"MUSHARAKA FINANCING BY ISLAMIC FINANCIAL INSTITUTIONS: AN EVALUATION OF PROFIT MEASUREMENT PROCESS OF PARTNERS"

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بسم الله الرحمن الرحيم

DEDICATION

This work is dedicated to all those who helped me in any stage of my life especially my teachers and parents

&

To all those making efforts for implementation and popularity of Islamic Banking in its true spirit.

ABSTRACT

This study is an attempt to understand the hurdles in the way of Sharia based financing namely Musharaka. Research questions include the investigation into profit measurement process of firms the ultimate customers of Islamic Financial Institutions (IFIs).Research questions include (1)An enquiry into the profit calculation process under conventional accounting standards, principles and conventions by the clients (entities) of Islamic Financial Institutions (IFIs). (2) Whether profit calculated under conventional accounting approach is transparent enough and depicts true results of the period under consideration as per requirements of Musharaka Financing principles? (3)What are the implications of earnings management/creative accounting for Musharaka Financing and its implementation? (4) What is the share of Musharaka Financing in the portfolios of IFIs and what are the hurdles in its way?

Methodology includes (1) literature survey on Islamic finance, issues in financial reporting and earnings manipulation. (2) Opinion survey of Islamic bankers, academicians and accountants is conducted to get their input on subject.

Findings disclose that number of factors is responsible for lesser popularity of sharia based financing including lack of transparency in financial reporting, earnings manipulation by firms, dominance of conventional banking, higher taxes, lack of awareness among masses, lack of new products development by Islamic Financial Institutions and risk attached with the return under Musharaka Financing.

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DECLARATION

I hereby declare that this thesis, neither as a whole nor as a part thereof, has been copied out from any source. It is further declared that I have prepared this thesis entirely on the basis of my personal effort made under the sincere guidenance of my supervisor.

No portion of the work, presented in this thesis, has been submitted in support of any application for any degree or qualification of this or any other university or institute of learning.

Muhammad Hanif

MS Scholar

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EXECUTIVE SUMMARY

The second half of 20th century is known for liberation and renaissance of Islamic world where they 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 uncovered the weaknesses. Capitalism was especially examined in detail due to its magnitude and general acceptability in various leading societies of the world. One of the pillars of capitalism is 'interest', as charge on capital. Interest is forbidden by Islam in all of its forms. Conventional banking system is based on the principle of charging interest on capital provided by the banks. In addition, banks can survive only by charging interest. Islamic financial institutions (IFIs) are established to provide an opportunity to Muslims to abide Sharia and save themselves from interest (Riba) based transactions.

The essence of Islamic financial system is justice. Transactions of present day Islamic Financial Institutions (IFIs) can be grouped into two broad categories. First, the Sharia based financial transactions i.e. those based on Musharaka and Modarba (the underlying principle is to participate in risks and rewards). Second, the Sharia compliant transactions such as Murabaha, Ijara, Diminishing Musharaka, Bai Salam, and Bai Muajjal (the principle is that financing is provided through assets and not in cash form to avoid charging of interest).

By the end of June 2009, there have been six Islamic banks operating in Pakistan. Their market share is about 3%. Islamic banking have been growing rapidly world wide in a short span of time, it has established itself in 50 countries with more than 280 banks and managing funds of more than US$ 700 billions. Focus of IFIs is on Sharia compliant transactions; however, the share of Sharia based transactions is negligible. This study is conducted to get some insight into the business and accounting framework and its likely impact upon Sharia based financial transactions. The purpose of the study is to document the hurdles in the way of popularity of Sharia based transactions especially Musharaka financing.

Conventional banks provide finance on a predetermined return i.e. interest basis. Existing accounting framework supports capitalism by design and transparency of financial reports is not above board. For example, earnings manipulation is well documented in literature. Through this study I examine the conduciveness of accounting and business environment for Sharia based financial transactions as the return is not predetermined and is linked with the outcome of project. The outcome is usually disclosed through financial reports and if financial reports fail in disclosing true and fair results due to its inherent limitations and/or earnings manipulation then application of Sharia based financial system is questionable. My methodology includes (1) literature review on accounting framework including International Financial Reporting Standards (IFRS), Generally Accepted Accounting Principles (GAAPS), accounting principles, accounting conventions and research papers highlighting issues in financial reporting and earnings management (2) opinion survey of Islamic bankers, entrepreneurs, accountants and academicians.

The results of the study support the hypotheses proposed in the study. These relate to (H1 :) lack of transparency in accounting framework, (H2 :) opportunistic manipulation of accounts by managers and (H3 :) non conduciveness of accounting and business framework for Sharia based financial transactions. It is also found in the process that increased awareness about Sharia based financial system, new products development through R&D, more incentives from government, general uplift in ethics, leadership role by central bank and capacity building of IFIs can enhance the application of Sharia based financial system especially Musharaka financing.

Rest of the study is in the following order. In chapter one I have explained the background of this research, purpose of the study, research questions and hypothesis and research methodology. Chapter two discusses the objectives of financial reporting framework, users and their needs, conceptual framework development, accounting principles followed in financial reporting and issues in financial reporting. Chapter three reviews the studies on earnings manipulation including meanings of earnings management, types, motives of manipulation, measuring methods, tools used in manipulation, consequences (direct) of earnings management and certain controlling measures.

In chapter four the results of an opinion survey is presented. It includes the percentage (%) shares in portfolios of IFIs of different modes of financing offered by Islamic banks to business, commerce and industry in Pakistan. This section is followed by hurdles in the way of Musharaka application. Third section presents the results of relative share of responsibility of operational level players of Islamic financial system for not getting the job done. Section four compiles the recommendations offered by respondents. Chapter five concludes the findings of study and offers recommendations.

CHAPTER 1

INTRODUCTION

Learning objectives

After going through this chapter, one should be able to understand:

a. Why this study is conducted & what are the objectives of this research?

b. What are the research questions?

c. How have the hypotheses been developed?

d. What methodology is used?

e. What is the contribution of this research?

1.1 Background

The second half of 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 its weaknesses. Capitalism was especially examined in detail due to its magnitude and general acceptability in various leading societies of world.[1]

Capitalism is based on four pillars namely land, labor, capital and organization. Accordingly rewards are distributed among these factors of production i.e. rent to land, wages for labor, interest for capital and profit for entrepreneur (Smith, 1776). 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

[1] Writings of Maudoodi, Umer Chapra and Shah Ul Hameed

banks to mobilize the savings and provide loans to the industry on interest basis. Interest charging is forbidden by all revealed religions including Islam. Muslim Jurists are of the view that reward for capital should be linked with the outcome of project.[2]

As the banks established under the principles of capitalism and transect business by charging interest, which is unacceptable (forbidden) in Islamic law, so Muslims started to establish their own financial institutions under Islamic principles. At present in more than 50 countries including Middle East, Europe, United States and far eastern countries of the world, more than 280 institutions are operating and they manage funds of more than US$700 billions[3]. The tremendous growth in the last 20 years in Islamic banking has paved the way for reporting transactions and presenting the financial statements according to the principles of Islamic Sharia.

The existing banking transactions and accounting systems best serve capitalism by design (Hameed, 2001) and demand modifications to meet the requirements of an Islamic financial system[4]. Under existing accounting systems the social objectives are ignored (Roselender, 1992)[5]. There is a widespread unrest and realization about the objectives of accounting system and deliberate efforts had been made in this regard to modify these, such as True Blood Committee (US), The Corporate Report (UK), Stamp Report (Canada) and FASB conceptual framework. (Belkaoui, 2004)

Empirical studies (Baralexis, 1989, Beasley, 1996, Beaty, 2002, Beneish, 1999, 2001, Blake et al., 1996, Breton et al, 1995, Iqbal et al., 2009) have revealed that managers have succeeded in managing the earnings and concealing the true financial

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[2] www.albalagh.net/Islamic_economics/riba_judgement.shtml, accessed on February 18, 2009.

3 (http://www.ifsl.org.uk/output/ReportItem.aspx?NewsID=32, accessed on February 11, 2009).

[4] /www.scribd.com/doc/9868179/Chapter-2-Worldveiws-Values-and-Accounting accessed on 18-02-09.

[5] As cited by Hameed, 2001

position in spite of all safeguards in the form of conventional accounting standards, principles and conventions (e.g. Enron case). According to Baralexis (2004) "Earnings management or creative accounting is a process of intentionally exploiting or violating the GAAP or the law to present financial statements according to one's interest" (page 440).

It is well documented in the accounting literature that manipulation of the reported accounting figures is an old problem that goes as far back as the 1920s (Naser, 1993)[6]. 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).

Under Sharia led financial system transparency and justice is required. After the establishment of Islamic financial institutions there was a need for redesigning of the accounting framework to meet the objectives of Sharia. This led to the establishment of Auditing and Accounting Organization of Islamic Financial Institutions (AAOIFI) with the task to issue standards and guidelines according to Sharia principles for operations and financial reporting of Islamic banks. Although AAOIFI has successfully issued accounting, auditing and Sharia standards and guidelines yet thirst is there for further improvement. So for, AAOIFI has issued 22 Accounting Standards, five Auditing Standards, four Governance Standards, 2 Codes of ethics and 21 Sharia Standards.[7]

The standards issued by AAOIFI are applicable to the accounting procedures and financial reports of Islamic financial Institutions (IFIs) subject to national laws of a society. An Islamic financial institution is supposed to provide finance to the business

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[6] As cited by Baralexis, 2004

[7] (http://www.aaoifi.com/keypublications.html, accessed on June 13, 2008).

firms and share the outcome under Sharia guidelines. The accounting procedures applied and financial reports prepared by business firms, except Islamic financial institutions, are regulated by conventional accounting standards. The conventional accounting standards and laws have failed in elimination of accounts manipulation; hence, calculation of true profit and loss could not be achieved. (Bruns et al., 1990, Dechow et al., 1996, 2000, Baralexis, 2004, Bens, 2006, Brein, 2005).

There is a need for studying the co existence of both approaches and the likely impact of conventional accounting framework on operations of Islamic Financial system. The objective of such study should be to research and conclude whether purpose of Sharia led financial system can be achieved in the existence of conventional accounting system applied by clients for profit calculation and assets valuation. Islamic modes of financing objectively categorized in following two heads; (1)Sharia compliant and (2) Sharia based. Table 1.1 displays Islamic modes of financing. Under Sharia compliant instruments return of the financier is predetermined and fixed. Risk of return is minimized while under Sharia based transactions return is linked with outcome. Outcome of the project can be normal or abnormal. Profit is shared among the partners as per agreed ratio while loss is shared according to capital contribution.

Table 1.1 displaying Islamic modes of financing categorized objectively.

Sharia Based	**Sharia Compliance**
Musharaka	Murabaha
Modarba	Ijara
	Diminishing Musharaka
	Bai Salam

	Bai Muajjal

According to the resolution passed at the fifth meeting of the Islamic Fiqh Academy (IFA) on December 10-15, 1988[8] Islamic financial products are defined as follows,

1-Mudaraba: A form of partnership where one party provides the funds while the other provides expertise and management. Any profits accrued are shared between the two parties on a pre-agreed basis, while loss is borne by the provider(s) of the capital.

2-Murabaha is a cost-plus sale type of arrangement, where a bank purchases an asset on behalf of a customer with the understanding that the customer will repurchase the asset back from the bank. The bank's price to the customer includes a stated profit known to both parties, and the payments are amortized across a payment period, similar to a secured loan.

3-Musharaka: A relationship established under a contract with mutual consent of all involved parties that sharing of profits and losses will take place in a specified joint business venture. It is an agreement which the Islamic bank provides funds, along with funds from the business enterprise and others. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by every partner strictly in proportion to respective capital contributions.

4-Diminishing Musharaka: A practice where a financier and his client participate either in the joint ownership of a property or equipment, or any fixed asset. The share purchased on behalf of the financier is divided into a number of units, and it is understood that the client will purchase the share units one by one over a length of time until he is the sole owner of the property or asset.

5-Ijara: Letting or lease is a sale of a definite usufruct of any asset in exchange of definite reward. It refers to a contract of land or other asset leased at a fixed rent payable in cash, a mode of financing which is also adopted by Islamic banks. It is an arrangement under which Islamic banks lease equipment, buildings and other facilities to a client against an agreed rental lease. The lessee generally also has an option to purchase the leased asset. *Ijara* is a contractual agreement comparable to a sale/lease back, where the bank buys and then immediately leases an asset to a customer for a fee. The duration of the lease and the fee is set in advance, and are in many terms comparable to the terms that may be applied to the loan.

6-Ijara wa Iqtina: A contract where an Islamic bank finances equipment, building or other facilities for a client against a rental agreement. There is a unilateral undertaking by the bank or the client so that at the end of the lease period, the ownership of the asset is transferred to the lessee. The undertaking or the promise does not have to become an integral part of the lease contract in order to make it conditional. The

[8] As cited by Sarah; http://www.arabinsight.org/aishowarticle.cfm?id=190 accessed on June 13, 2009.

rental as well as the purchase price is fixed in such a manner that the bank receives back its cost price along with some profit, which is usually determined in advance.

It is clear from above definitions that share in return of financier is linked with the outcome of project under Sharia based modes of financing. The outcome of business project is neither certain nor pre determined. Share of financier is also affected the way financial results are reported. As discussed briefly earlier (and detailed in following chapters) there are certain issues in financial reporting and we cannot say financial reports of firms are transparent enough to depict economic reality in the presence of these issues. There is a need for researching the suitability of business, accounting and legal framework for Sharia based financing. Islamic financial institutions are collecting 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, it is clean and within Sharia guidelines. All IFIs are accepting deposits under all of the schemes of Sharia based modes of financing. It is a healthy sign for IFIs and Muslim society as well. It shows that depositors have trust is 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 financing is the essence of establishment of IFIs. There is a need to study and search the causes/ hurdles in the way of popularity of Sharia based financial system.

1.2 Purpose of the study

This study is an attempt to examine the accounting standard No 4, "Musharaka Financing" issued by AAOIFI, and its applicability along with the existence of conventional standards of accounting. The reason for focusing on Musharaka accounting standard is its importance in Sharia based modes of financing. The focus of the study was to evaluate and interpret the process of measuring profit by clients of Islamic Financial Institutions which is ultimately shared (by IFIs) under the principles of Musharaka.

Under Musharika financing an Islamic Financial Institution (IFI) offers finance to clients (entities) on profit and loss sharing basis. However the profit and loss of the entities (firms) is calculated by following conventional accounting concepts, principles, standards and techniques as there are no guidelines, standards issued by AAOIFI for general-purpose accounting. The focus of this study is to highlight the issues relating to the profit and loss calculation of clients (entities) of IFIs. The study explores whether under the existing (conventional) accounting framework, true and transparent accounting figures of the entities for a specific period could be reported. Under agreement of Musharaka financing, Islamic financial institutions share the profit and loss of the entities.

1.3- Research Questions

To summarize, following are the aims and objectives of this study.

a. An enquiry into the profit calculation process under conventional accounting standards, principles and conventions by the clients (entities) of Islamic Financial Institutions (IFIs).

b. Whether profit calculated under conventional accounting approach is transparent enough and depicts true results of the period under consideration as per requirements of Musharaka Financing principles?

c. What are the implications of earnings management/creative accounting for Musharaka Financing and its implementation?

d. What is the (1) share of Musharaka Financing in the portfolios of IFIs and (2) what are the hurdles in its way?

1.4 Hypothesis Development

Under Musharaka principles result of the firm's activities is shared by Islamic financial institutions. The result is declared through the annual report of the firm which includes but not limited to income statement (showing profit or loss) and balance sheet (financial position). The existing accounting framework does not guarantee transparency as we have observed a number of fraudulent cases such as Enron. In almost every country where such studies have been conducted, we found cases of earnings management through manipulation of accounts. It means that a true financial picture of firms is not depicted through annual reports hence existing accounting and business framework is not supportive for the application of Musharaka financing. Keeping in view the research questions and literature on the issue in this study I have developed the following hypothesis for testing.

H1: Existing accounting framework does not eliminate opportunistic earnings management.

H2: Application of Musharaka (Sharia based financing) is hindered by opportunistic earnings management through manipulation of accounts.

As a result of earnings management the share of Sharia based (e.g. Musharaka) financing in portfolio of Islamic Financial Institutions (IFIs) is much lower as compared to others modes of Islamic (Sharia compliant) financing including Murabaha, Ijara, Diminishing Musharaka, Bai Muajjal and Islamic mortgages etc. The main reason for the popularity of Sharia compliant financing is that the share of IFIs in returns is not linked to outcome of the project rather it is fixed in advance hence reduces the risk of IFIs. In order to address this issue, I hypothesized as under.

H3: Share of Musharaka financing in portfolio of Islamic Financial Institutions (IFIs) is low as compared to other modes of Islamic financing offered by IFIs as existing accounting and business framework is not conducive (favoring) to Musharaka financing.

1.5 Research Methodology

Data is collected through primary and secondary sources. Primary data tools included personal observations, interviews with academicians and professionals and opinion survey of Islamic Bankers, entrepreneurs and accounting/finance professionals. Secondary data includes the examination of accounting procedures and principles followed by Musharaka partners, various publications, research journals, periodicals.

My methodology includes a (1) thorough review of literature and firsthand information through personal observations, (2) interviews and opinion survey. The basic document interpretation and statistical techniques are used for analysis, findings and conclusions.

I reviewed the research papers on earnings management, the accounting standards, principles and procedures which provide opportunities for earnings management. I also review the literature on issues in financial reporting in order to conclude whether, existing system of profit/loss calculation presents fair results of operations of a firm for a particular period. I conducted the interviews and opinion surveys of professionals to get their input on the subject.

I design a questionnaire (Appendix 01) consisting of both open and close ended questions. For reliable responses basic criteria for participants is laid down. Ideally five years experience is suitable how ever as the emergence of IFIs is relatively recent so at least three years post qualification experience was considered as an essential condition to be a respondent. This study covers all Islamic Banks working in Pakistan. I collected responses from entrepreneurs, Islamic bankers, accountants and academicians.

I use Excel to examine the results of the opinion survey such as averages, standard deviations, variances, co efficient of variations, correlations and regressions. Results are presented through tables and graphs with brief explanations. Basic statistical tools are used for results and analysis.

To test the first hypothesis, I surveyed existing accounting framework and literature highlighting the unresolved issues in financial reporting. I researched the literature including accounting standards, principles and procedures to understand the reporting process. I have gone through the research papers highlighting various issues in financial reporting and then I concluded hypothesis one.

To test second hypothesis, I surveyed the literature on earnings management (manipulation of accounts) covering different institutional settings (countries) and different aspects of accounts manipulation. My research includes a literature review on definition (meaning), motives of accounts manipulation, measuring methods of earnings management, tools of accounts manipulation, assistance of accounting and legal framework in accounts manipulation, consequences of earnings management and means and ways to curtail it.

To test third hypothesis, I conducted an opinion survey of Islamic bankers, academicians, entrepreneurs and accountants through questionnaires. The questionnaire was administered in all Islamic banks working in Pakistan. I tried my level best to get the input from all Islamic banks. This questionnaire was also completed by entrepreneurs, accountants' and academicians to get their input on the issue.

1.6 Contribution

This study is conducted at a time when Islamic Financial Institutions (IFIs) are growing both in number and popularity all over the world. They are looking for guidance in the area of operation and financial reporting. AAOIFI has made a contribution as far as preparation and disclosure of financial statements of IFIs are concerned, by issuing accounting, auditing and Sharia standards for guidance of Islamic financial institutions. This study is intended to examine the AAOIFI accounting standard Number 4 covering the Musharaka financing for Islamic financial institutions to determine its validity and applicability in an environment where conventional accounting standards are dominating the business world. This study shall benefit the standards setters (policy makers) for Islamic Financial Institutions, Islamic banking managers, accountants, investors and community at large including researchers, academicians and students of Islamic finance.

CHAPTER 2

FINANCIAL REPORTING FRAMEWORK

Chapter Objectives.

After reading this chapter, one should be able to understand and interpret:

a. The objectives of financial reporting

b. Users of financial reporting and their needs

c. Conceptual framework for financial reporting

d. Financial reporting principles

e. Issues in financial reporting

f. The chapter also tests hypothesis H1: Existing accounting framework does not eliminate opportunistic earnings management.

"Accounting theory constitutes the frame of reference on which the development of accounting techniques is based. This frame of reference, in turn, is based primarily on the establishment of accounting concepts and principles. Of vital importance to the accounting disciplines is that the accounting profession and other interest groups accept these concepts and principles. To guarantee such a consensus, a statement of the reasons or objectives that motivate the establishment of the concepts and principles must be the first step in the formulation of an accounting theory." (Belkauoi, 2004)

2.1-Objectives of financial reporting

The starting point in accounting framework is the establishment of financial reporting objectives. In the US, the first document suggesting objectives of financial reporting was in the form of Accounting Principles Board Statement (APBS) No. 4 (1970). APBS No. 4 classifies the financial reporting objectives into three groups (Tables 2.1, 2.2, 2.3)

Firstly, general objectives; Secondly, particular objectives; and lastly, qualitative objectives. APBS-4 has served as the bench mark for subsequent efforts in the development of financial reporting objectives. Every subsequent effort was based on or influenced by APBS-4 including the "True Blood Committee" report (US), "The Corporate Report" (UK) and "Stamp Report" (CA) on objectives of financial reporting.

In subsequent efforts, Institute of Chartered Accountants in England and Wales (ICAEW) published "Corporate Report" in 1975 which disclosed the objectives, users, and qualitative aspects of financial reporting. As per "The Corporate Report" financial statements should fulfill the needs of intended users and society at large. The corporate report also suggested six additional reports covering employment, tax, value addition, foreign currency translation, future prospects of firms and corporate objectives. In 1980 the Canadian Institute of Chartered Accountants published "Corporate Reporting: Its Future Evolution" stating the problems faced by standard setters, conceptual issues in standard setting, objectives of financial reporting and users (their needs) of financial reporting.

Table 2.1 Summary of the general objectives of financial reporting as per APBS-4.

General Objectives

The *general* objectives of financial statements are as follows:

1-To provide reliable information about the economic resources and obligations of a business enterprise in order to:

a. Evaluate its strengths and weaknesses;
b. Show its financing and investments;
c. Evaluate its ability to meet its commitments;
d. Show its resource base for growth.

2-To provide reliable information about changes in net resources resulting from a business enterprise's profit-directed activities in order to:

a. How expected dividend return to investors;
b. Demonstrate the operations ability to pay creditors and suppliers, provide jobs for employees, pay taxes and generate funds for expansion;
c. Provide management with information for planning and control;
d. Show its long-term profitability.

3-To provide financial information that can be used to estimate the earnings potential of the firm.

4-To provide other needed information about changes in economic resources and obligations.

5-To disclose other information relevant to statement users' needs

Table 2.2 Summary of the particular objectives of financial reporting as per APBS-4.

Particular Objectives
The *particular* objectives of financial statements are to present fairly and in conformity with generally accepted accounting principles, financial position, results of operations, and other changes in financial position.

Table 2.3 Summary of the qualitative objectives of financial reporting as per APBS-4.

Qualitative Objectives
The *qualitative* objectives of financial accounting are the following: ***1-Relevance,*** which means selecting the information most likely to aid users in their economic decisions. ***2-Understand-ability,*** which implies not only that selected information must be intelligible, but also that the users can understand it. ***3-Verifiability,*** which implies that the accounting results may be corroborated by independent measures, using the same measurement methods. 4-***Neutrality,*** which implies that the accounting information is directed toward the common needs of users, rather than the particular needs of specific users. ***5-Timeliness,*** which implies an early communication of information, to avoid delays in economic decision-making. 6-***Comparability,*** which implies that differences should not be the result of different financial accounting treatments. 7-***Completeness,*** which implies that all the information that "reasonably" fulfills the requirements of the other qualitative objectives, should be reported.

2.2 -Users of Financial statements and their needs

Financial statements are prepared to satisfy the users' needs. Users include everybody who has some stake in the firm. It includes investors, lenders, suppliers and customers of the firm. It also includes the employees of the firm. Various decisions of these stakeholders are based on financial information provided by financial reports of the company. A comprehensive list of users and their needs is provided in "Stamps report" issued by Canadian Institute of Chartered Accountants (CICA). As per "Stamp report" the users of financial statements are categorized into 15 groups and they might have any or all 13 types of needs as reported in Table 2.4.

Table 2.4 Summary of the users (and their needs) of financial reports[9]

Users Of Financial Reports	Users' Needs
1. shareholders (present and potential);	1. assessing performance;
2. long-term creditors (present and potential);	2. assessing management quality;
3. short-term creditors (present and potential);	3. estimating future prospects;
4. analyst and advisers serving the above (present);	4. assessing financial strength and stability;
5. employees (past, present and potential);	5. assessing solvency;
6. non-executive directors (present and potential);	6. assessing liquidity;
7. customers (past, present and potential);	7. assessing risk and uncertainty;
8. suppliers (present and potential);	8. aiding resource allocation;
9. industry groups (present); labour unions (present);	9. making comparisons;
10. governmental departments and ministers (present);	10. making valuation decisions;
11. the public (present);	11. assessing adaptability;
12. regulatory agencies (present);	12. determining compliance with the law or regulations;
13. other companies, both domestic and foreign (present);	13. Assessing contributions to society.
14. Standard-setters (present)	
15. Academic researchers (present).	

After identification of objectives of financial statements, users and their needs, the next step was the establishment of a conceptual framework leading to the issuance of standards, guidelines and regulations. Two well known efforts on this front were made; the FASB framework (USA) and IASB framework (International).

2.3-Conceptual framework for financial reporting

"A conceptual framework is a constitution, a coherent system of interrelated objectives and fundamentals that can lead to consistent standards and that prescribes the nature, function, and limits of financial accounting and financial statements. The objectives identify the goals and the purposes of accounting. The fundamentals are the underlying concepts of accounting concepts that guide the selection of events to be accounted for, the measurement of those events and the means of summarizing and communicating to interested parties. Concepts of that type are fundamental in the sense that other concepts flow from them and repeated references to them will be necessary in establishing, interpreting and applying accounting and reporting standards". (FASB)

[9] Classification as shown by Belkauoi 2004.

In summary, FASB specifies four major objectives of establishment of conceptual framework (CFW) as follows:

a. To serve as guiding principles for standard setters
b. To serve as a frame of reference for resolution of accounting questions
c. To determine the limits of professional judgments in preparation of financial reports
d. To enhance comparability by reducing the alternative accounting treatments.

In 1973, International Accounting Standard Committee (IASC) was established with the following objectives:[10]

1. To formulate and publish in the public interest accounting standards to be observed in the presentation of financial statements and to promote their world wide acceptance and observance.
2. To work generally for the improvement and harmonization of regulations, accounting standards and procedures relating to the presentation of financial statements.

Financial Accounting Standards Board (FASB) was established in 1973 by The American Institute of Certified Public Accountants (AICPA). It has issued the following statements of financial accounting concepts (SFAC) covering the objectives, qualitative characteristics and elements of financial reporting:

1. SFAC No. 1, "Objectives of Financial Reporting by Business Enterprises",
2. SFAC No. 2, "Qualitative Characteristics of Accounting Information",
3. SFAC No. 3, "Elements of Financial Statements of Business Enterprises",
4. SFAC No. 4, "Objectives of Financial Reporting by Non-Business Enterprises",
5. SFAC No. 5, "Recognition and Measurement in Financial Statements of Business Enterprises",.
6. SFAC No. 6, "Elements of Financial Statements", which replaces SFAC No. 3 and expands its scope to include not-for-profit organizations.

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[10] Khan, Amanullah 1999.

7. SFAC No. 7, "Using Cash Flow Information and Present Value in Accounting Measurements.

2.4-Accounting Principles

Ghani (2000) defines accounting principles as follows:

"Accounting principles may be defined as those rules of action or conduct which are adopted by the accountants universally while recording accounting transactions". (p.12)

Accounting concepts and conventions are vital for the development and implementation of an accounting system which generates financial reports. Only reports which adhere to universal principles of accounting can be comparable and useful for decision purposes. (Ghani, 2000). Table 2.5 lists the universal principles of accounting. The whole structure of accounting systems has been built by keeping in view its objectives, users and principles.

Table 2.5 Summary of accounting principles.

Accounting Concepts	Accounting Conventions
Separate business entity concept	Convention of disclosure
Going concern concept	Convention of materiality
Money measurement concept	Convention of consistency
Historical cost concept	Convention of conservatism
Dual aspect of every transaction	
Accounting period	
Matching principle	
Realization concept	

2.5-Issues in Financial Reporting

In spite of valuable efforts by FASB and IASB, there are certain loopholes in the accounting framework which provide opportunities for manipulation of accounts. Corporate world has trembled from time to time due to the fraudulent acts of managers and accountants. Three major issues of accounting are (1) recognition (2) classification (allocation) and (3) valuation.

2.5.1 Recognition

One of the most important issues is the recognition of revenues and expenses; recoding and classification of a transaction. When to record a particular item as revenue or expense as the case may be? Business is divided into three categories on functional basis i.e. manufacturer, trader and service provider. The nature of revenue is different for services business from that of trade and manufacturing business. In manufacturing and trade, source of revenue is sales while in case of services revenue is charged for the contract of labor etc. what is the appropriate time for revenue recognition? Is the time when order is received? Is the time when contract is completed? Or is it the time when cash is received?

According to international accounting standard (IAS) 18,

"revenue is the gross inflow of economic benefits during the period arising in the course of the ordinary activities of an enterprise when those inflows result in increase in equity other than increase relating to contributions from equity participants.......Revenue should be measured on fair value of the consideration received or receivable"

For recognition of revenue the following criteria is laid down by IAS-18,

2.5.1.1-Sales of Goods

a. The enterprise has transferred to the buyer the significant risks and rewards of ownership of the goods.
b. The enterprise retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold.
c. The amount of revenue can be measured reliably
d. It is probable that the economic benefits associated with the transaction will flow to the enterprise and
e. The costs incurred or to be incurred in respect of the transaction can be measured reliably

2.5.1.2-Rendering Services

Revenue against the service should be measured according to the stage of completion, can be measurable reliably, of contract on balance sheet date. The outcome of the transaction can be estimated reliably if following conditions are fulfilled.

a. The amount of revenue can be measured reliably
b. It is probable that the economic benefits associated with the transaction will flow to the organization
c. The stage of completion of transaction can be measured reliably
d. The cost associated with the transaction can be measured reliably

In spite of these comprehensive guidelines certain cases of fraud and opportunistic earnings management (see chapter 3) have been found empirically.

2.5.2 Manipulations through managerial actions.

2.5.2.1-Sales and Returns. The sales on the basis of retain or return. It is a tool of manipulation in the hands of preparer of financial reports, if s/he want to show good performance, then one would immediately recognize the sale otherwise s/he could report poor performance to defer the recognition of revenue.

2.5.2.2-Early/delayed recognition of sales. Furthermore, recognition of revenue can be manipulated at the end of reporting period. Under this approach, if preparer wants to show better performance S/he records advance sales and if s/he wants to show less performance then defer the revenue recognition.

2.5.2.3-provision against maintenance. If a firm (especially in case of after sale service) wants to show lesser profit it can defer the recognition of certain amount of revenue under the plea that a portion of contract is still incomplete and recognize it in next period however if intention is to show more revenue and profit, it can ignore any maintenance provision and recognize the whole amount of sale in the year of sale.

2.5.3 Allocation and classification

Allocation and classification is very important as it determines the results of the business. When an asset is converted to expense? a liability into revenue? an expense into asset and liability? Under what criteria cost of an asset is divided among useful life of the asset. Many of the answers to such questions are provided by professional judgments of managers and accountants which can be misjudged intentionally as well as unintentionally. Following discussion of certain items would make the point more clear.

2.5.3. 1-Depreciation. Depreciation is a systematic allocation of cost of assets used over the period of economic life. Depreciation can be charged on multiple methods (bases). It can be time based which includes straight line basis, diminishing balance method and sum of years digit method. Under straight line method equal amount of depreciation is charged during the economic life of the asset while under sum of year's digit and declining balance method more depreciation is charged in earlier years and lesser in following years. It can be performance based including number of working hours and number of units produced. It can be decided by government keeping in view certain specific goal in mind. For example if government want to increase investment in particular sector it can enhance depreciation up to 100% in the year of purchase. Each method shall provide different result which will directly effect earnings measurement. Which one of the method is more transparent and close to reality? Answer is none due to following reasons. Firstly depreciation is always charged on the basis of expected economic life or expected performance which cannot be measured accurately in advance. Second depreciation is charged on historical cost which ignores the current value of facility used.

2.5.3.2-Good will Amortization. Good will appears in the balance sheet when it is acquired. Normally at the time of purchase of a business if payment is made more than the amount of net assets the excess is treated as goodwill. Writing off goodwill has always remained in the hands of preparers of financial statements a tool of manipulation of accounts. At the inception of IAS 36, where impairment test was introduced to write off the good will, things are becoming worse than bad. The case of PIA[11] and other empirical results show the negative impacts of manipulation by managers. Daniel 2006 concludes about the amortization decision of good will

"BW provide interesting insight by examining multiple forces that might influence management's accounting choice, including contracting, equity market incentives and regulatory forces"

2.5.3.3-Employee compensation plans. In order to attract and retain value able employees and managers corporations frequently offer various compensations based on performance including stock options. These stock options are either offered without any charge or at a price which is certainly lower than market. What should be the accounting treatment of these compensations? Accountants have not yet concluded whether to charge these benefits as expenses or allocation of profit out of retained earnings.

2.5.3.4-Provision for bad debts. Selling on credit is a general tool of increasing sales and organizations use this tool very effectively. Certain organizations including banks are doing the business of providing credit facility. Certain portion of these credits may not be recoverable and organization has to forfeit the claims. Recently from 1999 to 2007 in Pakistan loans of amounting to Rs; 60 billions issued by nationalized banks were written

[11] Earlier PIA written off an asset by declaring impaired and debited to profit and loss account while re instated in 2002 and PIA jumped into profitable organization from loss incurring.

off by government[12]. In order to save the organization from future expected loss a provision is created for doubt full accounts. However the amount of provision is rest with the judgment and discretion of the preparer of financial statements.

2.5.3.5-Deferred expenditures. Certain expenses of the businesses are beneficial for short term and others for long term. The short term expenditures are charged to profit and loss account and expenditures with benefit for long term are capitalized and amortized over the period of benefit. Again it is upon the judgment of management of organization to decide whether expenditure should be capitalized or expensed out. The decision of capitalization has enormous effect on profit calculation. Profit and loss can be reduced or increased keeping in view the objectives of management.

2.5.3.6-Research and development cost. Research and development expenditures are necessary for the success of business entities as these expenditures create and maintain the differential advantage. Research and development cost gives the organization leading role in the sector. The accounting issue involves when to capitalize the research and development cost and when to expense out? Al though certain criteria's are laid down including research expenses not to be capitalized and development expenditures not to be expensed in the period of occurring. Again expensing the research spending in the period of occurring is debatable. If the criterion of capitalizing expenditures is benefit attached then it is the research which provides benefit up to the whole life of product.

2.5.3.7-Brand accounting. Certain organizations are capitalizing the spending on brand buildings others not. Again it is the discretion of management to build the brand or not.

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[12] http://blog.dawn.com/?p=1625 down loaded on 11th July 11, 2008.

2.5.4 Valuation

While recording transactions in books of accounts the value assigned is the fair market value of consideration given. This practice is generally known as historical cost principle of accounting. Historical cost is followed because, as argued, due to its objectivity and verifiability. However still two questions are unaddressed. First historical cost balance sheet is not relevant for decision making as it is not representing the current market value of business. Second even in spite of following historical cost due to alternative methods of accounting results are not comparable (e.g. LIFO, FIFO and Average). Another issue in valuation is that if we follow the market valuation then question of reliability arises. Who will determine the market value of an asset especially for an asset which's price quotes are not available like Stocks and Bonds. How much reliable that value would be? One of the feature of reliability is the independent verification of information disclosed which is not possible in these cases.

2.5.5 Principles Vs Rules Based Debate.

In last few years there is a debate in researcher's circle whether accounting standards should be principles based or rules based and whether uniform accounting standards are applicable to all societies of world. (Alexander et al 2006). It would be interesting to note that so for meanings of both the terms are subjective. Generally United States of America's generally accepted accounting principles (GAAP) are termed as rules based and United Kingdom's statement of standard accounting practice (SSAP), financial reporting standards (FRS), International accounting standards (IAS), international financial reporting standards (IFRS) are accepted as principles based.(Benston et al 2006).

Standards are required to prepare financial statements comparable, reliable, relevant to decision making and present true and fair view of economic reality of entity. True and fair presentation which is synonymous with US term present fairly is also a subjective construct. As per SEC of US "*present fairly*" means that accounts are prepared according to US GAAP. In US the confirmation of fair presentations rest with audit opinion as disclosed in AICPA SAS 69 (1992). (AICPA, 2001)[13]

> "That audit opinion should be based on his (auditor) judgment WHETHER,
>
> a. The accounting principles selected and applied have general acceptance;
> b. The accounting principles are appropriate in the circumstances;
> c. The financial statements, including the related notes, are informative of matters that may affect their use, understanding, and interpretation;
> d. The information presented in the financial statements is classified and summarized in a reasonable manner, that is, neither too detailed not too condensed;
> e. The financial statements reflect the underlying transactions and events in a manner that presents the financial position, results of operations, and cash flows stated within a range of acceptable limits, that is, limits that are reasonable and practicable to attain in financial statements"

The meaning of true and fair view as given in IAS is conformity of financial reports with international financial reporting standards. According to IAS 1

> "Financial statements should present fairly the financial position, financial performance and cash flows of an enterprise. The appropriate application of International Accounting Standards, with additional disclosure when necessary, results, in virtually all circumstances, in financial statements that achieve a fair presentation."(Paragraph 10, IAS 1).

In United Kingdom although fair presentation is not linked with UK accounting standards in principle however legal requirement is to comply with standards in order to disclose the true and fair economic reality.(Alexander et el 2006). It is clear from the above three citations that world leading bodies are almost in consensus about the meaning of true and fair presentation. (i.e to comply with the accounting standards). However UK accounting standards and IAS framework accept that a situation could arose

[13] As quoted by Alexander et el 2006.

where compliance with standards would be misleading: in such a situation professionals are allowed to over-ride the accounting standards;----- if compliance leads to compromise the depiction of true economic reality.---(Benston et el 2006, IAS 1).

Here a question arises if true and fair presentation is to comply with standards then no question of over riding the standards to depict true economic reality: but over-riding is allowed in both IAS and UK accounting framework which means merely compliance with accounting standards is not guaranteeing the depiction of true and fair view. Fair presentation is some thing above the mere compliance with accounting standards; it is in the mind of this family of professionals but not on paper. Kirk 2006, states about true and fair

"The nature of truth, whether it is absolute or relative, whether it exists as a reality, an incontrovertible thing, or as an abstraction, whether it is dependent or independent of the believer/ observer and whether any statement can be proven or merely falsified, are all aspects that that have been applied to accounting theory and research. Fair (and fairness) is also open to varying degrees of interpretation and application. Both truth and fairness may vary according to time and place, and may be relative to the framework within which they reside. This pattern is not surprising in a socially constructed and constructing discipline such as accounting."

Walton (1993) sees the meaning of true and fair view as one of three things:

1. A legal residual clause, or legislative safety net to cover any unforeseen eventuality,
2. A concept defined independently of accounting rules as a higher objective for accounting, or
3. Generally accepted accounting principles.

The above citation is providing sufficient evidence to conclude that meaning of true and fair presentation are different in different societies & cultures and professionals are not agreed upon single set of meanings. It is important to note that even the terms such as "true and fair view", "fair presentation" and " fairly reflects" are accepted as synonyms by various professional institute but individual members of those bodies are differentiating in meanings of these terms.(kirk 2006).

In US the over riding to accounting principles are not allowed. In US standards are prepared in details for which US GAAPs are blamed as rules based and not principles based. Most of the details are provided by US regulatory framework under the approach of 'if then analysis. (SEC report 2003). The distinction between rules-based and principles-based standards is not well defined and is subject to a variety of interpretations (SEC, 2003,p. 5). Yet there is a commonly held view that the FASB's standards are rules-based and the IASB's standards are principles-based. (Bruce et el 2006) Rules-based nature of U.S. GAAP has generated a mass of detailed rules and guidance and bright-line specifications in the standards encouraging financial engineering to meet the letter but not the intent of GAAP, resulting in less informative or misleading financial statements.(SEC 2003). Voices are raising in US in favour of principles based accounting as documented by Rebecca et al (2008).

> "Key concerns arising from the recent business scandals are that U.S. accounting standards have become "rules-based," filled with specific details in an attempt to address as many potential contingencies as possible. This has made standards longer and more complex, and has led to arbitrary criteria for accounting treatments that allow companies to structure transactions to circumvent unfavorable reporting. In addition, the quest for bright-line accounting rules has shifted the goal of professional judgment from consideration of the best accounting treatment to concern for parsing the letter of the rule. Simply stated, principles-based accounting provides a conceptual basis for accountants to follow instead of a list of detailed rules. Under a principles-based approach, one starts with laying out the key objectives of good reporting in the subject area and then provides guidance explaining the objective and relating it to some common examples. While rules are sometimes unavoidable, the intent is not to try to provide specific guidance or rules for every possible situation. Rather, if in doubt, the reader is directed back to the principles".

This shift from rules to principles is welcomed by professionals. This will help in international convergence of accounting standards. However as concluded by Benston et el 2006 that standards setters should provide guidelines for application of judgments in order to depict the economic reality of underlying organization. If at some point in time a professional thinks that adherence to standards would falsify the result and fair presentation can only be done through over riding a standard this should be allowed at his/r discretion. When ever there is true and fair over ride same should be disclosed in notes to financial statements along with reasons. As for as manipulation is concerned the issue should be addressed through disciplinary action by the relevant regulating bodies as concluded by Benston et al (2006)

"Nevertheless, we recognize that the usefulness of a true-and-fair override relies on effective disciplinary measures against managers and auditors"

Again it cannot be expected that principles based standards would ensure transparency as concluded by walker (2007),

"The cases examined here constitute evidence that contradict claims about the alleged superiority of principles based standards vs. rules based standards"

The success of principles based accounting would seem to depend upon the willingness of auditors to ensure compliance. It would also depend upon the capacity of monitoring regulators (Walker 2007).It is also effected by adherence to ethics by professional in question. Mel chine (1998) termed it as ethical knowing

"An approach turns the acquisition of understanding away from a focus on the external world of rules, concepts and exemplars to the interior world of how accountants, as people, arrive at an understanding that is consistently ethical".

Ethical standards are production of culture and we have different cultures in different societies which affect our psyche in professional judgment as concluded by Tsakoumis (2007) "supplemental analysis shows that US accountants consistently exhibit more conservatism than Greek accountants".

It is concluded on the basis of above citation that meanings of principles based accounting standards and rules based accounting standards are not yet clear in absolute terms as Bruce (2006) explained nature of difference and states that the rules based Vs principles based distinction is not meaningful, except in relative terms. With the increase in global businesses the comparability of financial information between firms from different countries has become an important issue (Tarca 2004).One way to address the issue is humanizations of accounting standards internationally. Efforts are in the way for uniform set of accounting standards under the title of international financial reporting standards. Standards setters of various countries are involved in harmonization process such as international accounting standard committee (IASC) and international accounting standard board (IASB) (Tarca 2004).

The burning question is whether a uniform set of accounting standards would meet the requirements of all societies having different economic systems and norms which transplant the institutional framework as concluded by Tarca (2004),

> "since institutional framework vary within countries, a company's country of origin will impact on its use of international standards. In theory and subject to minimum legal requirements, a company could prepare financial statements for the public based on any accounting standards it chooses. However in practice cost considerations mean that a company's choice of standards reflects the requirements of institutional framework of home country"

The firms with operations in foreign countries including production, sales and stock exchange listings are bound to use international standards to satisfy the stakeholders in various countries. Global accounting standards can be principles based and not rules based keeping in view the cultural aspects of various societies, which in turn rely more upon professional judgments of accountants as concluded by Bruce (2006)

> "We conclude that a relatively more principles based standards regime requires professional judgment at both the transaction level (substance over form) and at financial statement level (true and fair over ride). Further more it is suggested that any FASB and IASB convergence will require agreement on the weightings given to the qualitative characteristics".

From the above citation it is concluded that although the aim of financial reporting is to depict the true and fair picture of economic reality of underlying entity but meaning of true and fair view is not yet properly established. Certain efforts are being made to clarify the meaning but still a lot is to be done. It is a concept which is in the mind of professionals, not on papers, and they can understand and communicate to each other. In order to present true and fair position, accounting standards are developed by various nations. Two sets of them are recognized as international accounting standards i.e. US GAAPs and IAS. US GAAPs are labeled as rules based because they contain more details as compare to IAS which are known as principles based. General agreement among the professionals is that principles based standards are better than rules based which leaves the more rooms for professional judgments in changing situations. The principles based standards rest the transparency on the shoulders of professionals who are influenced by ethical standards which are based on cultural values of different societies. Keeping in view the differences in values, cultures and ethical standards of nations, unity can be achieved through diversity by developing the principles based standards and leaving the second stage with the nation itself to decide what further rules may be established keeping in view the special circumstances of matter under consideration.

2.5.6-Conclusion and Implications on Musharaka

The modern accounting framework is much complex and requires some specialized knowledge to understand the accounting reports including income statement. Traditionally annual report is prepared by firms at the completion of one year of operations which consists of a set of financial reports certified by independent auditors including income statement, balance sheet, cash flow statement and statement of owner's equity. Annual report also contains directors' report to users of financial statements and notes to financial statements necessary to understand the figures reported at the face of financial reports. How these figures are generated? What are the principles behind the recognition and measurement of revenue? Valuation of assets? etc;etc.

Accounting framework has developed certain principles and conventions over the years. These principles, (including business entity, going concern, historical cost, stable currency, materiality, matching and accruals) are the foundations for recognition and measurement of accounting revenues and expenses. The decision to recognize the revenue and expenses has implications for profit calculation which is the ultimate share of IFIs. Generally accepted accounting principles (GAAP) in US, and International Financial Reporting Standards (IFRS) are the two major sets of international accounting standards in addition to guidelines issued by numerous local accounting bodies of world. Accounting standards are guiding principles for accounting professionals responsible to prepare books of accounts. By looking at the issues raised above we conclude that under present framework true profit of the organization cannot be calculated. There are number of loop holes through which accounts can be manipulated and they are manipulated by the management in order to fulfill their objectives. These loop holes have opened the way for creative accounting as concluded by Baralexis (2004) *"the result of the study indicate that creative accounting is practiced in Greece frequently, and to a considerable extent, mainly with the blessings of law".* In the absence of clearly defined procedures relating to transactions and suggestion of number of alternative options to adopt for a particular transaction increases the subjectivity in accounting reports which is depicted from following remarks.

"Financial reporting rules require that managers make a significant number of subjective decisions when reporting accounting information to investors. As standard setters attempt (at least nominally) to move towards "principle-based" standards, while embracing such concepts as "fair value accounting" for assets and liabilities that are not actively traded, it seems likely that the subjectivity in accounting reports will continue to rise". (Daniel 2006).

While it is proved that under existing framework profit calculation is subjective then question arise that share of Islamic bank in profit of client, calculated under present general purpose accounting framework, stands where. Can we say the objective of justice which is the only reason for establishment of Islamic financial institution is fully met through Musharaka financing? Of course not!

Profit calculation process is very vital in sharia based financing. As well known under Musharaka return of the Islamic Financial Institution is depending upon the out come of underlying project and not fixed. Accounting is the language of business as it communicates the results of operation to the investors. If accounting frame work is not transparent enough and failed in overcoming its weaknesses. Consequently no chance of fair result depiction and false results cannot be over ruled. While profit calculation process is not transparent enough Islamic financing cannot be done. Now the issue is what to do? After all Islamic financing has to grow in the existing society and firms will continue profit calculation under conventional accounting frame work mainly due to no availability of any guidance under Islamic frame work and also as legal requirements of local laws.

Keeping in view the above discussion we suggest that AAOIFI should look into the matter and prepare guidelines for businesses dealing with Islamic financial institutions under Musharaka financing for preparation of a special set of accounts and earnings calculation to determine the share of Islamic banks. Existing accounting standards are providing guidance to Islamic Financial Institutions only.

On the basis of evidences discussed above we accept the hypothesis number one.

CHAPTER 3

EARNINGS MANAGEMENT

Chapter Objectives.

After reading this chapter, one should be able to understand and interpret:

a. Definition of earnings management
b. Motives behind earnings management
c. Measuring methods of earnings management
d. Earnings Manipulation tools
e. Factors assisting in managing earnings
f. Controlling tools
g. Consequences of earnings management
h. The chapter also tests hypothesis H2: Application of Musharaka (Sharia based financing) is hindered by opportunistic earnings management through manipulation of accounts.

3.1-Definition

Understanding of earnings management phenomenon is necessary before I proceed to measurement and its impact on financial and capital markets. Researchers are not in consensus in defining earnings management. Following are some of the definitions depicted through literature.

Dechow et al. (1996) *"Earnings Management (management of fraud) is earnings manipulation within (outside) the bounds of GAAPs"*

Healy and Wahlen (1999) *"Earnings management occurs when managers use judgment in financial reporting and in structuring transactions to alter financial reports to either mislead some stake holders about the underlying economic performance of the company or to influence contractual outcomes that depend on reported accounting numbers."*

Jackson and Pitman (2001) provided three definitions of earnings management to highlight the different aspects of phenomenon including the purpose and methods of earnings management.

a) *"Earnings Management is purposeful intervention in the external financial reporting process with the intent of obtaining some private gain".*

b) *"Earnings Management is an intentional structuring of reporting or production and investment decisions around the bottom line effect".*

c) *"Earnings Management is the use of judgments in financial reporting and in structuring transactions to alter financial reports either misleading some stakeholders about the underlying economic performance of the firm or influencing contractual outcome that depend on reported accounting judgments".*

Baralexis (2001) *"Creative accounting or earnings management is a process of intentionally exploiting or violating the GAAP or the law to present financial statements according to one's interest"*

Guan et al. (2008). "Earnings management is the manipulation of accounting numbers within the scope of generally accepted accounting principles (GAAP)".

Wang et al. (2008) *"Earnings management refers to companies' strong incentives to use judgment in financial reporting and in structuring transactions to alter financial reports".*

Following conclusions can be drawn through analysis of above definitions. First, the earnings management is a direct consequence of using judgments in financial reporting. The nature of accounting and market phenomenon forces the standard setters and regulators to leave room for professional judgments. US GAAPs are generally termed as rule based as compared to IFRSs which are generally claimed as principles based. It means there is lesser room for professional judgment under GAAPs environment but we saw various cases of earnings management (financial frauds) in US economy (e.g Enron).

Second, earnings are manipulated to achieve some motives including higher compensation for management, better prices of securities, meeting the targets of analysts, reducing contractual costs etc, etc. Third, earnings management can also be done by transactions structuring (e.g. keeping books open even after closing date, delay in sales recognition, increasing accruals etc) which is not the case of professional judgment rather a clear violation of accounting standards and regulations.

Fourth, earnings can be manipulated by violating the accounting standards and regulations or/and without violation. Earnings which are manipulated through breaking the standards and regulations are termed as fraud and misrepresentation which is punishable. In recent years the NACFE[14] (USA) has gone a step ahead by defining the fraud as *"one or more intentional acts designed to deceive other persons and cause them financial loss"*. In this definition law breaking is not necessary to commit fraud but intention to cause loss others is the key to fraud. The question still remains un-answered how to prove the intention of fraud.

To conclude earnings management is concealing the factual and true picture of underlying firm in order to achieve some preset objective(s). The process can be completed with or without violating the accounting standards and regulations. It can be with or without the intention to cause harm some one or to obtain personal benefit.

3.1.1 Types of earnings management

1. When earnings are managed within accounting and regulatory framework is generally termed as legitimate earnings management. Teoh, et al. (1998) states *"we do not consider fraudulent reporting behavior specifically because the majority of the seasoned equity issuers in our sample appears to comply with GAAPs." (Page 66).* It is very

[14] National Association of Certified Fraud Examiners (1993,p.6)

clear that only those cases of earnings management can be termed as illegitimate (fraud) where accounting standards and regulations are violated.

2. When accounting and regulatory framework is broken it is termed as illegitimate earnings management.

3.2-Motives of Earnings Management

As discussed in definition section that accounts are manipulated in order to achieve some preset objectives. In this section I will explore the literature offering explanation on motives of earnings management.

3.2.1-Particular figure is reference point

Targets of profit are set in advance for the period under review and then tried to achieve. If management fails in achieving that target then figures are managed to meet and beat the target. (Burgstahler, 1997., Degeorge et al., 1999., Skousen et al., 2004., Guan et al., 2008) Empirical evidence identified three reference points:

a. To avoid negative earnings
b. To show increase as compare to last year's earnings
c. To meet the expectations of analysts.

Former SEC chairman Levitt (1998), states the issue in these words *"Earnings management is widespread, at least among public companies, as they face pressure to meet analysts, expectations."* Beneish (2001). Degeorge et al (1999) constructed hierarchy of these reference points. Initial target is to achieve positive earnings. Once it is achieved then to show earnings more than the previous period and lastly to go for meeting the expectations of analysts, which is again vital especially for growing firms. Number of empirical studies has concluded that earnings are managed upward through rounding of figures, including the following:

1. Carslaw 1988 concluded that earnings are rounded up ward (in New Zealand) when they are just below the reference point.
2. Thomas 1989 confirmed the findings of Carslaw in US.
3. Kinnunen et al 2003 examined the rounding phenomenon in 187 countries and found evidence that most of firms in their sample were involved in rounding practices.
4. Skousen et al (2004) found that Japanese firms are also tending to round reported earnings.
5. Guan, et al (2008) states the rounding off issue *"Our empirical results suggest that reporting rounded earnings is a pervasive phenomenon among Taiwanese firms"* (page 20)

Prospect theory developed by Rehneman and Tversky (1979) [15]contends that decision makers set a reference point for gains and losses. Managers are trying to meet that reference point. Burgstahler 1997 explains that different decision makers might have different reference points. Zero change in earnings can be a natural reference point for those who measures wealth in earnings multiple.

Hayn (1995) documented "Interestingly there is a point of discontinuity around zero. Specifically there is a concentration of cases just above zero, while there are fewer than expected cases (assuming the above normal distribution) of small losses (just below zero). The frequency of observations in both the region just above and that just below zero departs significantly from the expected frequency under the normal distribution at the 1% significance level using the binomial test. These results suggest that firms whose earnings are expected to fall just below the zero earnings point engage in earnings manipulations to help them cross the 'red line' for the year" (p.132)

[15] As cited by Burgstahler, et. Al 1997

In summary it is proven from above citation that earnings are managed to stay around or above the reference point which can be loss avoidance, showing the performance above than previous year and/or beating the analysts' forecasts.

3.2.2- Avoidance of technical default of debt covenant.

Another area explored in literature is that earnings are managed to avoid technical default on debt covenant. Certain debt covenants are imposed by financiers including preset target of earnings. (Sweeney 1994, Gaun et al 2008, dechow et al 2004). Beneish (2001) says results are mix in this case. However Dichev et al, 2000 after examining the larger sample of debt agreements concluded that majority of firms disclosed the results of earnings above the target set by debt covenants.

3.2.3-Trnasections costs theory

Transactions costs theory suggests that firms with positive earnings can lower costs of transactions including capital cost, favorable supplier's contracts, customer preferences and value able employee's retention. Burgstahler 1997 identified that "Transactions costs theory relies on two assumptions:

1) Information about earnings effects the terms of transactions between the firm and its stake holders and, more specifically, terms of transactions are generally more favorable for firms with higher, rather than lower, earnings.
2) The costs of storing, retrieving, and processing information are sufficiently high that at least some stake holders determine the terms of transactions with the firm based on heuristic cutoffs at zero levels or zero changes in earnings" (page 122)

Cornell et al (1987) as quoted by Burgstahler (1997), contended that the value of stake holder's implicit claims (which is directly related to the market value of the firm) is sensitive to information about the firm's financial condition. Bowen et al (1995) as quoted by Burgstahler (1997) have listed the following incentives to report higher earnings.

Customers are willing to pay higher prices for goods because the firms are assumed more likely to honor implicit warranty and service commitments.

Suppliers offer better terms, both because the firm is more likely to make payments due for current purchases and because the firm is more likely to make larger future purchases.

Lenders offer better terms because the firm is less likely to either default or delay loan payments.

Valuable employees are less likely either to leave or to demand higher salaries to stay as firm is performing up to the expectations and market ranks high.

Burgstahler (1997) concluded " Firm reporting an earnings decrease (or reporting a loss) bears sharply higher costs in transactions with stake holders than if the firm had reported an earnings increase (or profit). P-123......... Managers opportunistically avoid reporting earnings decreases and losses to decrease the costs imposed in transactions with stake holders.

He further concluded "This paper provides compelling empirical evidence that earnings decreases and losses are frequently managed away. The evidence suggests that 8% to 12% of the firms with small pre-managed earnings decreases exercise discretion to report earnings increases. Similarly, 30% to 44% of the firms with slightly negative pre-managed earnings exercise discretion to report positive earnings."

Transactions cost theory offers value able explanation about earnings management behavior of managers. It shows that earnings are managed with positive intentions to earn certain gains for firm. This explanation at least does not declare earnings management a curse rather it portrays as business friendly. If a firm succeeds in negotiating favorable contracts through earnings management, a trade off may be created between the present transparency and future prosperity especially for growing firms.

3.2.4- Tax considerations

One of the reasons to manage earnings is tax consideration. As tax is levied on accounting income and ---more or less--- tax is the direct consequence of earnings. Tax aversion is common attitude of citizens especially in less developed countries where legal framework and accounting profession is relatively weak. Lack of documentation is another factor which helps in avoiding tax. Baralexis (2004), on the basis of opinion survey of professional accountants of Greek, documented that in Greek magnitude of earnings is about 25% of pre-managed earnings. His further conclusion is that small firms are managing earnings due to tax considerations while large firms for attracting external financing.

3.2.5-Launching Public Issues

Another motive of earnings management is to show the better image of firm at the time of public offerings. One to three years prior to public offering and in the year of offer, earnings are managed to show performance high than industry peers. Loughran and Ritter (1995), Spiess and Affleck-Graves (1995), Levis (1995), Teoh et al. (1998) and Rangan (1998).

Iqbal et al. (2009) documented, by testing hypothesis on UK open offers (seasoned equity offers) from 1991 to 1995 with sample of 181 companies, that earnings are managed up ward in pre offer and offer year to deceive the investors through increasing discretionary current accruals (DCA),consequently market valued the shares high than intrinsic value. In the post offer years earnings declined due to reversal of DCA and market corrected itself. They concluded: - "findings suggest that UK issuers of open offers successfully manipulate investors by temporarily inflating earnings pre offer. Naïve investors appear to under utilize the information available at the time of the offer announcement and mistakenly expect pre issue earnings increases of offers firms to be permanent. When earnings decline post offer due to accruals reversals, disappointed investors revise their expectations about firm values down ward"

Toeh et al.(1998) concluded with a sample size of 1265 US seasoned equity offerings (SEO) over the period of 1976-1989 that earnings are managed by firms three years pre offer and in the year of offer up ward while declines in post offer. Investors failed in realizing the impact of earnings management and valued the securities high, however this optimism could not lost longer and investors realized their mistake and market corrected itself in post offer years due to reversal of DCA which ultimately reduced the earnings of firms.

3.2.6-Manager's compensation

(Wang et al., 2008) Negative earnings or loss can effect management compensation negatively. Dechow and Sloan (1991) are of the view that earnings are managed in the last year of CEO in office in order to maximize their compensation contracts. Generally management compensation is performance based and performance is measured through earnings as one of key performance indicators in addition to other tools. Higher earnings mean better performance and better reward. So linking compensation with earnings motivates the managers to manipulate accounts and show better image in order to maximize their personal return. (Jensen and Murphy, 2004)

3.2.7-Financial analysts' forecasts

Financial analysts are playing major role in building the investors' perception about a particular security. Managers of growth firms especially are under pressure to maximize the value of security. On the basis of analyst's expectation investors' value the security. In order to maintain and increase the price of security managers are trying to disclose the

EPS which can beat the expectations of analysts. Burgstahler et al., 1997 documented that Researchers have identified three levels of earnings as target (reference point) for management. First is to avoid negative earnings (loss); second is to declare earnings more than previous year; third is meeting the analyst's forecast. Analysts forecasts are trusted and respected by investors and beating this target leads to higher value for firm. (Kasznik et al., 2002 as quoted by wang 2008)

3.2.8-Poor management performance

Earnings are managed to hide weaknesses of management. When management fails in meeting targets then the last option is to manipulate accounting numbers keeping in view the pressure of stakeholders' expectations. Beneish 2001 documented "much of the evidence of earnings management is dependent on firm performance, suggesting that earnings management is more likely to be present when a firm's performance is either unusually good or unusually bad."(p:4)

Baralexis 2004, states the following motives of earnings management concluded on the basis of opinion survey from independent accountants and external auditors of Greek

a. Demand for external finances (skinner 2000 as quoted by Baralexis 2004))
b. Maximization of utility of managers by disclosing smooth or increasing earnings stream (Summers 1998 as quoted by Baralexis 2004)
c. Management compensation
d. Increments in stock prices Barth et al (1995) as quoted by Burgstahler (1997), reports that firms with a consistent pattern of earnings increases command higher price to earnings multiples after controlling for earnings levels and this premium is larger for longer series of earnings increases and that the premium is eliminated

or reduced substantially when the established pattern of earnings increases is broken. DeAnglo et al (1996) as quoted by Burgstahler (1997), concludes that firms breaking a pattern of consistent earnings growth experience an average of 14% negative abnormal stock return in the year the pattern is broken.

e. Improvements in firm's public image
f. Dividends distribution firms manage earnings when they are not able to pay dividends. Healy and Palepu (1990) find that earnings are managed when firms are close to dividend constraints.
g. Sale or merger
h. Covering fraud or bad management
i. Pressure from institutional investors
j. Panning of fictitious bankruptcy
k. Competition
l. Listing requirements i.e firm must show satisfactory results for last 5-years.(ASE 1995 as quoted by Baralexis 2004)

To conclude this section, there are evidences which suggest earnings management and give explanation of managerial behavior. There exist strong incentives for managers to indulge in earnings management. These incentives include better pricing of securities, beating analysts expectations, avoid negative earnings, show better performance than past, better compensation of managers, tax evasion , external finance attraction, concealment of poor performance, favorable contracts from suppliers, customers, lenders and employees and avoiding technical default on debts covenants. Burgstahler, (1997) documented:

"There seem to be strong incentives of earnings management to avoid the reporting of earnings decreases, and the incentives appear to be increasing in the length of the preceding string of earnings increases. There is also much anecdotal evidence of incentives to maintain positive earnings. References to the desirability of 'consistent profitability' are commonplace in annual reports, news releases, and press coverage, suggesting that there are incentives to avoid losses" (page 100)

Although there are many negative motives behind earnings management, certain positive motives are also exist which includes but not limited to, better and favorable contracts for the firm from suppliers and lenders. Another dimension of earnings management is the stress level of managers builds up due to expectations of better performance by stake holders.

3.3-Measuring Earnings Management

Measurement rather correct measurement of earnings management is vital in understanding and controlling the phenomenon. It is the measuring method which uncovers the problem. In spite of the vital role of measuring method we do not have any single consensus method of earnings management. Depicting the earnings management and its correct magnitude through limited available information disclosed in financial statements is almost difficult job, especially while such reports are designed and produced by experienced and skilled accountants and have concealed the facts knowingly. The practicing accountants are very much part of the whole process of manipulation and they are smart enough to conceal facts in such a way that detection is almost impossible. Academic accountants in spite of having limited access to information have designed some methods of detection and measurement of earnings management. These methods include Jones Model 1991, and Modified Jones Model 1995, Standard Normal Distribution 1997, opinion survey 2004 and Mixed Normal Distribution 2004. Some of the methods are discussed critically in this section.

3.3.1-Jones (1991) & Modified Jones (1995) Model

The most popular method of detection and measurement of magnitude of earnings management is the Jones model. Numerous studies are conducted by following this model including Jennifer Jones (1991), Guay et al.(1996), Toeh et al.(1998), Jiraporn (2005, 2007), Iqbal et al (2009). This method detects and quantifies the magnitude of earnings management by estimating normal accruals according to firm size then comparing with actual accruals created by firm. If actual accruals are more than normal it means earnings are managed up ward and vice versa.

Toeh et al. (1995) states that Jones model has the most power to detect earnings management. Guay et al (1996) as reported by Jiraporn (2007), concludes that only Jones model has the potential to provide reliable estimates of discretionary accruals. Bartov et al (2001) as quoted by Jiraporn (2007) are of the view that only Jones models are able to detect and quantify the magnitude of earnings management.

Like any other model Jones model has also been criticized by researchers. Baralexis (2004) rejected the model on the basis that it is not taking into account the input from practitioners who are involved and primary witness of earnings management. Beneish (2001).concluded that this model, in spite of modifications, has failed in differentiating between discretionary accruals (accruals resulted due to exercise of discretion by manager) and non discretionary accruals (which are the result of economic performance of firm). Dechow, et al (2000) states: *"it is not too surprising that systematically identifying earnings management in large samples is difficult._______academic research offers limited evidence of actual earnings management in part because of these measurement issues."*

3.3.2-Standard Normal Distribution (Burgstahler et al., 1997)

According to this method researcher set in advance a reference point of earnings and examine the distribution of reported earnings weather concentrated around reference point. Burgstahler et al.(1997) documented that low frequencies of small decrease in earnings and high frequencies of small increase in earnings exist which means earnings are manipulated up ward to meet particular target. This method is also used by Degeorge et al., (1999), Leuz at al., (2003), Du et al.,(2003) and Shen and Cheh(2005).

Like any other method standard normal distribution (SND) also has some weaknesses and criticism. First it does not measure properly the magnitude of earnings management. Holland (2004) commented that (1) results are sensitive to choice of intervals (2) symmetric assumption to frequency might not be justified and (3) statistically reliable results may not be obtained if the peak of distribution is adjacent to reference point.

3.3.3-Opinion Survey 2004. (Greek)

Baralexis 2004 used the opinion survey method to document the earnings management and conducted survey on a sample consists of independent accountants and auditors in Greek. The chief reasons he stated favoring this method are as under.

a. The other models of earnings management not include the opinion of practitioners who are actually witnesses of earnings management.
b. This method helps in identifying the actual motives of earnings management. These motives may be different from the contracting view on which academics tend to focus.

However this method is also suffering from certain draw backs including following.

a. On the basis of opinion survey the magnitude of earnings management cannot be determined.

b. No evidential support is available to re check the accuracy of responses.

c. Inherent limitation of sampling prevails in all opinion studies.

3.4-Tools of Earnings Management

3.4.1-Working Capital

The most widely used method of measuring earnings management (Dechow, et al, Abdullah et al) is accruals model which shows that widely used method applied is accruals. Burgstahler 1997 documented:

"We find evidence that both cash flow from operations and changes in working capital have been manipulated to increase earnings"

3.4.2-Rounding off

Carslaw 1988 concluded that firms exercise discretion to increase earnings when the level of earnings or earnings per share is slightly below a round number. Through rounding firms can change the perception of users of financial statements. Showing a figure as 495 or rounding to 500 changes the perception.

3.4.3-Transactions structuring

Baralexis (2004) documented the following tools of earnings management concluded on the basis of opinion survey from independent accountants and external auditors in Greek.

a. Full amortization of interest expenses for fixed assets purchased contrary to amortize according to useful life of asset in order to understate earnings.

b. No valuation of claims/debts in foreign currency in order to over or under state earnings.
c. Under/ over statement of stock volume
d. Under/over statement of sales invoices and early record or deferring of sales revenue
e. Fictitious invoices of repair and maintenance of fixed assets in order to understate earnings.
f. Over/under statement of purchases at year end.
g. Fictitious transactions between holding subsidiary (and associates)
h. No transfer of expenditure to fixed assets in order to avoid depreciation.
i. Sale and purchase back of fixed assets investments (listed shares) at year end.
j. More or less provision for bad debts
k. Under or over charge of depreciation than normal
l. Advance treatment of revenue yet to be earned or deferring the recognition of revenue earned
m. Reducing the purchase of fixed asset to specific limit where whole asset can be depreciated in same year.
n. False treatment of accruals and prepayments
o. Changes in inventory valuation methods.
p. Borrowing at year-end to improve liquidity
q. Short-term liabilities still shown as long term liability
r. Repair and maintenance of fixed assets capitalized.
s. Less or more provision for retirement benefits

3.5-Environmental assistance in earnings management

3.5.1-Legal deficiencies: One of the reasons of earnings management is legal deficiencies and failure of law to detect earnings management and protect the investors.

3.5.2-Unsophisticated users: All users of financial statements are not sophisticated enough to understand and interpret the financial information. According to conceptual framework financial information should be understandable by those who have the basic knowledge and willingness to understand the financial reports. It means financial reports are not intended to general public rather a specific group is targeted as users. Due to lack of understandability of financial reports by general public an opportunity arises for prepares to manage earnings.

3.5.3-Weak accounting profession: Accounting profession itself is not strong enough yet to eliminate frauds and protect stake holders and needs much further improvements. IASB is working on various projects including international harmonization. Accounting choices and room for professional judgments pave the way for manipulation of accounts. (See chapter 2)

3.5.4-Weak corporate governance: Corporate governance is not equally stronger in all countries. In certain countries in spite of stronger corporate governance cases of earnings management were found. However in other countries like china and Greec (Baralexis 2004) etc one of the factors assisting in managing earnings is weaker corporate governance.

3.5.5-Limited extent of external audit Although auditing is conducted to certify the faithful representation of facts about businesses yet many frauds were discovered later on. Why audit fails in discovering discrepancies? Generally audit is not conducted of all transactions rather it is conducted on test basis. If nothing found guilty in sample it is assumed every thing is in order in the firm. If whole transactions audit is to be conducted this will increase the cost of transparency and one has to create trade off between transparency and its cost.

3.6-How to Control

Earnings management conceal the true picture of underlying firm which is against the basic principle of accounting whereby the objective of accounting is true and fair presentation of facts. In this section I will explore the tools which are helpful in reducing the magnitude of earnings management.

3.6.1-Employee's Stock Ownership. One of the effective tools of controlling or minimizing earnings management is to increase the share of employee's stock ownership (ESO). By increasing ownership of employees firms can increase monitoring of managers. Jiraporn, (2007) documented in US environment with a sample of 138 Companies (observations) from 1996 to 1999 that firms with employee's stock ownership plan (ESOPs) witnessed lesser degree of earnings management. He further concluded that firms having outsider block equity holders in the co existence of (ESOPs) were in better control of earnings management than firms with alone ESOPs.[This conclusion is consistent with the findings of Park and Song (1995)].ESOPs can be used as tool to mitigate earnings management as it increases loyalty in following ways. First it provides long term career opportunity hence interest of share holders and employees are better aligned which increases monitoring and make it difficult for opportunistic managers to manage earnings. Second it provides defense against hostile take over.

3.6.2-Board Composition; Board of director is responsible for smooth running of business being the highest operational and policy making authority. If composition of board contains the persons well aware of technical knowledge and skills then much lesser chances of manipulation could be. Xi et al (2003) documented lesser earnings management in firms where board of directors was financially literate. Klein (2002) as quoted by Jirapom examined board of directors and finds that earnings management is hindered in firms with independent boards and financially literate audit committee.

3.6.3-Corporate take over defenses; Corporate takeover defenses (CTDs) include blank check preferred stock, poison pills, classified boards and dual class stocks. Jirapone 2005 documented after testing the hypothesis on a sample of 1621 observations covering the years 1993,1995 and 1998 in US environment, that blank check preferred stock and dual class stock does not materially helpful in mitigating earnings management rather dual class stock increases earnings management by 2.6% on average. However poison pills and classified boards are helpful in mitigating earnings management and on average poison pills reduced earnings management by 1.9% and classified boards by 1.5% during the period for the sample under examination. He further explains:

"The fact that blank check preferred stock and classified boards alleviate earnings management is consistent with the hypothesis that these two defenses offer more job security to management because they reduce the probability that management is replaced in the event of a hostile takeover. Managers, realizing that they will likely remain in their jobs for a while, are more prone to ponder the long-term benefits of the firm rather than engage in short-term window dressing by managing earnings. Besides, they are aware that accounting accruals cannot be sustained indefinitely. They will eventually unwind in the opposite direction. Hence, managers who expect to remain in the firm for an extended period of time should not be motivated to manage accruals aggressively because they will have to deal with the reversal of the accruals in a later period" (page 301)

3.6.4-Audit; One of the tools which can effectively help out in reducing earnings management is transparency and capacity building in auditing. At present an external auditor forms an opinion on the basis of examination of certain portion of transactions. What is sufficient in forming that opinion is entirely professional judgment of auditor. Should the professional bodies regulating audit not consider the quality and quantity of examination necessary before forming the opinion by its members and issue further guidelines. Also professional auditing bodies should draw a strategy to build the capacity of its members after every major scandal. Guan et al (1998) documented

"An audit can be most effective when the auditors understand the motivations and methods behind abusive earnings manipulation. When auditors have determined that incentives exist for the firm's management to manipulate earnings aggressively, they should look for areas where the manipulation is most likely to occur" (page 21)

3.6.5-Regulations; Rules and regulations as Sarbanes Oxley Act can effectively assist in reducing the magnitude of earnings management. Guan et al (1998) states

"Following the Enron and World- Com debacles, earnings management has attracted substantial attention from regulators, accounting academics, and the investment community. The Sarbanes–Oxley Act of 2002 is one significant step toward enhancing the quality of financial statements in U.S. government". (Page 19)

Depken II et al (2006) documented after studying the quarterly data from Q:1 1987 to Q:2 2005 of all firms listed on three major stock exchanges of United States containing 116,820 firm quarters, that there was decrease in earnings management up to 12%.

3.6.6-Private sector actors; Private sector actors like financial institutions, labor unions and others dealing with the firm can play a role in reducing earnings management. Banks can ask for appointment of its representative on the board and can also appoint its own auditors as per agreement. Guan et al (2008) documented

"Private-sector actors, such as banks, also have revisited their lending practices, specifically targeting the weak spots of borrowers' financial statements. To solidify the enhanced effort to improve the quality of financial reporting, it is important that more evidence be documented regarding the pervasiveness of earnings management" (page 19)

3.6.7-Business ethics; One of the tools to reduce the earnings management could be to have training of managers where ethics may be taught to them from time to time. Another aspect of ethics is that organization should have some ethical values and standards which would affect the behavior of all personnel within the organization. In this regard tone at the top is very important. It is the top level managers and directors who set, promote and implement the values. An interesting study conducted in this regard by Elias (2004) and documented

> "The results of this study supported the contention that corporate ethical values were important determinants of earnings management perception. CPAs employed in organizations with high ethical values were more likely to view earnings management actions as unethical compared to CPAs in organizations with low values. In addition, CPAs in industry viewed their organizations to have significantly lower ethical values compared to CPAs in public accounting and academia. The latter group generally perceived their institutions to have high ethical values" (Page 96)

3.7-Consequences of Earnings Management

1- Higher taxes payment if earnings are managed up ward as a result to arrange extra cash. (Erickson et al., 2004)

2- Higher cost of capital when earnings management /manipulation is made public. (Dechow et al., 1996)

3- Higher dividend payment pressure when earnings are declared higher.

4- Loss of credibility in the eyes of public when traced.

3.8-Conclusion and implications for Musharaka

Earnings management is an old phenomenon which is still continue with increasing magnitude and has reached at a level where integrity of financial reports is at stake (Wang, et al, 2008, Healy et al, 1999). It is a story of almost every society where research on earnings management has been conducted. It creates mistrust and bad name for the profession of accounting in the eyes of society. Earnings can be managed by violating accounting principles or without violation. Although much work has been done on detection of earnings management yet two aspects are still needed to be addressed in depth. First is to develop a consensuses definition of earnings management. Second there is a need to develop a method of measurement of earnings manipulation which could be used in detection and measurement of magnitude reliably.

Earnings management as discussed above means profit manipulation and showing lesser or higher than actual in order to meet some goal by preparers of financial reports. Motives of earnings management are very strong and will continue to effect the decision making of managers especially motive of compensation of management, reduced transactions' cost, meeting expectations of analysts, tax considerations and earnings smoothness to project the company as lesser risky. These practices of profit manipulation have significant impact on Musharaka financing and in fact discourage its application. Implementation of Musharaka is difficult in manipulated accounting environment. The whole contract of Musharaka is based on the principle of sharing out come which is depicted through profit and loss account. If accounting figures are manipulated, true outcome is not displayed, where does stand the share of Islamic Financial Institutions. Why IFIs will invest if true profit is not depicted?

Earnings management is not affecting much the operations of conventional finance as the return is fixed while it is affecting severely the IFIs because the whole business depends upon the result communicated through financial reports. For implementation of sharia based financing elimination or at least reduction in earnings management is essential. Through regulation, capacity building of auditing professionals, compensating management through stock ownership, creating an environment of job security for managers and financially literate board of directors' earnings management can be minimized. On the basis of evidences listed above I cannot reject hypothesis number two.

CHAPTER 4

OPINION SURVEY

Chapter Objectives

After reading this chapter, one should be able to understand and interpret:

a. What is the share of Musharaka in portfolios of IFIs
b. Why the Musharaka mode of financing is not popular according to different market players
c. How the share of Sharia based financing can be increased in comparison with Sharia compliance financing by IFIs

The chapter also tests hypothesis H3: Share of Musharaka financing in portfolio of Islamic Financial Institutions (IFIs) is low as compared to other modes of Islamic financing offered by IFIs as existing accounting and business framework is not conducive (favoring) to Musharaka financing.

Musharaka as defined by Islamic Fiqh Academy: "A relationship established under a contract with mutual consent of all involved parties that sharing of profits and losses will take place in a specified joint business venture. It is an agreement which the Islamic bank provides funds, along with funds from the business enterprise and others. All providers of capital are entitled to participate in management, but not necessarily required to do so. The profit is distributed among the partners in pre-agreed ratios, while the loss is borne by every partner strictly in proportion to respective capital contributions"

By analyzing the definition, it is evident that under Musharaka agreement return is not fixed for any of the player and each one has to share the outcome. However, 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 ratio can be varied based on actual outcome of the underlying project. In case of loss the principle of sharing is well established i.e. Loss to be shared according to capital contribution. Except

Musharaka and Modarba the return on investment under Islamic modes of financing too, is pre-determined and the financier knows well in advance its share. In cases of Musharaka and Modarba, risk is relatively higher as the return is uncertain and generally financiers are reluctant to invest under these schemes.

I designed a questionnaire to get the opinion of Islamic Bankers, businessmen and professionals on the issue as to why Sharia based financing which is the essence of IFIs is not as popular as Sharia compliance financing. This questionnaire consist of four parts: the first part addresses the issue of portfolio management by IFIs. Second part addresses the causes with weightage which create hindrances in the application of Musharaka financing. Part three addresses the responsibility sharing by each of the players for not getting the job done while part four was to receive suggestions for improved application of Sharia based financing. Part one and three was exclusively addressed to bankers and rest 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 six in total. Total number of respondents is 68 comprising of 30 top or middle level finance professionals, 17 Islamic banking professionals (middle and top) 15 enterprenuers and 6 academicians.Table 4.1 presents the summary statistics of part one.

Table 4.1-Descriptive statistics of percentage share of different products in Portfolios of IFIs based on industry average

Description	*Musharaka*	*D.Musharaka*	*Mudaraba*	*Murabaha*	*Ijara*	*Mortgage*
Mean	***0.001***	***0.15***	***0.12***	***0.4***	***0.22***	***0.112***
S. Deviation	***-0-***	***0.127***	***0.159***	***0.169***	***0.087***	***0.106***
Variance	***-0-***	***0.016***	***0.025***	***0.028***	***0.007***	***0.011***
C. Variation	**-0-**	**0.85**	**1.33**	**0.42**	**0.40**	**0.95**

Although much of the deposits of Islamic financial institutions are collected under Musharaka and Modarba however the investment side shows less than 1% of portfolios of Islamic banks working in Pakistan containing Musharaka as shown in table 4.1 while figure 4.1, 4.2 and 4.3 reflects the graphic presentation of results.

According to table, the lowest share in portfolios of IFIs is of Musharaka and the highest is of Murabaha which is 40%. The most popular financing method is Murabaha (40%) followed by Ijara (22%) then Diminishing Musharaka (15%). All of these agreements ensure predetermined fixed returns to IFIs, thus minimizing the risk. A smaller CV of Murabaha and Ijara also indicate that irrespective of size and clientele, all Islamic banks are more interested in Murabaha and Ijara The highest variation is in Musharaka as out of 6 figures the values was in one and five was zero hence data was inconsistent for application of CV and standard deviation.

Figure 4.1-Graph of Industry average percentage share of each product in portfolio of IFIs whereby 1,2,3,4,5 are representing Musharaka, diminishing Musharaka, Modaraba, murabha and Ijara respectively.

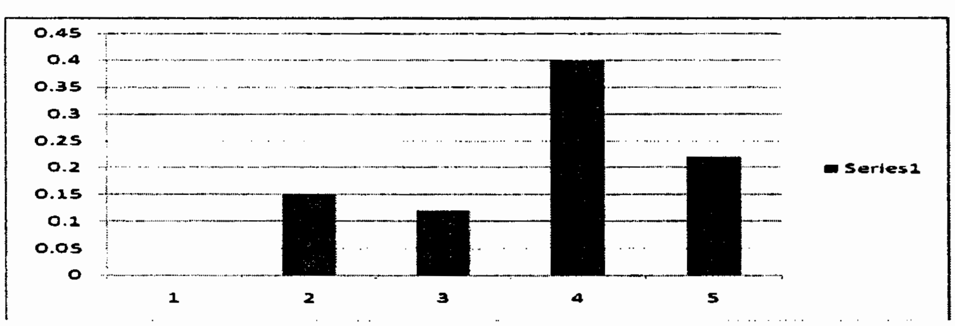

Figure 4.2- (next page) Graph of Standard deviations showing the variation of responses from average whereby 1,2,3,4 are representing diminishing Musharaka, Modaraba, murabha and Ijara respectively.

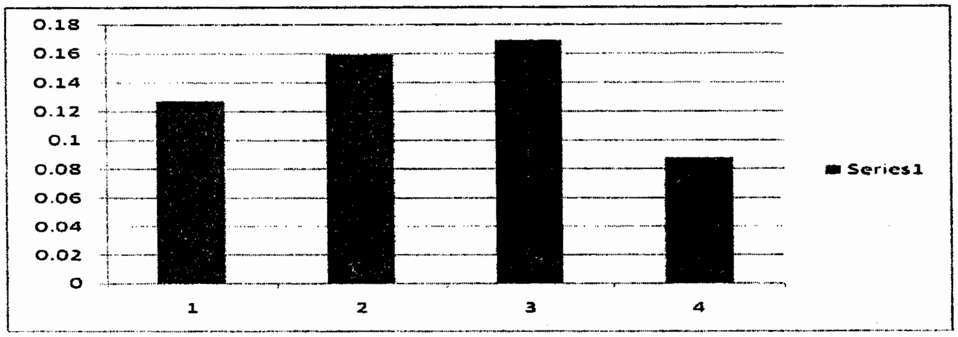

Figure 4.3- Graph of Coefficient of variation showing the relative variation of responses from average whereby 1,2,3,4 are representing diminishing Musharaka, Modaraba, murabha and Ijara respectively.

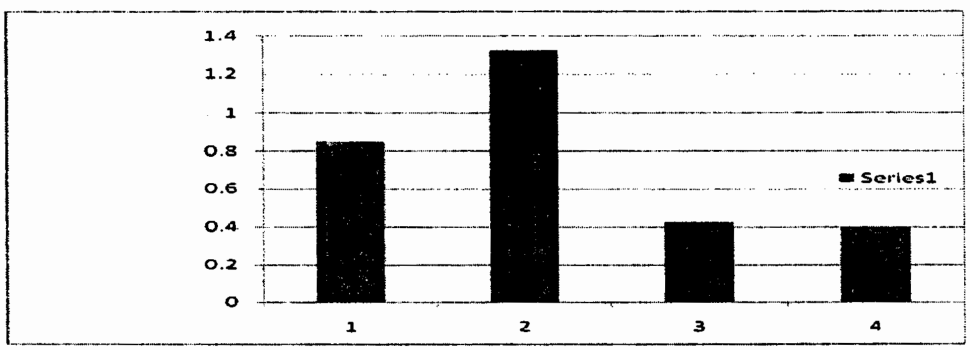

Table 4.2- The correlation matrix among different forms of financing.

-	DIMINISHING MUSHARAKA	IJARA	MUDARABA	MURAHBA	MUSHARAKA
DIMINISHING MUSHARAKA	1.00	0.10	-0.46	-0.33	-0.03
IJARA	-	1.00	-0.12	-0.51	-0.28
MUDARABA	-	--	1.00	-0.31	0.19
MURAHBA	-	--	-	1.00	-0.43

MUSHARAKA	-	--	-	-	1.00

Except for diminishing Musharaka and Ijara all others have negative relationship. Highest negative association is between Ijara and Murabaha which is justified that either a customer purchases an asset through Murabaha or Ijara for use. Although no pair of variables carries a strong relationship with any other however the negative relationships show that each product is somehow mutually exclusive.

Part two of the questionnaire was about the hurdles in the application of Musharaka financing. In this part, I identified the following 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.

1-**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 (Chapter 3). To my knowledge there is not a single country where research on profit manipulation is conducted and found clean. In every study, results confirmed that earnings are managed. (Baralexis, 1989, Beasley, 1996, Beaty, 2002, Beneish, 1999, 2001, Blake et al., 1996, Breton et al, 1995, Iqbal et al., 2009)

2-Confidence. The second hurdle which I 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 lack of trust and confidence in Musharaka partner.

3-Risk is the most vital factor from the banking point of view. For this study risk means variability in outcome. Bank has to manage and balance out the risk. If outcome is unknown then managing risk is an issue and cannot be mitigated through conventional methods. Under Islamic banking framework for risk management one has to look out of box. Risk also effects the savings mobilization through deposits.

4-Conventional accounting framework is the fourth factor identified which creates hurdles in the way of popularity of Musharaka financing. There are many loopholes in the conventional accounting framework which are exploited by opportunistic managers. (Chapter 2) Issues in financial reporting are well documented in the literature.

5-Higher taxes were identified as the fifth 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% only as compared to industrialized nation where it is 30% plus.[16] Number of tax payers is smaller and more burdens is borne by the people already in the tax net. Consequently higher tax rates are levied which leads to evasion of taxes. Baralexis (2004) identified in the Greek settings that low and medium size firms were engaged in earnings management to avoid taxes.

6-Dominant Conventional Banking was identified 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 of Islamic banking in Pakistan is around 3%[17] only. hence lesser access to capital market, lesser resource mobilization, and lesser manpower expertise. In fact Islamic banking industry is at infant stage, alhthough growing rapidly. Due to the dominance of conventional banking, even product pricing of Islamic banks is also linked with KIBOR which has been criticized by many sectors of society.

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

7-Weaker Auditing is another hurdle in the promotion of Islamic banking. In fact a transparent audit system can play the role of a catalyst in the promotion of Sharia based transactions. After all, the objective of audit the detection of errors and frauds. Auditing institutions in less developed countries are also not playing their due roles because of overall ethical practices of businesses. An auditor has to practice in the same society and is affected by the level of corruption or transparency in the society. S/he is also affected by the level of ethical or unethical practices prevailing in society.

Now I will share the opinions of experts on these issues. Each question was clearly displaying the importance for every factor from 0 to 4 whereby 0 means no weightage and 4 means the highest. Results of the study are summarized in Table 4.2. Columns 1, 2 ,3 ,4 ,5 ,6 and 7 are representing profit manipulation, lack of trust and confidence, riskiness, conventional accounting framework, higher income taxes, dominant conventional banking and weaker auditing respectively.

Table 4.3- Descriptive statistics of hurdles in the way of Musharaka Popularity

Description	*1*	*2*	*3*	*4*	*5*	*6*	*7*
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*
Skewness	*-0.65*	*-0.43*	*-0.46*	*0.16*	*0.03*	*-1.21*	*-0.34*
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*

As per Table 4.3 the highest average of 3.07 out of four represents the dominance of conventional banking (column 6). This means that the most influential factor or chief hurdle in the way of promotion of Sharia based financing is conventional banking. The second highest number is of the risk factor (column 3). Market opines that Islamic banks are not investing on profit and loss sharing basis due to the risk factor. Third position is of the profit manipulation by business firms (column 1). Fourth is the lack of trust and confidence in ability of Musharika partner (column 2) and fifth is the audit (column 7) while sixth is conventional accounting framework (column 4) and seventh is the higher taxes (column 5.

Table 4.4 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 Musharika 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 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 4.4, I list the factors according to their importance. 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 the dominance of conventional banking which is the chief hurdle in the way of Islamic banking.

Although the higher CVs of almost every factor shows that there is no consensus among the experts (relative dispersion among the respondents is very high). Mean is not very true representative of responses but in this type 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 important. As for CV is concerned although variation among the responses is very high in all factors however lowest CV (comparatively) is of conventional banking dominance which shows relatively better consensus among respondents. Highest CV is of conventional accounting framework which is placed at number six in ranking showing that the dispersion is very high and respondents think differently. If one of respondents is weighing conventional accounting framework as 4, the other may be giving it a score of zero.

Figures 4.4, 4.5 and 4.6 show the graphic presentation of results. Columns 1, 2 ,3 ,4 ,5 ,6 and 7 are representing profit manipulation, lack of trust and confidence, riskiness, conventional accounting framework, higher income taxes, dominant conventional banking and weaker auditing respectively.

Figure 4.4- Graph of averages from Table 4.2

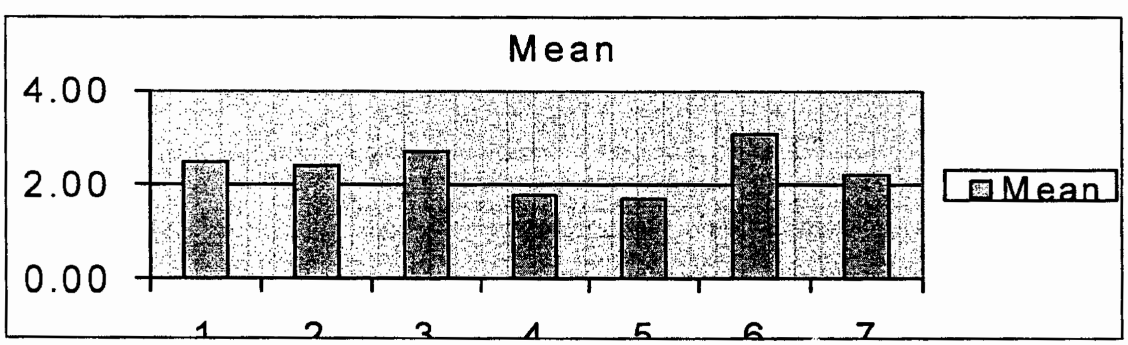

Figure 4.5- Graph of Variance from Table 4.2

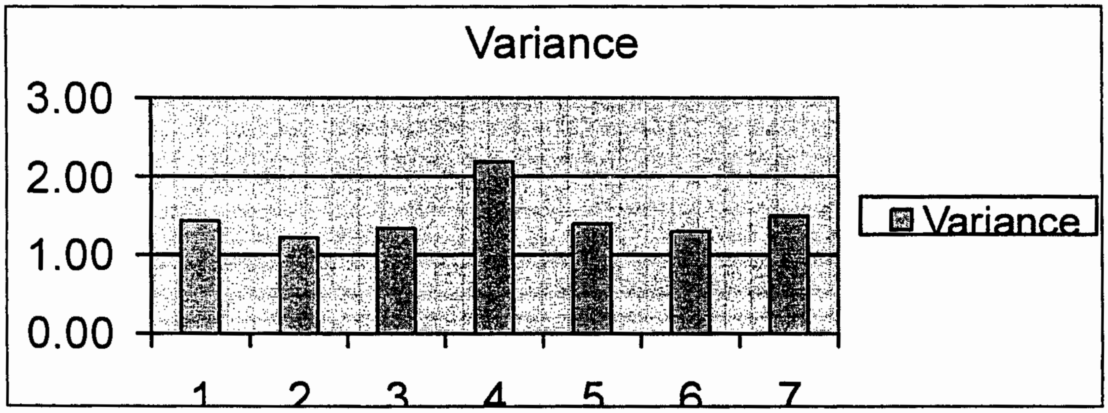

Figure 4.6-Graph of Co-efficient of Variation from Table 4.2

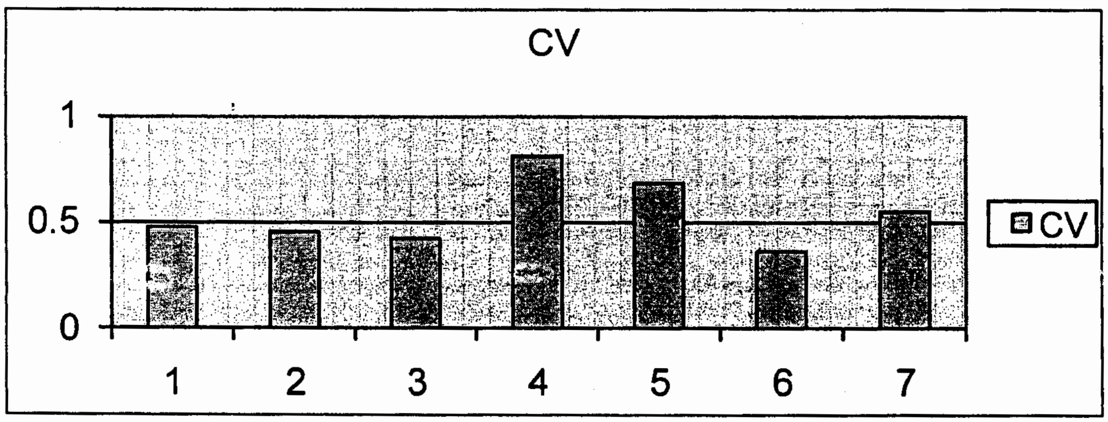

Table 4.5 shows the correlation between the variables

-	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 Banks	-	-	-	-	-	1.00	(0.03)
Weak Audit	-	-	-	-	-	-	1.00

Table 4.5 shows the mutual Correlation results of all factors. No significant correlation is found between any set of variables. Highest correlation is 0.44 between conventional accounting framework and weaker auditing. Lowest is -0.02 between conventional accounting and profit manipulation Rests of the combinations are also not representing relatively significant relationship.

Part D 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 tools and higher on Sharia Compliance) of each of the three market players in Islamic financial system i.e. supplier of funds (depositors), management of IFIs and users of funds (business & industry). This question was asked from only Islamic bankers and not from others 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 4.6.

Table 4.6- Descriptive statistics of relative share of responsibility by 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
Mode	0.40	0.20	0.20
Variance	0.05	0.01	0.08
CV	0.64	0.71	0.66

The highest responsibility share 0.44 of unpopularity is put upon business and industry with variance of 0.08 then management of IFIs with average of 0.36 with variance of 0.05 and least is depositors with average of 0.14 and variance of 0.01. Although directly depositors are not prohibiting IFIs to invest in Musharaka yet a pressure for profit on deposits is upon IFIs. This obliges IFIs to mitigate risk from return. Under Musharaka return is not predetermined which increases the risk. Coefficient of variation is highest for depositors' that means difference of opinion of higher degree exists among the respondents. CV of one and three is also very high again displaying lack of consensus among respondents. Graphic presentation of results of table 4.5 are shpwn in figure 4.7, and 4.8.

Figure 4.7- Histogram of average results presented in table 4.5.

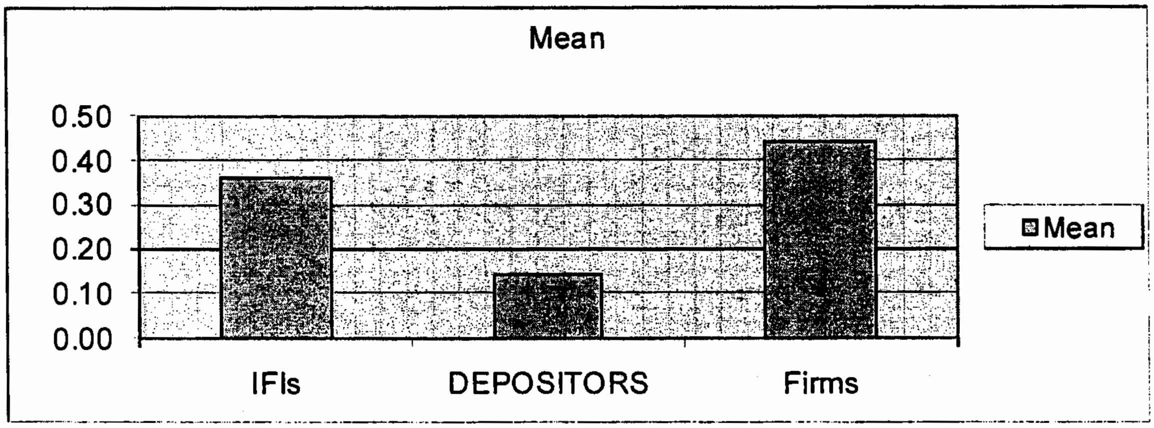

Figure 4.8- Histogram of CV results s presented in table 4.5.

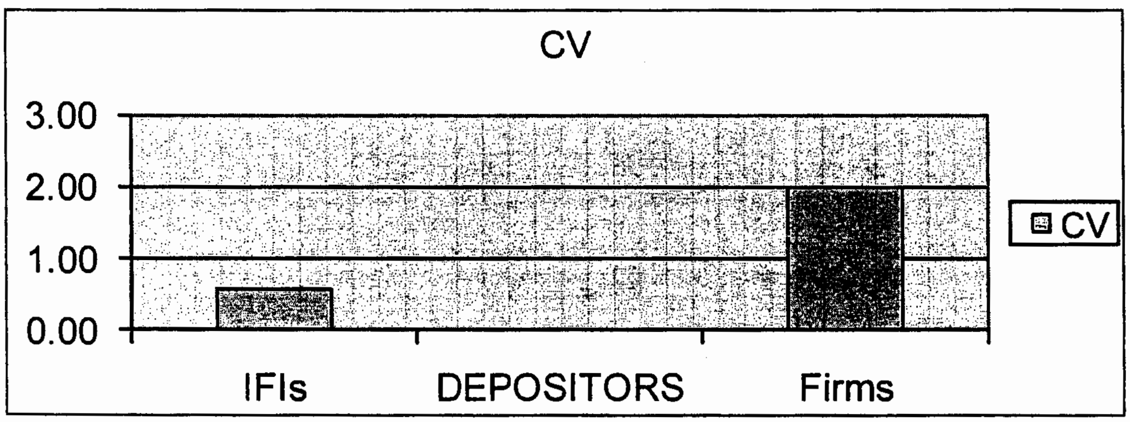

Table 4.7Correlation Matrix of Variables

-	***DEPOSITORS***	***FIRMS***	***IFIS***
-			
DEPOSITORS	1	- 0.39228	0.066269
FIRMS	-	1	-0.86605
IFIS	-	--	1

4.1 Recommendations

Part F (appendix 01) of questionnaire was about recommendations for improved application of Musharaka by respondents. In this section, I received valuable suggestions and I grouped them as follows: .

1-Awareness among masses

2- New products development

3- Capacity building of IFIs

4- Regulations by SBP

5- Improvements in financial reporting

6-Role of Government & Society

7-Miscellaneous

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 is recommended by the highest number (41) of respondents through awareness seminars, advertisements, workshops and inclusion in syllabus of business and finance students/professionals. Better links should be created with customers by educating them through seminars, trainings and workshop. One major misconception needs to be removed on urgent basis that is the difference of conventional and Islamic banking.

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

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 shall certainly help in boasting the 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 board of director's member of partner firm. **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.

Accounting Framework. Reforms in 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 cost of financing should be reduced.

Documentation of the accounting records should be made compulsory for business and general documentation of economy should be observed strictly.

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 whole financial system is a dream. In order to promote Musharaka financing, Government should give certain incentives including lower taxes, favorable laws, transecting business with IFIs, and serious efforts to exclude interest from the economy 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 of general uplifting of moral values of society.

Miscellaneous Banks should be owned by government and NGOs so that service 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 de linked 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.

To conclude, the results of opinion survey confirms that the share of Musharaka is negligible in portfolios of IFIs and more focus is upon Sharia compliant financial tools while lesser or nil emphasis on Sharia based financial tools. IFIs are using Murabaha, Ijara and diminishing Musharaka where return is fixed in advance and the outcome is certain and finance is secured. This is a form of debt based 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 identified in this study include the risk level in Musharaka, profit manipulation behavior of businesses, lack of trust and confidence in the ability of Musharaka partner, manipulations of accounts 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, granting tax incentives, capacity building of IFIs, fostering by SBP and new products development with focus on small and medium enterprises under Musharaka principles, Sharia based financing can be promoted. On the basis of evidence documented above, we cannot reject hypothesis number three.

CHAPTER 5

CONCLUSION

Chapter Objectives:

After reading this chapter, one should be able to understand and interpret:

a. What are the aims and findings of this research?

b. What is the practical application of these findings?

c. What were the limitations of this study?

d. What are the areas identified for future research

Accounting information system is key to decisions and much of accuracy of these decisions depends upon relevant and reliable provision of information through financial reports. The modern accounting framework is much complex and requires some specialized knowledge to understand the accounting reports including income statement. Traditionally annual report is prepared by firms at completion of one year of operations which consists of a set of financial reports certified by independent auditors including income statement, balance sheet, cash flow statement and statement of owner's equity. Annual report also contains directors' report to users of financial statements and notes to financial statements necessary to understand the figures reported at the face of financial reports. How these figures are generated? What are the principles behind the recognition and measurement of revenue? Valuation of assets? etc;etc.

Accounting framework has developed certain principles and conventions over the years. These principles,(including business entity, going concern, historical cost, stable currency, materiality, matching and accruals) are the foundations for recognition and measurement of accounting revenues, expenses, assets and liabilities. The decision to recognize the revenue and expenses has implications for profit calculation which is the ultimate share of IFIs. Generally accepted accounting principles (GAAP) in US, and International Financial Reporting Standards (IFRS) are the two major sets of international accounting standards in addition to standards and guidelines issued by numerous local accounting bodies of world. Accounting standards are guiding principles for accounting professionals responsible to prepare books of accounts. By looking at the issues raised in this study it is concluded that under present framework true profit of the organization cannot be calculated. There are number of loop holes through which accounts can be manipulated and they are manipulated by the management in order to fulfill their objectives. These loop holes have opened the way for creative accounting as concluded by Baralexis (2004) in Greek settings "the result of the study indicate that creative accounting is practiced in Greece frequently, and to a considerable extent, mainly with the blessings of law".

In the absence of clearly defined procedures relating to transactions and suggestion of number of alternative options to adopt for a particular transaction increases the subjectivity in accounting reports which is depicted from following remarks of Daniel (2006) "Financial reporting rules require that managers make a significant number of subjective decisions when reporting accounting information to investors. As standard setters attempt (at least nominally) to move towards "principle-based" standards, while embracing such concepts as "fair value accounting" for assets and liabilities that are not actively traded, it seems likely that the subjectivity in accounting reports will continue to rise".

While it is proved that under existing framework of accounting, profit calculation is subjective then question arise that share of Islamic bank in profit of client, calculated under present general purpose accounting framework, stands where. Can we say the objective of justice which is the only reason for establishment of Islamic financial institution is fully met through Musharaka financing? Of course not!

Profit calculation process is very vital in sharia based financing. As well known under Musharaka return of the Islamic Financial Institution is depending upon the out come of underlying project and not fixed. Accounting is the language of business as it communicates the results of operation to the investors. If accounting frame work is not transparent enough and failed in overcoming its weaknesses. Consequently no chance of fair result depiction and false results cannot be over ruled. While profit calculation process is not transparent enough Islamic financing cannot be done. Now the issue is what to do? After all Islamic financing has to grow in the existing society and firms will continue profit calculation under conventional accounting frame work mainly due to no availability of any guidance under Islamic frame work and also as legal requirements of local laws.

Keeping in view the above discussion we suggest that AAOIFI should look into the matter and prepare guidelines for businesses dealing with Islamic financial institutions under Musharaka financing for preparation of a special set of accounts and earnings calculation to determine the share of Islamic banks. Existing accounting standards are providing guidance to Islamic Financial Institutions only.

Earnings management is an old phenomenon which is still continue with increasing magnitude and has reached at a level where integrity of financial reports is at stake.(Wang, et al, 2008, Healy et al, 1999) It is a story of almost every society where research on earnings management has been conducted. It creates mistrust and bad name for the profession of accounting in the eyes of society. Earnings can be managed by violating accounting principles or without violation. Although much work has been done on detection of earnings management yet two aspects are still needed to be addressed in depth. First and the foremost is to develop a consensuses definition of earnings management and separate it from fraud. Second although in different phases different measuring methods are used and improved yet no method is above criticism which makes the findings skeptical. There is a need to develop a method of measurement of earnings manipulation which could be used in detection and measurement of magnitude reliably. Earnings management as discussed above means profit manipulation and showing lesser or higher than actual in order to meet some goal by preparers of financial reports. Motives of earnings management are very strong and will continue to effect the decision making of managers especially motive of compensation of management, reduced transactions' cost, meeting expectations of analysts, tax considerations and earnings smoothness to project the company as lesser risky. These practices of profit manipulation have significant impact on Musharaka financing and in fact discourage its application. Implementation of Musharaka is difficult in manipulated accounting environment. The whole contract of Musharaka is based on the principle of sharing out come which is depicted through profit and loss account. If accounting figures are manipulated, true outcome is not displayed, where does stand the share of Islamic Financial Institutions. Why IFIs will invest if true profit is not depicted?

Earnings management is not affecting much the operations of conventional finance as the return is fixed while it is affecting severely the IFIs because the whole business depends upon the result communicated through financial reports. For implementation of sharia based financing elimination or at least reduction in earnings management is essential. Through regulation, capacity building of auditing professionals, compensating management through stock ownership, creating an environment of job security for managers and financially literate board of directors' earnings management can be minimized.

Results of opinion survey confirm that share of Musharaka is negligible in portfolios of IFIs and more focus is upon Sharia compliant financial tools while lesser or nil on Sharia based financial tools. IFIs are using Murabaha, Ijara and diminishing Musharaka where return is fixed in advance and outcome is certain and finance is secured. The major hurdle in the popularity of Musharaka financing is dominance of conventional banking and this hurdle can be removed only through the expansion and growth of IFIs. Other factors identified in this study includes the risk level in Musharaka, profit manipulation behavior of businesses, lack of trust and confidence in ability of Musharaka partner, manipulations of accounts under conventional accounting framework, relatively higher taxes, weaker auditing and lack of awareness among masses about philosophy and operations of IFIs. Through increased awareness, granting tax incentives, capacity building of IFIs, fostering by SBP and new products development with focus on small and medium enterprises under Musharaka principles Sharia based financing can be popularized.

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 include comparative study of IFRS and AAOIFI accounting standards, earnings management in Pakistan, earnings management by partners of IFIs, valuation of Islamic securities, corporate governance of IFIs, and legal framework for IFIs and application of AAOIFI Standards by IFIs.

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Appendix

Dear Sir,

Assalam-o-alikum

Islamic banking is growing at a rapid speed all over the world. However the share of Sharia based transactions (Musharaka and Modarba) is very low as compare to Sharia compliance transactions (Murabha, Bai Muajal etc) which creates doubts in the minds of ordinary Muslims about the difference between Islamic and conventional banks. This study is planned to identify the factors which create hindrances in application of Musharaka financing. My hypothesis is as under.

"Share of Musharaka financing is low as compared to other modes of Islamic financing offered by Islamic Financial Institutions (IFIs), as existing accounting framework is not conducive (favoring) to Musharaka financing"

Kindly take some time out of your precious moments (busy schedule) to answer the following questions and assist in forming the opinion. I assure you the confidentiality of responses.

Your co-operation is highly appreciated in anticipation.

With regards

Truly yours

Muhammad Hanif FCMA
Assistant Professor
FAST Business School
Islamabad.
Ph. 0300-5529495

A-This section "A" is optional.

Name (optional)____

Age (in years)__________________Qualification__________________

Experience (in years)________

Organization name (optional)____

B- Kindly state (if applicable) the % share (in financing portfolio of your firm) of multi-products offered by Islamic Financial Institutions (IFIs) to finance the business and industry operations. (Total should not be more than 100%)

1. Musharaka__________ 2. Diminishing Musharaka______________
3. Mudaraba__________ 4. Murahba____________
5. Ijara______________ 6. Mortgages (Housing Finance)___________

C-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 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

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

1.
2.
3.