Islamic Financing and Business Framework: A Survey

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Abstract

Islamic financial instruments are categorized objectively as Sharia compliant and Sharia based. Sharia compliant instruments are used by Islamic Financial Institutions (IFIs) aggressively and the share of Sharia based financial instruments is even less than 3%[A] in investment portfolios of IFIs working in Pakistan. This study is conducted to evaluate the suitability of existing business environment in Pakistan for application of Sharia based financing. Opinion survey of finance professionals, Islamic bankers, entrepreneurs and academicians is conducted through questionnaire. Findings suggest a number of hurdles (e.g. the dominance of conventional banking, earnings manipulation by firms, higher taxes, weaker auditing, lack of trust and confidence in the abilities of Musharaka partners, riskiness of Musharaka and inability of conventional financial reporting framework to ensure transparency) are there in the way of popularity of Musharaka financing. Increased awareness, new product development, capacity building of IFIs, reforms in financial reporting framework and strengthening audit institution, may help in the implementation of Musharaka financing.

Keywords: Musharaka, Sharia based financing, Pakistan, IFIs
JEL Classification Codes: R 11, G 15, G 21

1. Introduction

Islamic financial system is not a mere theory rather it is a reality.. The tremendous growth in the last two decades in Islamic banking and insurance services are unmatched in the known history. However the modes of doing business (i.e. profit and loss sharing known as PLS) which clearly differentiate it from conventional financial services are not getting their due share in the operations of Islamic Financial Institutions (IFIs). Major part of investment portfolios of IFIs consists of Sharia compliant products where return is predetermined and fixed, helping IFIs to mitigate the risks while a negligible portion consists of Sharia based investments under the principles of profit and loss sharing. This study is focusing on the issue of lesser popularity and use of Sharia based products by IFIs and clients to identify and document causes (factors) creating hindrances in the application of Sharia based financial system.

Methodology consists of opinion survey of professionals working with IFIs, finance professionals working with firms, entrepreneurs and academicians. Personal observations, discussions

[A] http://www.sbp.org.pk/ibd/Handbook-IBD.pdf accessed on November 9, 2009.

with experts, literature on conventional financial reporting process and Islamic financial system also form part of study. Findings identify certain factors, present in the existing business environment, that are the barriers to implementation of Sharia based financial system. Accordingly, issues including profit manipulation practices, conventional accounting framework, weaker audit, higher taxes, dominance of conventional banking, riskiness of Sharia based financing, lack of mutual trust and lesser awareness among masses are identified as main hindrances in the way of popularity and implementation of Sharia based financial system. Through increased awareness, granting tax incentives, capacity building of IFIs, strengthening audit institution, fostering by central bank and new product development with a focus on small and medium enterprises under Musharaka principles, Sharia based financing can be promoted.

This study is an attempt to examine the existing business environment to understand and document the hurdles in the way of popularity and implementation of Sharia based financing with a focus on Musharaka financing. The reason for focusing on Musharaka is its prime importance in Sharia based modes of financing. Under Musharaka financing, an IFI offers finance to its clients (entities) on profit and loss sharing basis. However the profit and loss calculation of the entities (firms) is affected by various factors including financial reporting framework, taxes, and expectations of investors, management compensation and debt convents etc. The focus of this study is to highlight the issues creating hurdles in the way of application of Sharia based financing.

The rest of the study is as follows. Section 2 documents the literature and background of the study. Section 3 explains the research methodology. . Section 4 outlines the major possible hurdles in the way of Musharaka popularity/application. Section 5 presents the results and the recommendations. Section 6 concludes the study.

2. Background/Literature Review

The second half of the 20th century is known for liberation and renaissance of Islamic ideology whereby the masses started looking at the existing social systems through Islamic lenses and proposed modifications and developments. The Muslim thinkers and philosophers challenged the world's ruling economic systems and exposed their weaknesses. Capitalism was especially examined in detail due to its magnitude and general acceptability in the leading societies of the world.[B] Capitalism is based on four pillars namely land, labor, capital and organization. Accordingly, rewards are distributed among these factors of production i.e. rent for land, wages for labor, interest for capital and profit for entrepreneur (Smith, 1904). In capitalism, capital is a factor of production and hence deserves the reward in the form of interest --- a risk free reward. This led to the institutions building in the name (or form) of banks to mobilize the savings and provide loans to the industry on interest basis. Interest charging is forbidden by all revealed religions including Islam and Muslim Jurists are of the view that the reward for capital should be linked with the outcome of the project.[C]

As the banks established under the principles of capitalism and transact business by charging interest, which is unacceptable (forbidden) in Islamic law, so Muslims are left with no choice except to establish their own financial institutions under Islamic principles. In December, 2008 more than 280 IFIs were operating while managing funds of more than US$950 billion, in more than 50 countries including the Middle East, Europe, United States, South Asia and Far Eastern countries of the world,[D]. In Pakistan alone, six full fledge IFIs and twelve conventional banks with independent Islamic branches, duly controlled by Islamic banking divisions of respective banks, are operating.

The tremendous growth in the last 20 years in Islamic banking has paved the way for reporting transactions and presenting financial statements according to the principles of Islamic Sharia. The existing banking transactions and accounting systems best serve capitalism by design (Hameed, 2001)

B. Writings of A.A. Maudoodi, Umer Chapra, Nijatullah Sidiqqi, Asad Zaman, Taqi Usmani and Shah Ul Hameed.
C. www.albalagh.net/Islamic_economics/riba_judgement.shtml, accessed on February 18, 2009.
D (http://www.ifsl.org.uk/output/ReportItem.aspx?NewsID=32, accessed on February 11, 2009).

and demand modifications to meet the requirements of an Islamic financial system. Under Sharia led financial system more transparency, more disclosure and openness is required to ensure distributive justice. Hence there was a need for redesigning of the accounting framework to meet the objectives of Sharia. This led to the establishment of Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) with the task to issue standards and guidelines according to Sharia principles for operations and financial reporting of IFIs. Although AAOIFI has successfully issued accounting, auditing, governance and Sharia standards and guidelines, yet the thirst is there for further improvement. So for, AAOIFI has issued 23 Accounting Standards, 5 Auditing Standards, 6 Governance Standards, 2 Codes of ethics and 21 Sharia Standards.[E]

The standards issued by AAOIFI are applicable to the accounting procedures and financial reports of Islamic financial Institutions (IFIs) subject to national laws of the country. An IFI is supposed to provide finance to the business firms and share the outcome under Sharia guidelines. The accounting procedures applied and financial reports prepared by business firms, except IFIs, are regulated by conventional accounting standards. The conventional accounting standards and laws have failed in eliminating accounting manipulation; consequently, calculation of true profit and loss could not be achieved. (Dechow, et. al., 1996, 2000), (Baralexis, 2004), (Brein, 2005).

2.1. Islamic Modes of Financing

Generally, Islamic modes of financing can be categorized as (1) Sharia compliant and (2) Sharia based. Table 1 displays Islamic modes of financing under each category.

Table 1: Categories of Islamic modes of Financing.

Sharia Based	Sharia Compliance
Musharaka	Murabaha
Mudaraba	Ijara
	Diminishing Musharaka
	Bai Salam
	Bai Muajjal
	Istasna

2.1.1. Sharia Compliant

Sharia compliant products mean the modes of financing where return of financier is predetermined and fixed but within Sharia constraints. The tools which are relatively harmonizing the operations of Islamic financial system with conventional banking includes Murabaha (cost plus profit sale), Ijara (a rental arrangement), Bai salaam (spot payment for future delivery), Bai Muajjal (sale on deferred payment), Istasna (order to manufacture) and Diminishing Musharaka (housing finance) are all Sharia compliant products.

2.1.1.1. Murabaha

Murabaha is a cost-plus sale contract whereby disclosure of cost to the buyer is necessary. Under *Murabaha* arrangement customer requests to the Islamic Financial Institution (IFI) to purchase an asset for him (customer) and sell on deferred payment. Bank charges a certain profit usually linked with Inter Bank Offered Rate. Recovery could be agreed in installments or Balloon payment. Amount of installment or price of the asset cannot be (stipulated) increased or decreased in case of default or early payment (Sharia standard 8). In order to create pressure on client for prompt payment a penalty is imposed upon customer as agreed in Murabaha contract. Amount of penalty recovered for default in prompt payment cannot be included in income of IFIs in any case and must be spent for charity. (Usmani, 2002)

[E] http://www.aaoifi.com/keypublications.html accessed on November 11,2009.

2.1.1.2. Ijara

Ijara is a rental contract whereby IFI leases an asset for a specific rent and period to the client. Ownership risks of the asset are born by IFI while expenses relating to use the asset are the responsibility of client. The difference between Ijara and sale is that ownership in Ijara remains with lesser while in case of sales it is transferred to purchaser. Ending Ijara in sale of asset is allowed by Islamic Fiqh Academy (IFA) through a separate contract at completion of term of lease. Contract can be executed prior to purchase and possession of asset. Consumables cannot be leased out. Right of lessee to use the asset is restricted to lease agreement or and as per normal course of business. Lessee is liable for any harm to the asset caused by any misuse or negligence on his part. Rentals of joint property are shared according to equity. A joint owner can rent his share only to the co partner. Inter Bank Rate can be used as a benchmark for amount of rentals. At the completion of Ijara term either asset is returned to IFI or purchased by client.(Sharia standard 9)

2.1.1.3. Diminishing Musharaka

Diminishing Musharaka is a form of declining partnership between IFI and client generally used to finance real estates. When a customer requests to IFI for financing to purchase an asset IFI participates in the ownership of asset by contributing required finance. Certain portion (e.g.20%) must be contributed by customer. Total equity of bank is divided into units of smaller amounts which are purchased by client in installments. Under this mode of financing one of the partners (client) promises to buy the equity share of the other partner (IFI) gradually until the title to the equity is completely transferred to him. Buying and selling of equity units must be independent of partnership contract and must not be stipulated in partnership contract. Generally IFI rent out his share to client and earns rentals. Any profit accruing on property is distributed among the co owners according to agreed ratio however losses must be shared in proportion of equity.(Sharia standard 12)

2.1.1.4. Bai Salam

Bai Salam is a form of sale contract where by IFIs purchase goods for spot payment with deferred delivery. Practically it is used in financing of agricultural needs of farmers. Farmers sell their crops prior to harvesting to IFIs in order to get money to purchase seeds and fertilizers. Generally spot price agreed is lesser than future the actual date of delivery, hence IFIs are making profit. As a matter of practice IFIs are entering into a parallel Salam with third party to sell the proceeds once taken over however execution of second contract is not conditional to first. (Sharia standard 10)

2.1.1.5. Bai Muajjal

Literal meaning is deferred / credit sales. Islamic financial Institutions (IFIs) are using this mode to finance the customers' needs by supply of desired commodity. The difference between Murabaha and Bai Muajjal lies in disclosure of cost. Under Bai Muajjal cost may or may not be disclosed. All other features are same as discussed in Murabaha.

2.1.2. Sharia Based

Sharia based transactions means the financing modes adopted by IFIs on profit and loss sharing basis including Musharaka (partnership in capital) and Mudaraba (partnership of capital and skill). Under Sharia based modes of financing, return of financier is not fixed in advance rather it depends upon the outcome of the project. However loss is to be shared according to capital contribution. Following the rule of substance over form one can conclude that the major difference between conventional and Islamic financing is Sharia based modes of financing.

2.1.2.1. Musharaka

Allah (swt) will become a partner in a business between two Mushariks [partner] until they indulge in cheating or breach of Trust. [Hadith Qudasi]

Literal meaning of Musharaka is sharing. Its root in Arabic language "Shirka" means being a partner. Musharaka means a joint enterprise formed conducting some business in which all partners share the profit according to pre agreed ratio while loss is shared according to the ratio of contribution (Meezan bank guide 2002). For a valid Musharaka fulfillment of certain conditions required. First is there must be an agreement written/verbal among the partners stating clearly the terms and conditions including management, capital contributions and profit sharing among the partners. Second capital can be contributed in cash as well as in assets. However once an asset is contributed as capital that belongs to firm and contributing partner is relieved from the bar of risks and returns attached with ownership. Third profit is distributed according to agreement of partnership however sleeping partner cannot claim share in profit more than his proportionate share in equity. None of the partner can guarantee the capital or profit share to any other partner (Sharia standard 12). Under Musharaka IFIs are receiving deposits and finances business requirements for profit and loss sharing.

2.1.2.2. Mudaraba

Mudaraba is a type of partnership whereby skill and money brought together to conduct business. Profit is shared according to agreement while loss is born by capital provider only. Under this scheme of financing IFIs provide capital to financially weak but skilful people to do the business and share outcome with IFIs. This scheme is also used in deposit collection. Mudaraba contract can be restricted or unrestricted. No one can claim a lump sum amount of profit. It must be based on actual outcome. (Sharia standard 13)

Under Sharia based transactions, the return is linked to outcome of the underlying project. Outcome of the project is unknown and the share of any partner including that of capital provider cannot be determined in advance. Profit is shared among the partners as per agreed ratio while loss is shared according to capital contribution. Calculation and reporting of true economic reality is vital for the implementation of Sharia based financing. Share of financier is also affected due to the way the financial results are reported. It is well documented in the accounting literature that the manipulation of the reported accounting figures is an old problem dating back to the 1920s (Naser, 1993)[F]. This trend is still continuing at a larger scale as concluded by Baralexis, 2004, "creative accounting is practiced in Greece frequently, and to a considerable extent (i.e. about 25% of pre managed earnings or so), mainly with the blessings of law" (page 454).

Empirical studies (Beasley, 1996; Beneish, 1999, 2001; Blake, et. al., 1996; Breton, et. al., 1995; Teoh, et. al., 1998; Wang, et. al., 2008; Iqbal, et. al., 2009; Baralexis, 2004) have revealed that managers have succeeded in managing the earnings and concealing the true financial position in spite of all the safeguards in the form of conventional accounting standards, principles and conventions. Literature on earnings management has identified various motives behind earnings manipulation including e.g. a particular reference point to be achieved (Burgstahler, 1997, and Guan, et. al., 2008); avoiding technical default on debt covenants (Sweeney, 1994, Gaun, et. al., 2008,); reduction in transactions costs (Burgstahler, 1997); tax considerations (Baralexis, 2004); attracting better price at public offerings (Teoh, et. al., 1998, and Iqbal, et. al., 2009); better management compensation (Wang, et. al., 2008, Dechow and Sloan, 1991); beating financial analysts' forecast (Kasznik, et. al., 2002 as quoted by Wang, 2008 and Burgstahler, 1997); and hiding poor performance of management (Beneish, 2001). While it is evident from above citations that the true picture of performance is not depicted through conventional financial reports, implementation of Sharia based financing become a complex challenge for IFIs.

IFIs collect funds from public and invest in business and industry within the Sharia framework. As for deposit collection or liabilities side of IFIs' balance sheet is concerned, no serious question about the violation of any Sharia principle is being raised by any quarter at theoretical and/or operational level; hence, it is clean and within Sharia guidelines. All IFIs are accepting deposits under Sharia based modes of financing. It is a healthy sign for IFIs and Muslim community at large. It shows

[F] As cited by Baralexis, 2004.

trust of depositors in IFIs. The asset side of balance sheet or investments by IFIs is mostly in Sharia compliant instruments and a very low or a negligible portion is invested under Musharaka (Sharia based). Table 2 shows the investment portfolio of IFIs working in Pakistan, as at December 2008[G].

By definition, under Musharaka agreement, return is not fixed for any of the partner and each one has to share the outcome. However for profit sharing, partners are open to make an agreement but none of them can ask for a fixed sum or fixed percentage of capital as return. Profit sharing percentage may vary based on the actual outcome of the underlying project. In case of loss, the principle of sharing is well established i.e. Loss is to be shared according to capital contribution. Except Musharaka and Mudaraba the return on investment under Islamic modes of financing too, is pre-determined and the financier knows his return well in advance. In cases of Musharaka and Mudaraba, risk is relatively higher as the return is uncertain and generally financiers are reluctant to invest under these schemes.

As per Table 2, IFIs has made most of their investments in Murabaha followed by and diminishing Musharaka with Ijara being the third choice. This shows that 93% of investment portfolio consists of sharia compliant instruments in which the return is determined in advance to mitigate the risk. The share of sharia based financing is only 2% under Musharaka and nothing invested in Mudaraba.

Table 2: The Share of each mode of Financing in Aggregate Portfolio of (IFIs) working in Pakistan

Serial No	Financing Mode	% share in portfolio
1.	Murabaha	37%
2.	Diminishing Musharaka	29%
3.	Ijara	22%
4.	Others	05%
5.	Istasna	03%
6.	Salam	02%
7.	Musharaka	02%
8.	Mudaraba	00%

Sharia based financing is the essence of the establishment of IFIs and a distinct position of Islamic financial system can only be claimed through its promotion. Excessive use of Sharia compliant instruments (where return is predetermined) makes the operation of IFIs skeptical.

3. Research Methodology

The data is collected through primary sources. Primary data tools include personal observations, interviews with academicians and professionals. Opinion survey of Islamic bankers, entrepreneurs and accounting/finance professionals is conducted through questionnaires. The authors conducted the interviews and opinion surveys of professionals to get their input on the subject.

We design a questionnaire (Appendix I) consisting of both open- and close-ended questions. For reliable responses, basic criteria for participants is laid down. Given that the emergence of IFIs is relatively recent so at least three years post qualification experience (for an IFI professional) was considered as an essential condition to be a respondent. This study covers all Islamic banks operating in Pakistan. We collected responses from entrepreneurs, Islamic bankers, accountants and academicians. The questionnaire consists of four parts: Part A is about basic information about the respondent; Part B addresses the causes (factors) with weightage (0 to 4) which create hindrances in the application of Musharaka financing; Part C addresses the responsibility sharing by each of the players for not getting the job done; and Part D is included to take suggestions for improved application of Sharia based financing. Part C was exclusively addressed to the bankers and the rest of

G. http://www.sbp.org.pk/ibd/Handbook-IBD.pdf accessed on November 9, 2009 the questionnaire to all respondents. Convenience sampling is used with the condition that at least one questionnaire must be get filled from each Islamic bank which are (at present) six in total.

We used MS-Excel to compile and examine the results of the opinion survey such as averages, standard deviations, variances, coefficient of variations, correlations and regressions. Results are presented in tables with brief explanations. Total number of respondents is 68 comprising 30 top or middle level finance professionals, 17 Islamic banking professionals (middle and top), 15 entrepreneurs, and 6 academicians.

4. Hurdles in Popularity of Musharaka Financing

Part B of the questionnaire was about the hurdles in the application of Musharaka financing. In this part, we included the following possible hurdles in the way of Musharaka application and asked for the opinion from all players in the industry of Islamic banking. It would be useful to briefly discuss each of these hurdles (factors) and their likely impact on Musharaka financing.

4.1. Earnings Manipulation

Manipulation of profit or earnings management is a serious problem for modern corporate sector. It is well documented in the literature now that earnings are manipulated in order to achieve some motives including achieving a particular reference point, avoiding technical default on debt covenants, reducing transactions cost, tax considerations, better pricing on new issue, favorable management compensations, meeting financial analysts forecasts and hiding poor performance of management. To our knowledge, the results of all the studies, irrespective of the country in which the study is conducted, confirm that earnings are managed. (Breton et al, 1995; Beasley, 1996; Blake et al., 1996; Dechow et al,1996, 2000; Burgstahler, 1997; Beneish, 1999, 2001; Baralaxis, 2004; Canegham, 2004; Cook et al, 2008; Guan et al, 2008; Iqbal et al., 2009). As Sharia based financing is equity based and the share of financier is determined from profit, hence, if true profit cannot be reported, this results in discouraging Musharaka financing.

4.2. Lack of Confidence

The second hurdle which we identified was lack of confidence in the ability of Musharaka partner. IFIs are reluctant to extend financing facility to firms on profit and loss sharing basis due to the lack of trust and confidence in Musharaka partner.

4.3. Riskiness

Risk is one of the most vital factor from the banking point of view. For this study, risk means variability in expected outcome. Banks have to manage and balance out the risks. If the outcome is unknown then managing risk becomes a major issue and may not be mitigated through conventional methods. For risk management under Islamic banking framework, one has to look out of the box. Risk also effects the savings mobilization through deposits.

4.4. Conventional Accounting Framework

Conventional accounting framework is another factor which may create hurdles in promoting Musharaka financing. There are many loopholes in the conventional accounting framework which are exploited by opportunistic managers. Issues in financial reporting are well documented in the literature. (Khan, 1999; Tollengton, 1999; Hameed, 2001; Belkaoui, 2004; Tarca, 2004; Alexander, et. al., 2006; Bennet, et. al., 2006; Bens, 2006; Benston, 2006; Flangan, 2007; Kirk, 2006; Tsakumis, 2007; Walker, 2007; and Rebecca, et. al., 2008). As conventional accounting framework plays a vital role in reporting the result of economic activities of an entity financed under Sharia based financing, hence it might be a hurdle in the way of application of Sharia based financing.

4.5. Higher Taxes

Higher taxes are also identified as a potential hurdle. Higher taxes oblige the business firms to declare lesser profit in order to avoid payment of taxes. Tax evasion is a major issue in most of the less developed countries such as Pakistan where tax-to-GDP ratio is about 14% as compared to industrialized nations where it is more than 30%.[H] The tax burden is borne by the tax payers that are already in the tax net. Consequently higher tax rates are levied which potentially leads to evasion of taxes. Baralexis (2004) shows that in Greece, low and medium size firms are engaged in earnings management to avoid taxes.

4.6. Dominant Conventional Banking

Dominance of conventional banking is identified as another hurdle in the way of promotion of Sharia based financing. If funds are available for a fixed charge and without going into much details of usage then motivation to go for Musharaka by business firms lessens. Currently, the market share[I] of Islamic banking in Pakistan is around 5% only, hence lesser access to capital market, lesser resource mobilization, and lesser manpower expertise. In fact, Islamic banking industry is at its infancy, although growing rapidly. Due to the dominance of conventional banking, even product pricing of Islamic banks is also linked with KIBOR (Karachi Interbank Offer Rate) which made the operation of IFIs skeptical in the eyes of masses.

4.7. Weaker Auditing

Weaker auditing could also hinder the promotion of Islamic banking. In fact, a transparent audit system can play the role of a catalyst in supporting Sharia based transactions. The objective of audit is to detect errors and frauds (if any). Auditing institutions in less developed countries may not playing their due roles because of overall ethical practices in businesses, there. An auditor practices in the same society and is prone to be affected by the level of corruption or transparency in the society. Similarly, s/he may also affected by the level of ethical or unethical practices prevailing in the society.

5. Findings

Now we share the results of the opinions of experts on these issues. The first subsection presents the results while the second subsection outlines the recommendations made by the respondents to promote Musharaka financing.

5.1. Results of the Survey

Each question was clearly displaying the weight (importance) for every factor from 0 to 4 whereby 0 means no weightage and 4 for highest. Results of the study are summarized in Table 3.

[H] http://www.dawn.com/2005/04/12/ebr4.htm accessed on 16th June 2009.
[I] http://www.sbp.org.pk/about/speech/governors/dr.shamshad/2007/Islamic-Banking-11-Sept-07.pdf accessed on June 16, 2009

Table 3: Descriptive statistics of the hurdles in the way of Musharaka popularity/application

Description	Profit manipulation	Lack of trust	Risk	Conventional Accounting framework	Taxes	Conventional banking	Audit
Mean	**2.50	2.40	**2.70	1.80	1.70	**3.07	2.20
S.D	1.2	1.1	1.15	1.47	1.17	1.13	1.22
Variance	1.44	1.21	1.34	2.18	1.39	1.29	1.51
CV	0.48	0.46	**0.43	0.82	0.69	**0.37	0.55

** Significant

As per Table 3, the highest average (3.07/4) is for the dominance of conventional banking. This means that the most influential factor or chief hurdle in the way of promotion of Sharia based financing (or more specifically, Musharaka financing) is conventional banking. The second highest number (2.7/4) is for the risk factor. Market opines that Islamic banks are not investing on profit and loss sharing basis due to the risk factor. Third major factor is profit manipulation (2.5/4) by business firms. Fourth (2.4/4) is the lack of trust and confidence in the ability of Musharaka partner and fifth (2.2/4) is the audit while sixth (1.8/4) is conventional accounting framework and the seventh (1.7/4) is the higher taxes.

Table 4: The hurdles in the way of Musharaka financing in Descending order

Rankings	Factors	Mean	C.V
01	Dominance of conventional banks	3.07	0.37
02	Risk of Musharaka financing as return is linked with outcome	2.70	0.43
03	Profit manipulation	2.50	0.48
04	Lack of trust and confidence in the ability of Musharaka partner	2.40	0.46
05	Weaker Auditing	2.20	0.55
06	Conventional accounting framework	1.80	0.82
07	Higher taxes	1.70	0.69

In Table 4, we listed the factors according to their importance (average weights) as per the results of the survey. It is very interesting to note that the two top most of hurdles are against the general perception of profit manipulation as chief hurdle in Musharaka application. Although the rest of the factors identified are directly and/or indirectly relate to profit manipulation and carries reasonable weight but the point is that the highest mean with lowest CV is for the dominance of conventional banking which is the chief hurdle in the way of Islamic banking. Although the higher CVs of almost every factor show that there is no consensus among the experts (relative dispersion among the respondents is very high). Mean with higher standard deviation is not very true representative of responses but in these types of studies such results are expected and conclusions are drawn on the basis of averages. We can conclude and generalize that the dominance of conventional banking is the main hurdle in the way of Musharaka financing whereas the evasion of taxes is considered the least significant factor. As for CV is concerned, although variation among the responses is very high for all factors however the lowest CV (comparatively) is for conventional banking dominance which shows relatively better consensus among respondents. The highest CV is for conventional accounting framework which is placed at number six in ranking showing that the dispersion is very high and respondents think differently i.e. if one of the respondents is allocating conventional accounting framework a score of 4, the other might be giving it a score of zero.

Table 5 shows the mutual correlation results of all factors that may hinder the promotion of Musharaka financing. Relatively significant correlation is found between weaker audit and profit manipulation and weaker audit and conventional accounting framework. The highest correlation is (0.44) between conventional accounting framework and weaker auditing. The correlation between profit manipulation and weak audit is also very high (0.44). These figures make sense as if an audit institution is strong enough then profit manipulation through loopholes of conventional accounting can be minimized. The lowest of (−0.02) is between conventional accounting and profit manipulation. The rests of the correlations are also not showing any significant relationship.

Table 5: Correlation matrix among different hurdles in the application of Musharaka

	Profit Manipulation by firms	RISK	lack of trust in ability of MP	Conventional accounting	higher taxes	Conventional Banks	Weak Audit
Profit Manipulation by firms	1.00	0.22	0.25	*−0.02	0.22	*(0.09)	** 0.44
RISK	-	1.00	0.24	0.12	* (0.05)	* (0.09)	*(0.03)
lack of trust in ability of MP	-	-	1.00	*0.02	(0.09)	*0.03	0.10
Conventional accounting	-	-	-	1.00	0.36	0.17	**0.44
higher taxes	-	-	-	-	1.00	*(0.05)	0.39
Conventional Banking	-	-	-	-	-	1.00	*(0.03)
Weak Audit							1.00

** Significant relatively * Negligible

Part C of the questionnaire was about the determination of relative share of responsibility for not getting the job done (i.e. lesser focus upon Sharia based financing and higher on Sharia compliant products) by each of the three market players in Islamic financial system i.e. supplier of funds (depositors), management of IFIs and users of funds (business and industry). This question was asked from only Islamic bankers and not from other player because only the Islamic bankers can view the full picture as a routine matter and posses more relevant and accurate information than any other group of respondents. Summary statistics is provided in Table 6.

The highest responsibility share of unpopularity of Musharaka financing is put upon business and industry with an average of 0.44 and variance of 0.08. The second major player is considered to be the management of IFIs with an average of 0.36 and variance of 0.05 and the least responsible are the depositors with an average of 0.14 and variance of 0.01. Although, depositors do not directly prohibit IFIs to invest in Musharaka yet a pressure for profit on deposits is felt by IFIs. This obliges IFIs to mitigate risk and increase return. Under Musharaka, return to the depositors is not also predetermined which contributes to increasing the risk. Coefficient of variation is the highest for depositors' that means difference of opinion of a higher degree exists among the respondents. CV of responses about management of IFIs and business firms is also very high, again displaying lack of consensus among the respondents.

Table 6: Descriptive statistics of relative share of responsibility put upon each player of Sharia based financing.

Descriptions	Management of IFIs	Depositors	Business Firms
Mean	**0.36	0.14	**0.44
S.D	0.23	0.10	0.29
Median	0.40	0.20	0.40
Variance	0.05	0.01	0.08
CV	0.64	0.71	0.66

** Significant

5.2. Recommendations

Part D of the questionnaire (Appendix I) was about recommendations for improved application of Musharaka by the respondents. In this section, we received valuable suggestions and grouped them accordingly. Figure 1 shows a summary of suggestions in graphic form.

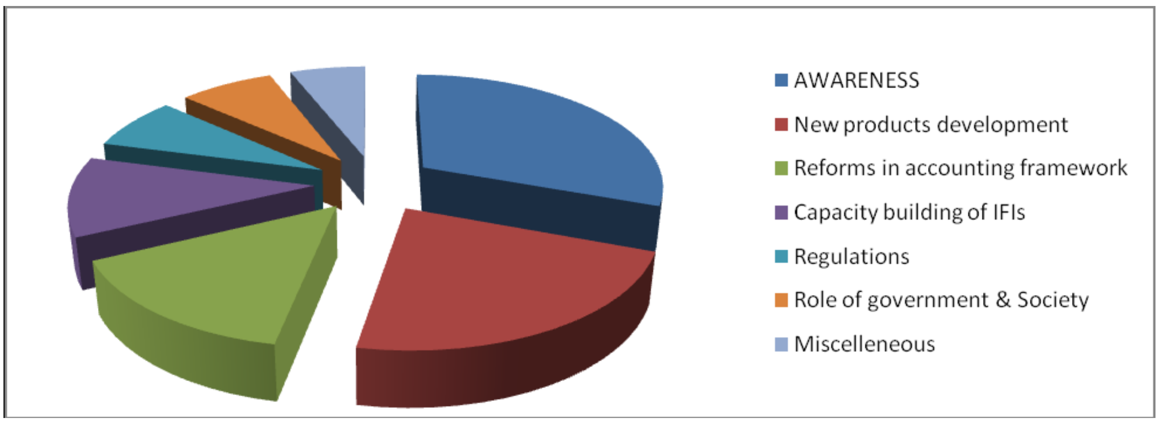
5.2.1. Awareness

Islamic banking is relatively new and generally masses are not well aware of its philosophy as well as operations. Increased awareness about Islamic financial system through awareness seminars, advertisements, workshops, and inclusion in syllabus of business and finance students/professionals is recommended by the highest number (41) of respondents. Better links should be created with customers by educating them through seminars, trainings, and workshops. One major misconception needs to be removed on urgent basis that is the difference of conventional and Islamic banking.

5.2.2. New Products Development

New product development (NPD) recommendation is given by 30 respondents. Products of IFIs means services (financing modes) offered in the form of Ijara, Murabaha, etc. There is a need to develop more Musharaka based products to facilitate the specific needs of the industry. New business avenues should be explored including small and medium business projects. Separate departments for dealing under Musharaka financing principle might be established in every IFI. Restricted investment deposits as per (AAOIFI) accounting standards may be accepted by IFIs for Musharaka financing which could help in balancing the risk.

Figure 1: Graphic display of recommendations by respondents.



5.2.3. Accounting Framework

Reforms in the current accounting system were suggested by 20 respondents. There should be more disclosure and openness on corporation's part in the annual reports. Reforms are needed in the present accounting rules and procedures to align them with the objectives of Sharia-led financial system. The strengthening of financial and Sharia audit will play the role of catalyst in the promotion of Sharia based financial system. Under Musharaka financing, costs of financing could be reduced. Documentation of the accounting records should be made compulsory for businesses and general documentation of economy should be observed strictly.

5.2.4. Capacity Building of IFIs

Capacity building of IFIs has been recommended by 15 respondents. The most vital area is to build the capacity of human resource of IFIs through training and incentives for knowledge acquisition. There is a need to strengthen Islamic capital markets. More transparency, openness, and disclosure of financial reports as guided by AAOIFI standards would certainly help in boasting Sharia based financing. A separate Musharaka department may be established in every IFI to promote, execute and operate Sharia based transactions. IFIs should offer Musharaka financing and participate in management through appointing its representative in the board of directors of partner firm.

5.2.5. Regulations

Suggestions included in this section were recommended by 10 respondents. State Bank of Pakistan should play parental role for the development of Islamic financial system. It should issue prudential regulations, fix quota of Musharaka financing for every IFI, determine sector specific normal rate of return for Musharaka. Islamic windows of conventional banks should be demolished as it creates doubts in the minds of masses and only full fledge Islamic banks should be allowed to deal in Sharia compliant transactions.

5.2.6. Role of Government and Society

Suggestions listed below were recommended by 10 respondents. Government of any country plays an important role in promoting a specific sector of the economy and Islamic banking is also looking for support. Although at conceptual level, Government of Pakistan has always extended its warm support for Sharia led financial system yet translation of the whole financial system is a still a dream. In order to promote Musharaka financing, Government should give certain incentives including lower taxes, favorable laws, transacting business with IFIs, serious efforts to eliminate interest from the economy (as stated in the Constitution of Pakistan) and reducing the dominating influence of conventional banking. Government and society should strive for an environment of entrepreneurship through small businesses. There is also a need for general uplifting of moral values of society.

5.2.7. Miscellaneous

Banks should be owned by government and NGOs so that the services offered might be preferred over commercial interests. Musharaka management firms might be established by professionals to assist both IFIs and clients. Pricing of services by IFIs should be delinked from KIBOR to clarify the skepticism of masses. Business of Islamic insurance should be promoted to balance out the risks associated with the outcomes of any project.

6. Conclusion

To conclude the results of opinion survey, IFIs are using Murabaha, Ijara and diminishing Musharaka where return is fixed in advance and the outcome is certain and the finance is secure. This is a form of debt based (although Sharia compliant) rather than equity based financing. The major hurdle in the popularity of Musharaka financing is the dominance of conventional banking and this hurdle can be removed only through the expansion and growth of IFIs. Other factors discouraging Sharia based financing, identified in this study, include the higher risk level in Musharaka, profit manipulation behavior of businesses, lack of trust and confidence in the ability of Musharaka partner, manipulations of accounts by firms under conventional accounting framework, relatively higher taxes, weaker auditing and lack of awareness among masses about the philosophy and operations of IFIs. Through increased awareness, grants of tax incentives, capacity building of IFIs, strengthening audit institution, fostering by central bank and new products development with a focus on small and medium enterprises under Musharaka principles, Sharia based financing can be promoted.

Results of this study are fruitful for IFIs, AAOIFI, IDB, SBP, and researchers in Islamic financial system, academicians, students and government for policy decisions. Future research areas could include a comparative study of IFRS and AAOIFI accounting standards, earnings management by partners of IFIs, corporate governance, and legal framework for IFIs.

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Appendix-I

A-This section "A" is optional.

Name (optional)____
Age (in years)______________________Qualification____________________
Experience (in years)_________
Organization name (optional)_______________________________________

B-Following are listed possible causes which create hindrances in application of Musharaka Financing. Kindly encircle / color the relevant number.

(Zero is designated for no weightage while four for the highest).

1. Profit manipulation by businesses	0	1	2	3	4
2. Lack of confidence in abilities of Musharaka partner	0	1	2	3	4
3. Relatively higher risk	0	1	2	3	4
4. Conventional accounting framework	0	1	2	3	4
5. Higher income taxes	0	1	2	3	4
6. Dominant conventional banking	0	1	2	3	4
7. weaker Auditing	0	1	2	3	4
8. ____________________________________	0	1	2	3	4
9. ____________________________________	0	1	2	3	4
10. ____________________________________	0	1	2	3	4

C-Kindly state in % the share of responsibility of lesser popularity of Musharaka Financing. Which of the players listed below is responsible up to what extent.

(Total should not exceed 100%)

1. Management of Islamic Financial Institution_______________
2. Depositors of Islamic Financial Institution_________________
3. Business and Industry requiring finances__________________

D- Kindly state the measures which can assist in enhancing Musharaka Financing application.

1.
2.
3.