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Determination of Profit and Loss Sharing Ratios in Interest-Free Business Finance

Journal of King Abdulaziz University: Islamic Economics, Vol. 3, No. 1, 1985

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Abstract

Current models of profit-and-loss-sharing (PLS) financing assume that the ratio in which profits are shared may be different from the ratio the financier's capital bears to the total capital of the firm, which is the ratio in which losses must be shared. This can be better justified as a growth promoting policy than as an instrument for ensuring distributive justice. In a system where interest and PLS financing co-exist, the aggregate profit-sharing ratio is a function of the overall rate of return on investment, rate of interest, degree of leverage, and risk premium. PLS financing is more profitable to financiers in the long run than interest financing.

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