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VALUE ADDED PARTICIPATION (VAP)-
A NEW FINANCING INSTRUMENT FOR ISLAMIC BANKS*

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It is a commonplace in the academic literatur on Islamic economics that the interest-free Islamic financial system would be both more efficient and just than the present-day interest-based system. The reason is that the conventional debtor/creditor relations would be replaced in the Islamic system by partnership relations where entrepreneurs and banks would share the profits and losses.

However, if one looks at the practice of operating Islamic financial institutions, one does not find much profit and loss sharing. By far the most earnings of the most Islamic banks originate for leasing, mark-up trade and similar forms of financing which - in contrast to profit and loss sharing - carry factually no risk for the bank and come economically very close to conventional interest-loans. Thus there is a marked discrepancy between the theory or ideology of Islamic banking, centered on profit and loss sharing (PLS), and the actual practice which shows a clear preference for transactions yielding set earnings for the banks. There are a number of more or less obvious micro-economic reasons for this discrepancy: Among the factors militating against PLS are the uncertainty of the bank's future earnings in absolute terms, the danger of accumulating bad risks, the problems of identifying and judging market opportunities from among the proposed entrepreneurial projects, problems of evaluation and profit assessment, supervision of the partner's management of the financed enterprise, etc. In the light of problems such as these,

several Islamic banks have in a sense imposed self-restrictions with regard to the amount of PLS financing they will undertake.

On the long run, this would mean a very serious limitation and defect of Islamic banking because it implies that Islamic banks would only finance specific 'real' transactions like the purchase of raw materials or of machinery, but they have no suitable instruments to provide an enterprise with funds to be used by the discretion of the management, i.e. with free or unconditional liquidity.

When the practical problems with the ideologically emphasized PLS financing are so great that this instrument is applied by Islamic banks only in exceptional cases (while it should be the rule according to the academic literature), one should look for alternative approaches and techniques of participation financing to take the place of PLS.

The aim of this paper is to make a first attempt towards the formulation of such an alternative instrument. In the part I. of the paper, the principles of traditional business partnerships according to the Shari'a are reviewed; from this sprang some ideas for the development of a new partnership resp. participation model. Inspired by but not identical with the traditional forms of partnership, the value added participation (VAP) will be outlined and the admissibility of its principles under the Islamic law will be discussed. Part II. of the paper deals with the economic features of VAP. After a more precise definition of the "value added" (with respect to financial accounting standards), some peculiarities of the VAP calculus of entrepreneurs and banks in an interest-based economy are shown. The last section will balance the costs and benefits of VAP in contrast to other financing instruments. The overall result is that VAP is neither free from specific problems nor is it a panacea for Islamic banks; but

it has - from the banks' point of view - essential advantages over the PLS approach. Therefore it should be considered by Islamic banks who do not want to confine their financing activities to interest-like 'fixed cost' financings (like leasing, mark-up, etc.) but strive for a promotion of participation financing.

Part I: Shari'a Aspects of Participation Financing

1. Traditional Forms of Business Partnerships

Proponents of Islamic banking are all agreed that the primary sources of Islamic law (Shari'a) - the Qur'an and the Sunna - prohibit any kind of interest on loans, regardless of the loan's use (consumptive or productive), and that this prohibition is not just confined to usurious rates of interest.

- If a person gets into difficulties through no fault of his own and needs a loan to support himself and his family, it is meritorious conduct to provide him with an interest-free loan; it would be an immoral act of the lender if he would try and extract some other advantage from the debtor beyond the repayment of the loan. On the other side, the debtor is morally obliged to pay back the loan in full as quickly as possible.
- If, on the other hand, a person wants to take out a loan to finance a commercial venture, there is certainly no moral constraint preventing the lender from sharing in the results of that venture he has financed, providing that he not only participates in a positive result (profit), but also helps to carry the burden of a negative one (loss). Were the lender to participate only in the profits of an enterprise, then all fi-

nancial risk would be concentrated on the entrepreneur, which is felt to be unjust and held inadmissible under Islamic law.

Islamic jurists therefore began at an early stage to recognize and develop contractual forms (which were basically known already in the pre-Islamic Arabia) in which the creditor/debtor relationship - where interest is payable regardless of a venture's results - would be replaced by a partnership relation in which both partners (each of which could also be a group of persons) are rewarded in proportion to the results.

a) Mushāraka, Muḍāraba: Profit and Loss Sharing (PLS)

There are two forms of partnership relations which have been established as the basis of Islamic banking by the academic (and ideological) literature on the subject, namely mushāraka and muḍāraba.¹

- Partnerships known as mushāraka involve the bank and the entrepreneur jointly providing the capital for a given project, or the bank putting in additional funds for an enterprise already in operation. The bank is entitled to a pre-agreed percentage share of the project's or enterprise's profit, the absolute amount of which is as yet unknown. Losses must be carried by the capital-owning partners in proportion to the size of their shares in the venture. Both the entrepreneur and the bank have

1) See for example the widely recognized books of Muhammad Nejatullah Siddiqi: *Banking without Interest*, Leicester (The Islamic Foundation) 1983; *Issues in Islamic Banking*, Leicester (The Islamic Foundation) 1983; *Partnership and Profit-Sharing in Islamic Law*, Leicester (The Islamic Foundation) 1985. See also M. Umer Chapra: *Towards a Just Monetary System*, Leicester (The Islamic Foundation) 1985, and the Report of the Council of Islamic Ideology (in Pakistan) on the Elimination of Interest from the Economy, first published in 1980 and reprinted in: Ziauddin Ahmed, Munawar Iqbal, M. Fahim Khan (eds.): *Money and Banking in Islam*, Islamabad (Institute of Policy Studies) 1983, pp. 103-200.

the right to manage the venture (jointly), though the bank may decide not to exercise that right.

- Partnerships known as mudāraba involve the bank alone providing the capital in return for a profit participation, and the partner simply provides his entrepreneurial efforts, for which he too receives a share of the profit. Any losses, however, must be met entirely by the provider of capital, though the entrepreneurial partner will receive no payment for his efforts. Only the entrepreneurial partner has the right to manage the venture.

Both because the bank is required to share any losses occurring, and because the absolute return to which it is entitled on the capital it provides is not known at the outset, the bank is said to share the business risk with the entrepreneur in these PLS financings, thus relieving some of the burden on the economically active partner, the entrepreneur.

In practice, however, the financing operations of Islamic banks are by no means confined to these PLS arrangements. Other forms apart from PLS which are both admissible and used in practice fundamentally involve the bank providing the entrepreneur not with the funds he needs to acquire a given asset, but with the asset itself. In case of capital goods such as machinery, it may do this by way of hire purchase or leasing; in the case of raw materials or trade merchandise a possible route is a double purchase agreement with a fixed profit margin (mark-up) for the bank (murābaḥa): First the bank purchases the goods required, and then the entrepreneur buys them from the bank at an augmented price. Such transactions are fully admissible under Islamic law as they do not involve the pure lending of money (provision of liquidity) but represent special methods of conducting the financial side of a real transaction (purchase) by making use of

the right to demand a higher price for delayed or instalment payment than for immediate cash payment.

b) Muzāra'a, Musāqāt: Profit without Loss Sharing

Besides muḍāraba and mushāraka there are two other types of contracts establishing relations which can be interpreted as kinds of business partnerships, namely muzāra'a and musāqāt.²

- Muzāra'a means the leasing of bare lands to be made fertile by the tenant where the landlord receives a certain share (predetermined as a percentage) of the produce.
- Musāqāt means the leasing of an orchard to be cultivated by the tenant where the landlord receives a certain share (predetermined as a percentage) of the fruits.

There is a controversy on the legal admissibility of muzāra'a. The conflict of opinions results from basically different interpretations of the character of muzāra'a-contracts.

- On the one hand, muzāra'a is seen as a form of ijāra, i.e. of a contract where a worker is hired whose wages must be known and specified (in cash or in kind) in advance; no aleatory elements are allowed. If the worker is hired not for a fixed payment but for a share of the crop, this is held to be not permissible because the nature and amount of the later produce of the bare land is unknown in advance. Among the jurists for whom muzāra'a is therefore not a valid contract are Mālik ibn Anas, Abū Ḥanīfa and al-Shāfi'ī.

2) The following summary of the legal controversies on muzāra'a and musāqāt is based on Ziaul Haque: Landlord and Peasant in Early Islam, Islamabad (Islamic Research Institute) 1977.

- On the other hand, muzāra'a is interpreted in analogy to or as a form of a business partnership (mushāraka, muḡāraba) where both partners share profits and losses. For Abū Yūsuf and Ibn Ḥanbal land in a muzāra'a-contract and capital in a muḡāraba-partnership are similar, and since the later is allowed, the former should also be permissible for analogical reasons (even if muzāra'a is still considered to be a special case of ijāra and not of mushāraka). Ibn Taymiyya departs from the positions of most older jurists in that for him muzāra'a (and also musāqāt) does not belong to the category of ijāra but to that of mushāraka (so that he does not have to rely on somewhat problematic muḡāraba-analogies).

There is a broader consensus among the above mentioned jurists on the legal admissibility of musāqāt because - besides some supporting Ḥadīths of the Prophet - here most of them accept the muḡāraba analogy.

- Only Abū Ḥanīfa, who strictly adheres to the principles of ijāra for both muzāra'a and musāqāt, also invalidates musāqāt. Al-Shafi'i allows musāqāt, but only for date-palms and vineyards; this restriction is based on his interpretation of respective Ḥadīths (which, obviously, is not accepted by most other jurists).
- The main reason why the muḡāraba analogy is more readily accepted for musāqāt than for muzāra'a seems to be the following: Under 'normal conditions' fruit trees will produce fruits (like properly invested money), i.e. they are factors of production similar to money capital, while it is not clear at all that the cultivation of bare lands would produce fruits in the future; in vast areas of the Arab world bare lands were desert lands at the time when muzāra'a and musāqāt were developed.

In business partnerships (mushāraka, muḡāraba) the partners share profits according to an agreed ratio, while losses have to be

borne in proportion to the partners' shares in the business capital; in a muḡāraba-partnership, only one partner provides all the capital and therefore he has to bear the total loss while the working partner's work goes unrewarded. "Loss" here means a diminution of the business capital, but not forgone revenues.³

An example: A and B form a muḡāraba-partnership where A provides a capital of 100' and B contributes his managerial skills. B purchases raw materials for 60' and hires workers for 40' for the production of some consumer goods; A and B expect that they can sell these goods for 120'. Since they agreed to share profits equally, in this case A and B would receive 10' each. But suppose they can sell their goods for only 80': This means that the capital is reduced by 20' to 80', and the foregone profits of A and B amount to another 20'. One could argue that A and B have 'lost' capital of 20' and profits of 20' so that the total loss amounts to 40'. But this is not the result which one finds in authoritative writings of Muslim jurists and economists: They calculate a loss of only 20' because for them loss is defined as the diminution of capital; forgone advantages are treated as irrelevant.

If this conception of loss (diminution of capital) is analogically applied to muzāra'a and musāqāt, a first and striking result is that the landlord factually never, or only under exceptional circumstances, has to bear a loss:

- If he provides bare lands and if the tenant's efforts for cultivation come to nothing, the landlord forgoes some expected revenues (namely his share of the expected produce), but he does not lose part of his land.

3) The opportunity costs for the working partner: could be approximated by the payment he could expect if he would have worked as an employee for a fixed contractual income.

- If the landlord provides an orchard and if the fruits are destroyed by a storm, he, again, 'loses' only expected revenues but no capital (unless the storm has also destructed some of his trees).

Disregarding the devastation of fruit-trees by thunderstorms as exceptional incidents, one can say that the landlords under muzāra'a and musāqāt participate only in the positive results of the efforts of the tenants.

If one looks more closely at these "positive results" one can see a substantial difference between them and the profits shared in a mushāraka- or mudāraba-partnership. In muzāra'a- and musāqāt-contracts, the landlord receives a predetermined share of the produce of the land or the orchard, for example 50 %. In financial or accounting terms, the tenant has to pay the landlord 50 % not of his profit but of his turnover (= gross receipts from sales). It seems clear that the tenant has the obligation to provide all implements, manpower, etc.,⁴ and he has to cover all respective expenses out of his share in the produce.⁵

To make an example: Landlord A and tenant B enter a musāqāt-contract; they expect that A's orchard will bear fruits worth 100', and they agree that A will get a share of 50 % of the produce. B buys implements and hires some workers to help him in the orchard;⁶ his total expenses amount to 40'. If the fruits can be sold for the expected 100', then A will receive 50 % of the

- 4) According to Ibn Hanbal, who disagrees with the opposite view of the Malikīs, the seed has to be provided by the landlord in a muzāra'a contract.
- 5) In contrast to this, the costs of implements, hired manpower, etc. are subtracted from the gross receipts in partnership contracts, and the share due to the capital owner is calculated on the basis of this difference (profit).
- 6) This may have been an unusual or even an unknown practice in the first Islamic centuries, but there is no reason at hand why it should be inadmissible.

gross receipts, i.e. 50'. B has to cover the expenses of 40' out of his 50' so that only 10' are left as his profit.⁷ But now suppose that the sale of fruits yields only 70'. Then A and B receive 35' each, but B's share is not sufficient to cover all his expenses. He suffers a loss of -5', i.e. he has to mobilize some reserves in order to meet his obligations against the suppliers of the implements, the workers and the landlord.

The conclusion is that under muzāra'a and musāqāt conditions the landlord always - except in cases of natural disasters - will receive a positive return while the tenant might suffer a loss even if the gross receipts are positive. This is a basic difference to mushāraka and muḡāraba-partnerships.

If one follows the reasoning of jurists like Abū Yūsuf, Ibn Hanbal or Ibn Taymiyyah and

- considers muzāra'a and musāqāt as partnership contracts and
- treats land and capital alike,

one could say that - in contrast to statements in many writings on Islamic economics - the capital owners do not participate in losses in all business partnerships; there are partnership forms where capital owners (under 'normal' circumstances, i.e. disregarding natural catastrophes etc.) participate only in the positive results of a joint business but not in losses which occur with the working partner (lessee/borrower) and have to be covered out of his revenues.

The question now is, what are the consequences for the financing techniques of Islamic banks.

7) Under a muḡāraba-partnership the distributable profit is only $100' - 40' = 60'$, and A and B would receive 30' each.

2. Partnership, Participation and the Evolution of the Financial System

An obvious consequence would be to argue that Islamic banks in their role as capital providers (lenders) could apply financing techniques where they would participate under normal circumstances at a predetermined percentage only in positive results, e.g. in the gross receipts from sales. Only if the capital is 'destroyed' because of bankruptcy of the borrower, the bank would participate in that kind of loss. However, this analogical application of sharecropping principles in financial transactions would probably be in conflict with the prohibition of ribā (interest).

There seems to be a consensus that the prohibition of ribā does not only prohibit the fixing of a specific amount to be paid to the capital owner (implying that his remuneration should be stipulated as a percentage of something); it also prohibits that the return for the capital owner is always positive (or nil at worst) irrespective of the final outcome of the joint business.

If one agrees to this interpretation - that the prohibition of ribā means the prohibition of the 'unconditional' positiveness of the capital provider's return - then the attention should be focussed on the adequate definition of the "final outcome" as the basis for the participation of a capital providing bank.

In early Islamic times, banks as institutions of financial intermediation (between savers/investors and entrepreneurs) were unknown. Entrepreneurs and the providers of capital were usually the same people. The motive for the provision of capital in business partnerships was the chance to yield a profit, i.e. a residual income from buying low and selling high. Mushāraka and muqāraba contracts were typically concluded for the execution of a particular trade venture; these partnerships were contracted for a limited period of time (not determined in weeks or months but with respect to the completion of a specific project). If

capital was provided by more than one party of a partnership (mushāraka), then all these parties had a right to participate in the management of the respective venture. All the capital of one venture had the same legal status, there was no other kind of capital than equity capital.

The situation today is basically different in several respects. Most important is the emergence of two different kinds of capital, namely the inside or equity capital and the outside or loan capital (in a broad sense). Typically, the amount of outside capital is a multiple of the inside capital of an enterprise. Most of the capital thus is provided by other people than those who own and/or manage a firm; banks play an important role as financial intermediaries. Enterprises are no longer formed as business partnerships for the execution of a particular trade activity which promises the fetch of a residual income (profit) and which are dissolved after the completion of their particular purpose. Enterprises today are established for an unlimited period of time as permanent institutions for the continuous creation of wealth resp. income (by trade, production, etc.).

3. Principles of the Value Added Participation (VAP)

The results of this continuous process of wealth creation become manifested in the "value added"; the value added can be calculated - roughly speaking - as

- the difference between the sales or gross receipts and the value of the bought-in materials and services, or as
- the sum of the incomes of employees (wages, salaries, pensions) and of providers of capital (interest on loans, dividends for shareholders); often the 'income' of the government (taxes) is also added.⁸

8) There is no consensus on the treatment of depreciations; see below, pp. 25-26,

a) Creation and Distribution of Wealth in an Enterprise

Profits are only a part of the created wealth resp. income as expressed in the value added. The value added is the result of the joint efforts of the management and workers, and a necessary precondition for this wealth creation is the availability of financial means, esp. of outside capital. Unlike in the early Islamic business partnerships, the primary function of capital is not to yield a profit in a singular venture but to facilitate the process of continuous wealth creation.

The question now is how the value added of an enterprise should be distributed among those who have contributed to its creation, namely

- the workers,
- the providers of outside capital,
- the providers of inside capital.⁹

That different principles for the distribution lead to basically different results is mainly due to the fact that the value added is unknown in advance and subject to unpredictable (annual) fluctuations.

A first model for the distribution of the value added would be that all three groups participate in it according to a predetermined percentage, e.g.

- 80 % for the workers,
- 15 % for the providers of outside capital,
- 5 % for the providers of inside capital.

There is no need to discuss details of this model here because it seems to be unacceptable under the principles of Islamic law:

9) For brevity, neither the management nor the government will be considered explicitly as separate 'contributors'.

It has been mentioned above that wages and salaries must be certain and fixed in advance in absolute amounts. If they are defined as a percentage of the value added, then the absolute amount of the income of an individual worker is not determined for two reasons: On the one hand, the absolute amount of the value added is unknown, and, on the other hand, when the value added share of all workers together is fixed, then the 'per capita income' of an individual worker depends on the number of workers employed which may change during the year.

It has to be taken as inalienable that the income of the workers is contractually fixed in absolute amounts. But if one group receives a fixed income and if the value added can fluctuate, it is impossible that the income of both remaining groups (providers of inside and outside capital) could still be defined as percentages of the value added; the income of at least one group must become a residual income.

b) VAP and the Prohibition of Ribā

For short, it is taken for granted that the income of the equity holders should be a residual one. The question then is whether the income of the providers of outside capital

- should also be a residual income so that inside and outside capital are treated alike with respect to their returns, or that it
- should be defined as a percentage of the value added so that inside and outside capital are treated differently.

The second alternative would deserve no further attention if the proposed value added participation (VAP) would be tantamount to a predetermination of the positiveness of the capital income; this would be impermissible. But this is not the case: The value added of an enterprise can well become negative when the gross receipts from sales do not cover all the expenses for bought-in materials and services. Parts of these expenses and all wages have then to

be financed by the provision of fresh (inside or outside) capital. If the providers of outside capital have agreed to participate in the value added at a ratio of, for example, 15 %, then they should also participate in a negative value added, i.e. they should contribute 15 % of that capital that is needed for the enterprise to meet its contractual obligations.¹⁰

It is beyond doubt that an enterprise whose value added is negative passes through a very serious crisis, and one could complain that the providers of outside capital participate in negative results only when the losses reach an exceptional and perilous size while smaller losses have to be borne by the equity holders. Complaints of this kind express the feeling that such a participation in only exceptional negative results is not enough. This, however, is a second(ary) question, a question of degree; the first and more important question was one of principle, namely whether a VAP would be tantamount to a predetermined positiveness (or non-negativeness) of returns, and here the answer in principle is a clear "no".

This result is important because otherwise a VAP would contradict a 'technical' or 'positive' principle of the Islamic law which leaves little room for interpretation or discussion. In contrast to this, the question of degree resp. justice points to a 'normative' principle of (resp. the rationale behind) the prohibition of ribā which is far less clearly defined and gives considerable room for interpretations and modifications for a reasonable application.

c) VAP versus PLS: The Problem of Justice

A simple example may serve as an illustration of a case with a substantially different treatment of inside and outside capi-

10) As an alternative one could imagine that the providers of outside capital have to contribute a percentage that is equal to their share in the total capital of the enterprise. This provision were analogous to that in mushāraka-partnerships.

tal. The turnovers of an enterprise may be 220', and the value of the bought-in materials and services may amount to 120'. Then the value added is 100'. Suppose the contractually fixed wages were 90' and the participation ratio for outside capital 20 %. In this case, the residual income of the equity holders must be negative, i.e. a loss of -10'. In other words: While the providers of outside capital receive a positive return (20'), the providers of inside capital have to finance parts of the value added applied by the two other groups and, as a consequence thereof, they suffer a loss (of -10').

Is this different treatment of outside and inside capital a just one, and could it be considered admissible under Islamic law?

In business partnerships of early Islamic times, profits and losses were calculated when the trade venture was executed and the partnership was dissolved; thus profits and losses were definite. Under these circumstances it might have been unjust, if the wealth of one provider of capital increases while that of the other decreases. But today, enterprises are established for an unlimited period of time and losses in one year are usually not definite but could be offset by profits in later periods; this should be expected under 'normal' circumstances. Therefore, what seems to be unjust if looked at in isolation loses most of its dubious appeal when looked at in a more encompassing perspective.

Paying due attention to the time dimension one can argue that the differing treatment of outside and inside capital is not unjust. Outside capital is provided only for a limited and often quite short period of time, while inside capital is provided without a time limit. For the wealth of the equity holders, the cumulated profits/losses of the lifetime of their enterprise are relevant. These cumulated profits/losses were impossible without all the outside capital provided throughout the years. Therefore it would be just if all providers of outside capital would par-

ticipate in the cumulated profits/losses. But these are not known in advance, and so a participation in the lifetime profit/loss of an enterprise is unpracticable.

What is considered practicable by Muslim jurists and economists is the participation of providers of outside capital in the annual profits/losses. But this leads to just results only when outside and inside capital were provided for the same period of time. If this precondition is not met - and it is not met in most real cases - the results can be judged unjust. This can best be explained by a numerical example. Suppose an enterprise with a lifetime of 5 years. In and for every year the expected profits amount to 15'. Considering alternative employments of their funds, providers of outside capital agree to a participation ratio of 33.3 % of the profits. The actual annual profits may fluctuate unexpectedly as shown in table 1, but the cumulated profit of the total period is 75' as expected ($5 * 15$).

Table 1

| Year | 1 | 2 | 3 | 4 | 5 | Total | Aver. |
|-------------|------|--------------------|------|-----|-----|-------|-------|
| Profit/Loss | 40 | -10 | 30 | 15 | 0 | 75 | 15 |
| Value Added | 240 | 190 | 230 | 215 | 200 | 1075 | 215 |
| PLS a) | 13.3 | -3.3 ^{b)} | 10.0 | 5.0 | 0 | 25 | 5 |
| VAP a) | 5.6 | 4.4 | 5.3 | 5.0 | 4.7 | 25 | 5 |

a) Share for the provider of outside participation capital.

b) Depending on the share of participation capital in total capital more or less.

- If the outside capital were provided for the total period of 5 years (i.e. for the same period as the inside capital), the provider of outside capital would receive a total of 25' or on the average 5' annually.

 - But if there were not one provider of outside capital for the period of 5 years but 5 for the period of one year each (all expecting profits of 15' in one year and agreeing to a profit share of 33.3 %), then, as table 1 shows, two of the providers of outside capital would gain an unexpected profit, one would receive no return at all, and one would even suffer a loss.¹¹ These profits and losses are definite to them, and no inter-temporal compensation is possible. Such a result, where the returns for the provision of the same amounts of outside capital for identical periods (one year each) differ substantially, can hardly be called a "just" one.

 - A "just" arrangement should allocate to those who made basically the same contributions to the financial result the same returns. Probably a perfectly just and practicable method for the distribution of profits/losses does not exist, but there is an alternative to the participation in the annual profits or losses which comes much closer to the ideal: the value added participation (VAP). Suppose that, for example, the value added exceeds the profits/losses in each year by 200'; then the cumulated value added amounts to 1075'. If the providers of outside capital want the same 5' p.a. as return for their capital as assumed in the profit and loss sharing (PLS) case, they have to participate by 2.3 % in the total resp. in the average annual
- 11) The losses of the income statement must not mean a real diminution of the real assets of an enterprise but could be due to some accounting procedures; then the loss would be real only for the providers of outside capital but not for the equity holders.

value added. Table 1 shows the actual (unexpected) value added and VAP returns if the ratio of 2.3 % is applied in each year. One can immediately see from the table that the annual relative fluctuations of the value added are much more moderate than those of the profits/losses (although the absolute fluctuations of value added and profits/losses are identical). Consequently, the actual value added shares come much closer to the 'ideal' (expected) annual average, i.e. the distribution of returns is far more equitable and "just" than in the case of a PLS participation (mushāraka, muḍāraba).

The consequence is that the different treatment of outside capital (that receives a share in the value added) and inside capital (that receives a share in the residual profits/losses) leads to a distribution of returns which is more just than a distribution based on equal treatment with PLS participations for both kinds of capital.

However, an important implicit assumption was that the overall result of the enterprise is positive. Table 2 shows an example where the final result is not a profit of 75' but a loss of -25'. The participation in annual losses was calculated by the application of the profit sharing ratio to losses; this is a simpli-

Table 2

| Year | 1 | 2 | 3 | 4 | 5 | Total | Aver. |
|-------------|-----|--------------------|--------------------|---------------------|-----|-------|-------|
| Profit/Loss | 20 | -10 | -5 | -40 | 10 | -25 | -5 |
| Value Added | 220 | 190 | 195 | 160 | 210 | 975 | 195 |
| PLS a) | 6.6 | -3.3 ^{b)} | -1.7 ^{b)} | -13.3 ^{b)} | 3.3 | -8.3 | -1.7 |
| VAP a) | 5.1 | 4.4 | 4.5 | 3.7 | 4.9 | 22.6 | 4.5 |

Notes see table 1

fication because in PLS-partnerships the losses have to be borne in relation to the share in the total capital.¹² Depending on that share, the shares in the annual losses might be larger or smaller, but what is important here is not the absolute amount but the variability of the shares in the annual losses.

- In the PLS case one can see that two of the providers of outside capital receive positive returns and two have to bear 'too large' losses.
- In the VAP case all providers of outside capital receive positive returns although the final result of the enterprise is negative.

The objections against these results from the point of justice are for the PLS case the same as in the example with a positive final result, namely the variability and disproportionality of the shares for the different providers of outside capital. For the VAP case, however, the judgement is different: The problem here are not divergencies within the group of providers of outside capital but the basic difference between that group and the group of equity holders. Since the value added is not negative the providers of the outside capital receive a positive return whereas the equity holders have to bear the overall loss - which is enlarged by the returns for the providers of outside capital which have to be financed by the equity holders. Is that unjust? Maybe - but that is, in the last instance, no convincing argument against the VAP and in favour of the PLS approach.

- It must be noted that both approaches lead to "unjust" results in the problematic case of a final loss. But the injustice of PLS is that it leads to unequal 'outputs' for equal 'inputs',

12) The calculation implies that the share of outside capital is 33.3 %.

while VAP ends in unequal outputs for unequal inputs: Inside and outside capital are not identical in several respects; most important, the equity holders have the right to manage the enterprise. It is, for example, in the last instance up to their decision under what conditions necessary financial means are acquired: as additional inside (i.e. loss-sharing) or outside capital on a PLS or VAP basis. The equity holders can take decisions which determine to a large degree the final results of their enterprise: They can decide on the termination or continuation of the enterprise. If, for example, the equity holders had brought their enterprise of example 2 to an end after the third year, the overall result would have been a profit of 5', and if they would have continued after the fifth year, the result could also have turned to the positive (but also to the more negative). Arguments of this kind could justify a different treatment of providers of inside and outside capital in cases of loss.

- The problematic case of a final loss is an exceptional one; at least it is not the typical case. Normally one can expect that an enterprise will bring its capital owners an overall positive return, and it is not unreasonable to assume that on the average the profits of a successful enterprise would, in the long run, develop roughly in proportion to the development of the value added. With respect to 'typical' or 'normal' situations, the VAP approach is superior to the PLS approach: It can bring the annual remunerations for the providers of outside capital in a closer relation to the average (expected) returns for inside capital, and it avoids the unfounded and unjust divergencies within the group of providers of (short-term) outside capital.

The reasoning started with some comments on traditional forms of contracts (muzāra'a, musāqāt) and business partnerships (mushāraka, muḡāraba); an unmodified application to financial transactions in modern times, where two basically different types of

capital - inside and outside capital - have emerged, seems to be inadequate. Therefore, a new approach - inspired by but distinct from the old constructions of Islamic law - was developed: the value added participation (VAP). The aim of the discussion so far was to show that, on the one hand, the VAP is not in contradiction to the prohibition of ribā because it is not tantamount to a loan contract with a predetermined positiveness of the return; the value added can well become negative, although this will happen only in cases of serious crises. On the other hand, it was argued that the VAP approach is not only compatible with the claim for justice in economic transactions (raised in particular by modern Muslim economists), but that under normal circumstances it is even superior to the PLS approach from the point of justice.

Part II: Economic Aspects of Participation Financing

1. Value Added and Financial Accounting

The value added is known in macro-economics since the general recognition of national income statistics and accounting in the 1930s. In business economics, however, it found a wider attention only in the last decade. The idea of value added statements as additional disclosures to the conventional income statements and balance sheets found more support in public discussions in the English-speaking world after the publication of "The Corporate Report" of the British Accounting Standards (Steering) Committee in 1975.¹³ In 1980, the practice of value added reporting in

13) See Accounting Standards (Steering) Committee: The Corporate Report, Discussion Paper, July 1975. "The simplest and most immediate way of putting profit into proper perspective vis-a-vis the whole enterprise as a collective effort by capital, management and employees is by presentation of a statement of value added ... It usefully elaborates on the profit and loss account and in time may come to be regarded as a preferable way of describing performance". Ibid, p. 49, quoted in Sidney J. Gray, Keith T. Maunders: Value Added Reporting - Uses and Measurement, n.p. (London: Association of Certified Accountants) 1980, p. 1.

the United Kingdom was examined in a research study prepared for the Association of Certified Accountants.¹⁴ Not only in the United Kingdom but also in several other European countries the value added statements are judged as important parts of a new approach towards the evaluation of the 'social performance' of a company (social accounting).¹⁵

There is no need to summarize all the discussion on value added reporting and social accounting here. But some of the issues of these discussions are also of relevance in the present context, namely questions concerning the definition and measurement of the value added:¹⁶

- Should the value added of a manufacturing enterprise be calculated at the time of production or of sale?
- Should depreciations be treated as external costs (bought-in factors) or as a distribution of value added?
- Should extraordinary items be included into or excluded from the value added?

These questions indicate that there is no generally accepted definition of the value added, but that the calculation procedure depends to a large degree on the intended use of the value added statement. Answering questions like the above mentioned will give a better understanding of how the value added can be influenced by accounting procedures; to know this is a precondition

14) See S.J. Gray, K.T. Maunders: Value Added Reporting ... (note 13).

15) See, for example, Frederick D.S. Choi, Gerhard G. Mueller: International Accounting, Englewood Cliffs (Prentice-Hall) 1984, pp. 235-239, 272-280, 285-291.

16) The following arguments are summarized from S.J. Gray, K.T. Maunders, Value Added Reporting ..., pp. 27-33.

for an assessment of manipulation possibilities for entrepreneurs when the value added is used as the participation basis in VAP agreements with Islamic banks.

a) Value Added on Production or Sale?

A decision on the temporal recognition of the value added in manufacturing enterprises must be taken: Should the value added (VA) be calculated at the time of production or at the time of sale?

- A production oriented measurement is based on the value of the output of an enterprise irrespective of whether the output has been sold or not. The problem is the valuation of stocks of finished goods, works in progress and own-manufactured fixed assets; they should be valued at market selling prices (though this would be contrary to the conventional accounting practice based on the realization principle).
- A sales oriented measurement of the VA is in line with conventional accounting principles; stocks are valued at cost prices.¹⁷

There is no definite argument in favour of one of these approaches; they mainly differ in the valuation of stocks. Which one is chosen depends on the intended use of the value added. In the long run, i.e. for a number consecutive periods, the production should be in close relation to the sales. For that reason and

17) "However, this approach gives rise to problems where ... employee costs are treated as a distribution of value added on a production basis, i.e. the total amounts payable are reported, whilst the measurement of value added is carried out on a sales basis. The difficulty here is that any increase or decrease in the employee element of the cost of stocks over the year must be treated as an adjustment to external costs, if an imbalance between the amount of value added created and distributed is to be avoided." S.J. Gray, K.T. Maunders: Value Added Reporting ..., p. 27.

because it is more convenient and less costly to take the figures for the VA calculations from the ordinary accounts and income statements, the sales orientation seems reasonable for medium- and long term VAPs. For short-term VAPs the production oriented measurement should be considered, esp. in cases where the sales fluctuate more pronouncedly (e.g. for seasonal reasons) than the production.

b) Gross or Net Value Added?

Of no less importance than the production or sales orientation is the treatment of depreciations: Are depreciations of fixed assets a distribution of value added for the maintenance of the assets (to be reinvested), or are they part of the external costs for bought-in goods and services? Again, no definite answer can be given.

- When the enterprise is seen as a separate entity whose long-term continuity and preservation is the most important objective of all its stakeholders (esp. the equity holders, the providers of outside capital and the employees), then the earmarking of funds for reinvestment seems justified. The gross calculation of VA, i.e. the treatment of depreciations as distribution of value added were adequate.
- The net calculation, i.e. the treatment of depreciations as external costs, is more in line with the conventional treatment of depreciations in profit and loss accounting. Comparisons of the managerial efficiency between companies with different capital intensities give more evidence when the value added is calculated on a net basis: Two enterprises can disclose identical figures for gross VA, but if they operate on different capital intensities, their figures for net VA will differ as the managerial efficiency seemingly differs.

With respect to VAP, a problem with the net calculation is that the management is left with a considerable discretionary influence on the VA of particular periods through the choice of the depreciation policy.

The Corporate Report recommended a value added statement where depreciations are treated as part of the value added distribution:¹⁸

Statement of Value Added

| | £M |
|---|-----------|
| Turnover | xx |
| Bought-in materials and services | xx |
| | <hr/> |
| Value Added | xxx |
| | ==== |
| Applied the following way: | |
| To pay employees | |
| Wages, pensions and fringe benefits | xx |
| To pay providers of capital | |
| interest on loans | x |
| dividends to shareholders | x xx |
| To pay government | |
| Corporation Tax Payable | xx |
| To provide for maintainance and expansion of assets | |
| depreciation | x |
| retained profits | x xx |
| | <hr/> |
| Value Added | xxx |
| | ==== |

c) Exclusion of Extraordinary Items?

Extraordinary or non-operating items - such as gains/losses from the sale of fixed assets or investments and from foreign currency transactions - can substantially influence the total profit/loss

18) Quoted from the reproduction in S.J. Gary, K.T. Maunders: Value Added Reporting ..., pp. 19-20.

of an enterprise. It is a controversial question whether these extraordinary items should be considered a part of the value added or not.

- Since these items are extraneous to the normal operations, they could be excluded from the value added calculation. This seems justified esp. when the value added shall be used for an evaluation of the efficiency of the present management.
- The main argument for an inclusion of extraordinary items is that though these items have their basic cause not in normal operations, they nevertheless are consequences of past decisions of the management; therefore they are attributable to the enterprise. And the extraordinary items ultimately affect the amounts available for distribution (esp. to the equity holders).

Balancing these arguments and considering the serious practical problems of a clear delimitation of extraordinary from normal operations, the non-operating items should be included in the calculation of the basis for the VAP (but one should be clear on the magnitude of the extraordinary component of the value added).

d) Manipulation of the Value Added?

From the bank's point of view, it is a serious problem of PLS financings that the entrepreneurial partner has many possibilities for a manipulation (i.e. reduction) of the participation basis, i.e. the profit, so that the costs of participation capital - which are the earnings of the bank - can be reduced. Two main strategies are

- to increase wages and salaries (esp. of the management),
- to increase depreciations (by a suitable strategy for the temporal distribution of depreciations, by the anticipation of purchases, etc.).

Other possibilities include the increase or revaluation of stocks and the acquisition of not really needed assets.

Under the terms of VAP, however, most of the manipulation possibilities will be excluded or sharply reduced in their attractiveness.

- To reduce the profit by an increase of management salaries does no longer reduce the costs of the participation capital: The profit-component of the value added decreases, but the wage-component increases by the same amount. Thus the participation basis (VA) is unchanged.
- If the participation is based on the gross value added, the profit- and the maintenance-component of the (gross) VA will change in a compensatory way so that the participation basis is not affected by the depreciation policy.

Admittedly, there still remain some possibilities for manipulation, e.g. the purchase of 'unnecessary' assets during the period of the VAP financing of the enterprise. But quantitatively these manipulation possibilities should no longer be a serious problem. The main reason is that the manipulations are concentrated on a reduction of profits, but the profit-component of the VA will amount, in most cases, probably to not more than 5 - 10 % of the value added. Therefore even substantial manipulations of profits would change the value added resp. the costs of funds only by marginal amounts. For example, for a 10 % weight of the profit-

component and a 25 % reduction of the profit by manipulation, the value added would be reduced only by $0.1 * 0.25 = 2.5 \%$.

Considering the uncertainties of VA forecasts, it seems that there is not much need for very elaborated (and costly) measures to forestall possibilities of profit manipulation. This is an important advantage for the practical application of VAP as compared to PLS.

2. VAP Calculus in Interest Economies

Most Islamic banks operate in economies where the financial sectors are dominated by 'interest banks'. Entrepreneurs seeking funds have a choice among a great variety of financing modes and models which can be categorized into either 'fixed cost financings' or 'participation financings'.

- In cases of fixed cost financing (e.g. interest-bearing loans, leasing), the costs of funds, i.e. what the debtor has to pay to the bank, is known in absolute figures in advance.
- In cases of participation financing (e.g. PLS, VAP) the absolute figures for the costs of funds is not known in advance. Only the participation ratio, i.e. the percentage of the participation basis (profit of value added) which has to be paid to the bank, is fixed in advance. The participation basis, however, is not known in advance. Entrepreneur and bank have only some expectations about the absolute amount of the participation basis resp. the cost of funds.

From the entrepreneurial point of view a VAP offered by an Islamic bank competes with interest-based forms of fixed cost financings.¹⁹ The decision for one of these alternatives depends fundamentally on expectations - both of the entrepreneur and of

19) It is not assumed that entrepreneurs are so 'Islam-minded' that they will no longer consider interest-based financings as soon as Islamic banks appear on the market and offer non-interest forms of financing (esp. PLS and VAP).

the bank - which therefore shall be considered in more details in the next section. For that and for the following arguments it is generally assumed that the rate of interest (i) is determined by market forces so that it cannot be influenced by individual entrepreneurs. Consequently, for a given amount of outside capital (C) the interest-costs of funds (which function as opportunity costs for the entrepreneur) are given ($F = i * C$). Another assumption is that Islamic banks strive for returns for the capital provided by them which are not less than the returns of interest banks for the same capital provision. If VA is the value added, r the participation ratio and R the returns of the Islamic bank ($R = r * VA$), then the Islamic bank strives for $R \geq F$ ($= i * C$).

a) Pessimistic and Optimistic Expectations

Entrepreneurs and banks have to make forecasts on the prospective value added (VA). The exact future value of the VA is determined by factors which are unknown at present. Therefore one can say that the final outcome of the VA is - within a certain range - a matter of chance. Then the VA can formally be treated as a random variable, and in order to keep the mathematics as simple as possible, the VA shall be interpreted as a discrete random variable. This means that only a limited number of outcomes (of the random process) is held possible by the forecasters, e.g. VA values of 80', 100' and 120'.²⁰ The forecasters can not only enumerate all possible future VA s; they can also assign to each one a certain probability (p) for its realization. The sum of these probabilities must be 100 %. For example, the forecasting entrepreneur holds a VA of 100' to be the most probable, but he cannot exclude the possibility that the VA could be either 80' or 120'; so he assigns a p of 60 % to the VA of 100', 20 % to 80' and also 20 % to 120'.

20) If, in contrast, the VA is interpreted as a continuous random variable, the number of possible outcomes within a certain range (e.g. from 70' to 130') is infinite; see also note 21 below.

- If the probability for VAs smaller than the most probable one (formally speaking: the modus of a unimodal probability distribution) is the same as for larger VAs, then the expectations of the forecaster may be called "symmetric".
- If the probability for smaller VAs than the most probable one is larger than that for larger VAs, the expectations may be called "pessimistic".
- If the probability for smaller VAs than the most probable one is smaller than for larger VAs, the expectations may be called "optimistic".

Examples for symmetric, optimistic and pessimistic expectations are given in table 3. The last line of table 3 shows the expected value of VA, $E(VA)$, for alternative probability distributions. $E(VA)$ is simply calculated as the sum of the products of the possible VAs and their respective probabilities, that is e.g. for column 2: $0.20 * 80 + 0.60 * 100 + 0.20 * 120 = 100$.²¹

The 'optimism' or 'pessimism' of the forecaster is expressed not only by the probability distribution, but is also manifested in the value added expectations, $E(VA)$. Optimistic forecasters end up with a larger $E(VA)$ than that for symmetrical expectations which again is larger than $E(VA)$ under pessimistic expectations.

Even if one assumes that an entrepreneur and his bank know that they base their individual expectations on the same set of VAs

21) If VA were held to be a continuous random variable, one had to use correspondingly continuous probability functions. In formal terms, the probability density function were unimodal and skewed, for the entrepreneur to the left (negatively, i.e. the mean is smaller than the mode) and for the bank to the right (positively, i.e. the mean is larger than the mode). The arithmetic mean of a discrete probability distribution is the expected value (expectation) of the random variable; the expected value of a continuous random variable is calculated analogically by replacing the operation of summation through that of integration.

Table 3

| Value Added (VA) | Probabilities p(VA) | | | | |
|------------------|---------------------|-------------|-------------|------|------|
| | sym-metric | opti-mistic | pessimistic | | |
| 1 | 2 | 3 | 4 | 5 | 6 |
| 80 | 20 % | 10 % | 30 % | 25 % | 20 % |
| 100 | 60 % | 60 % | 60 % | 60 % | 70 % |
| 120 | 20 % | 30 % | 10 % | 15 % | 10 % |
| E(VA) | 100 | 104 | 96 | 98 | 98 |

held possible, one cannot assume that they will end up with identical expectations; this, namely, would require identical probability distributions of entrepreneur and bank, but the number of possible distributions is indefinite. Thus it seems more plausible to assume the value added expectation of the entrepreneur, $E(VA)_e$, is different from that of the bank, $E(VA)_b$.

b) Compatible and Antagonistic Expectations

It was assumed that the Islamic banks strive in their VAP policy for returns not less than those of conventional banks offering interest financings: $r * E(VA)_b \geq i * C = F$. Since F is given, the bank will demand a minimum participation ratio which is the larger the smaller $E(VA)_b$ is.

If the bank offers a VAP at a ratio of r , the entrepreneur can accept it if his expectations, $E(VA)_e$, are identical with or smaller than those of the bank, i.e. $E(VA)_e \leq E(VA)_b$. Then his payments to the Islamic bank would be the same or less than interest payments would be: $F = r * E(VA)_b \leq r * E(VA)_e$.

If the entrepreneur expects a VA larger than that expected by the bank, i.e. $E(VA)_e > E(VA)_b$, then the entrepreneur would prefer

the interest-financing because the interest-payments would be less than the expected payments out of a VAP: $F = r * E(VA)_b < r * E(VA)_e$.²²

In short one can say that - with respect to the conclusion of a VAP agreement - the expectations of the entrepreneur and of the bank are

- compatible if the bank is as optimistic/pessimistic as or more optimistic/less pessimistic than the entrepreneur: $E(VA)_b \geq E(VA)_e$,

- antagonistic if the bank is more pessimistic/less optimistic than the entrepreneur: $E(VA)_b < E(VA)_e$.

The compatibility condition - that, in short, the bank must be more optimistic than the entrepreneur - poses some problems for the bank.

- Suppose the bank claims a participation ratio calculated on the basis of its own VA expectations, $r = F/E(VA)_b$. This ratio is less than that ratio which the entrepreneur were willing to accept due to his more pessimistic VA expectations. So the bank can increase the expected revenues by claiming a higher participation ratio; the maximum would be reached when the bank asks for the ratio $r = F/E(VA)_e$. This maximum ratio, however, is ex ante unknown to the bank, and the entrepreneur has no incentive to communicate it freely to the bank. Quite contrary, it is his advantage if the bank is too optimistic and claims a ratio supposed to be the maximum but factually less than that. Thus the bank has to find out the real maximum ratio in sensitive negotiations with the entrepreneur.

22) Thus the interest costs limit the earnings of an Islamic bank from VAPs.

- The bank can fetch returns larger than those of interest banks only when the realized value added (VA_0) exceeds the expectations of the entrepreneur ($VA_0 > E(VA)_e$) and when the agreed participation ratio is larger than it has to be for balancing the participation returns at VA_0 with the given interest costs ($i * C = F$), i.e. $r > F/VA_0$ resp. $r = F/VA_0 + a$ ($a > 0$). This condition ($r > F/VA_0$) is the easier to meet the closer the agreed participation ratio comes to the maximum ratio acceptable to the entrepreneur ($r = F/E(VA)_e$).
- The critical but necessary condition for better bank returns from VAP compared to interest financings is that the realized VA exceeds the entrepreneurial expectations. One could hardly say that it is normal that entrepreneurial expectations turn out, ex post, as too pessimistic. Such a pessimistic bias would need a justification. For example, one could interpret the biased expectations as the result of a certain type of risk aversion: An entrepreneur may have informations concerning the future VA which would lead to a symmetric probability distribution. But because of his risk aversion, the entrepreneur wants to attach to the above-average results a smaller and to the sub-average results a higher value. The simplest way to do this is to 'correct' the respective probabilities, i.e. to transform the symmetric into a pessimistic probability distribution. The resulting expectations are not only based on factual informations but also on a psychological attitude towards risk. If a sufficiently large number of entrepreneurs would form their expectations in such a way, it is not unplausible to expect that on the average the factual results will surpass the biased entrepreneurial expectations.

One can assume that entrepreneurs are aware of their 'pessimistic bias'. If they do not take actions to correct it, and if they agree to participation ratios corresponding to their biased expectations ($r = F/E(VA)_e$), they are willing to bear higher costs of funds under a VAP arrangement than under terms of fixed

cost financing. The difference can be interpreted as a kind of 'insurance premium' which entrepreneurs with risk aversion are ready to pay to the bank for its willingness to reduce the absolute costs of funds in cases of poor economic performance of the enterprise. Unlike outside capital provided on a fixed cost basis, outside participation capital can function as a 'shock-absorber', i.e. the compression of profits in cases of (unexpected) poor performance is less than it would be under terms of fixed cost financing.

The Islamic banks should try to find for their VAPs entrepreneurs to whom the shock-absorbing capacity of participation financing has a positive value. These entrepreneurs should be willing to pay a price for participation capital which is under 'normal circumstances' somewhat higher than the price of fixed cost capital. Shock-absorbing capital may be of special interest to entrepreneurs operating in markets where, for example, preferences or technologies or prices change or fluctuate rapidly so that forecasts must have large margins of error. But it goes without saying that under conditions of rapid and frequent change the chance for above-average returns is only one side of a coin for the capital providing bank; the other side is the risk of sub-average returns. Therefore the bank should try to become familiar with the relevant markets (by own expertise or by recourse to outside consultants) since it is absolutely necessary that the bank can evaluate project proposals, business strategies, etc. of the VAP partners so that the bank can form own and independent VA expectations. This will probably cause higher administrative costs for the bank which have to be balanced with the chances for above-average returns. In general, there is no guarantee for a bank that VAP will be more profitable than fixed cost financing.

3. Costs and Benefits of VAP

For a balancing of the costs and benefits resp. advantages and disadvantages of VAP, it is not only important to separate the perspective of the entrepreneur from that of the bank (because in many cases an advantage/benefit for the one side is a disadvantage/cost for the other side). It is also important to state clearly with which other forms of financing the VAP is compared.

a) Entrepreneurial Perspective

Compared with fixed cost financing, the main advantage of VAP is for the entrepreneur the shock-absorbing capacity of a participation financing; this capacity reduces the costs of funds and leaves a profit which is larger than it would have been under terms of fixed cost financing in cases of poor economic performance of the enterprise.

The shock-absorbing capacity, however, would be even more pronounced in forms of participation financing where the participation basis were not the value added but the profit itself. PLS financing would be an example, but also financing by the issue of new equity shares or by the floatation of commercial papers where the subscribers receive no fixed interest but a kind of dividend; examples are nonvoting preferential shares or Participation Term Certificates (a new type of paper developed in Pakistan in order to replace the interest-bearing obligations).²³ But these alternative forms of participation financing have all particular problems or disadvantages which reduce their attractiveness compared to VAP.

23) On the conception of PTCs see the Report on Elimination of Interest ... (note 1), pp. 135-136.

- The problem with PLS financing is not only that it is hardly offered by the Islamic banks in cases where its shock-absorbing capacity were of particular interest to the entrepreneurs. If it were offered in these cases, then the banks would take a substantial financial risk so that one can expect that a PLS financing would be clearly more expensive than a VAP.

- The issue of new equity shares creates on the one hand new permanent claims for parts of the future profits, and on the other hand the new equity holders could try to get an influence of the management of the enterprise.

- The issue of PLS commercial papers is probably even more expensive than a PLS financing from a bank would be: The subscribers of these papers could hardly have an intimate and fact-supported knowledge of expected profits, risks and chances which is comparable to that knowledge a bank can gain from own sources and in the negotiations on a VAP. Since the subscribers have factually risk-free alternatives to invest their money (e.g. in government securities), they probably will claim a significant compensation for the risk of unforeseen fluctuations of profits; these claims will be less based on calculated expectations than on subjective guesswork and risk aversion of the subscribers.

For these reasons VAP could be the relatively 'cheapest' form of shock-absorbing participation financing.

Nevertheless, the shock-absorbing capacity of VAP has its price, and entrepreneurs more prepared to take a risk may judge this as a disadvantage: Under 'normal' circumstances the costs of funds are higher under VAP conditions than under terms of fixed cost financings, and in cases of 'good' performance, the financial leverage effect of outside capital for the profitability of inside capital is reduced.

Summing up one can say that the benefits of VAP do not necessarily outweigh its costs, but there are certain groups of (risk averse) entrepreneurs to whom the VAP could be an attractive form of financing.

b) Banking Perspective

In part I. of this paper, the VAP was contrasted to the PLS approach, and important advantages for the bank have been explained in some details. Leaving aside the question of justice, the main economic points were the limitation of the financial risk for the bank and a much better predictability of the returns for the bank. Further it has been argued in part II. that there is a chance for these returns to exceed those from fixed cost financings, provided that the bank can conclude VAP agreements with a sufficiently large number of risk averse entrepreneurs who are willing to pay a premium for the shock-absorbing capacity of VAP financings.

It could be judged as a disadvantage that the financial risk and the uncertainty are reduced compared to PLS but not factually eliminated as in fixed cost financings. Sub-average returns threaten the bank when entrepreneurial VAP partners were not chosen carefully and when the bank consented to a too 'optimistic', i.e. too low participation ratio in the VAP negotiations. However, these problems are characteristic for all forms of participation financing, and for VAP they are much less serious than for PLS. And if Islamic banks attach these problems of VAP much importance, they have hardly any other choice than to restrict their financing activities to fixed cost forms like leasing or mark-up. But then they are competing with numerous other banks so that they could hardly come to above-average or even outstanding results.

What is even more critical in the medium- and long-term perspective is that a bank offering only finance for particular real

transactions, esp. purchases, does not look very attractive to many entrepreneurs. What they often need are not only financial means for planned purchases of raw materials, machines, etc., but it is - often very urgently - unconditional liquidity to cover unexpected or extraordinary expenses. Since interest-based overdraft facilities, lines of credit, etc. are prohibited for Islamic banks, the provision of unconditional liquidity must take the form of participation financing, i.e. PLS or VAP. Therefore Islamic banks who want to offer their customers a similar variety of financial services as interest banks but on a ribā-free basis should think about the VAP approach.

It seems quite impractical to provide unconditional short-term liquidity under a PLS arrangement when "profit" means the profit shown in the annual income statement resp. balance sheet. What deserves a special attention is the provision of short-term liquidity on a participation basis. Short-term credits, e.g. for three months, look somewhat curious and cumbersome under PLS arrangements since the costs of funds can be calculated only after the profit has been determined in the annual income statement resp. balance sheet - and that can well be several months after the credit transaction was completed. Under VAP conditions, however, the largest part of the participation basis (value added) can be known without much delay, namely the wages and the interest costs. Except for enterprises where the monthly wages fluctuate substantially within the year (esp. for seasonal grounds), there is no reason why the bank and the entrepreneur should not base their VAP on the value added of those months during which the credit was taken up. This principle needs an exemption only for the profit component of the value added, at least as long as the profit is not calculated e.g. on a monthly but on an annual basis.²⁴ For most enterprises, the profit com-

24) Some modifications might also be necessary for parts of the other VA components, e.g. taxes, which incorporate some elements calculated only on an annual basis.

ponent is the smallest and amounts to only 10 - 20 % of the VA. Thus the costs of VAP funds can be calculated shortly after the completion of the short-term credit transaction with an accuracy of approx. 80 - 90 %.

The need for liquidity often arises when an enterprise runs into financial troubles. Suppose that an enterprise needs a credit for six months to secure its economic survival, but for the next two years the expected profits (as shown in the balance sheets) are negative. There is no chance to get the needed liquidity from an Islamic bank under PLS, but the provision of funds on a VAP basis would be possible as long as the overall VA is expected to be positive; the negativeness of one of its components could be compensated by a respective participation ratio. If Islamic banks do not want to take recourse to somewhat tricky and dubious "sell/lease-back/repurchase"-constructions,²⁵ VAP seems to be the most suitable method for the participation of an Islamic bank in the financial reorganisation of an enterprise in temporary difficulties.

The costs and benefits of the VAP have been discussed under the assumption that Islamic banks have to compete with interest banks. The general result is that Islamic banks should offer financings on a participation basis, and that VAP solves resp. avoids many of the problems of PLS which is so far the only form of participation financing in Islamic banking. For banks operating in an Islamized environment where interest financings are no longer permissible, the VAP approach should be even more attractive. The aim of this paper was to introduce the basic rationale of VAP; the elaboration of more technical details may follow at a later date in case this first outline of the VAP approach will receive a not completely negative response.

25) A company could get liquidity from selling an asset to the bank which then is leased back by the company and later on re-purchased from the bank.