multiplied by average collection period and divided by 365 and resulted value added to book value of identified fixed assets.

Formula to compute business value of service industry is as follows:

Total average value of Musharakah business = (Adjusted Musharakah Expenses * Average Collection Period/365) + Current Book Value of Identified Fixed Asset

While in travel agencies trade receivables, payables, and fixed assets are used for calculating the average value of Musharakah business. The total average Musharakah investment is calculated by subtracting the average trade payables from the average trade receivables and adding the book value of fixed assets.

Formula to compute business value of travel agency is:

Total Average Musharaka Investment = (Average Trade Receivables – Average Trade Payables + Book Value of Identified Fixed Asset)

These tailored methods ensure that RM financing aligns with the unique financial realities of each industry, as the difference in the formula of total Musharakah investment (value) between the services and travel industries are due to their operational business models. Both sectors include current value of identified fixed asset to reflect essential operational resources of businesses. For the service industry, operational cost and revenue collection are added to book value of fixed assets, while in contrast the differential between of trade receivables and payables is added to book value of fixed assets in the travel industry.

5. CONCLUSION

This study presents an in-depth analysis of the Running Musharakah (RM) product, highlighting practical steps and examining variations in its implementation. The primary objective of this research is to achieve a comprehensive understanding of how the RM product is practically implemented within the Islamic banking industry. Our study suggests that while Running Musharakah adheres to the general principles of Musharakah/Shirkah, but in practice, RM is a new form of Musharakah as its underlying assumptions, maxims, and calculations are different from classical Musharakah/Shirkah. For instance, the traditional method of valuing a business is based on net assets (i.e., assets minus liabilities), while RM utilizes the Cost of Goods Sold (COGS) as a benchmark for business valuation in manufacturing/trading companies. The calculation of total business value varies across industries; for example, in the service industry identified fixed assets are also included as part of total Musharakah value in addition to Cost of Sales (COS). While in contrast within the travel industry, COS is excluded, as business value is calculated through net current assets.

Secondly, RM uses a very novel method of profit distribution, i.e. utilizing a two-tier profit distribution method called “above ceiling” and “below ceiling” amounts. The profit-sharing ratio is fixed according to the investment ratio up to the ceiling amount, while profits exceeding the ceiling amount are shared at 99.999% and 0.0001% between customers and the banks respectively. Interestingly, the ceiling amount remains undefined throughout the Musharakah tenor, as it is calculated after the end of the Musharakah period. The reasoning for this two-tiered profit distribution, is that the banks expected profit (i.e. profit based on normal financing calculation) is fully realized up to the ceiling amount, and they do not seek additional profits beyond this ceiling amount. The objective of Islamic banks is to earn only as much as standard debt-based running finance. Thus, for any profit above the ceiling amount, Islamic banks charge a negligible percentage to comply with Shariah principles and to ensure that the customer incurs only a minimal additional cost beyond the agreed profit ceiling.

Moreover, gross profit is considered as the total profit of the business for distribution purpose rather than net profit. This effectively excludes distribution, administrative, depreciation, financing costs, and taxes from business expenses. Furthermore, even COGS calculations exclude various expenses such as repairs, insurance, printing and stationery, overheads, office supplies, resulting in a higher profit available for distribution in Musharakah.

Our study is pioneering in providing a detailed analysis of the Running Musharakah product, as implemented in the Islamic banking industry of Pakistan. The insights gained from this research not only enhance the understanding of RM but also lay a strong basis for future research regarding the operational, accounting, and Shariah related aspects of Running Musharakah. Additionally, the findings of this research can serve to improve Shariah compliance and regulatory oversight within the Islamic banking industry.

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