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Time for Paradigm Shift in Islamic Finance Industry and Economy: Concepts of Profit, Loss, Enterprise Performance-Measure

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ABSTRACT

The growth of Islamic Finance (IF) is hindered by non-conducive environment globally despite acceptability, efficiency and effectiveness of its products and services. The elements of non-conduciveness are bedded in the accounting methodology, tax- deductibility of interest expenses on bank loans, over-helming use of credit by households, businesses and governments, excessive use of leverage in banks, yielding disproportionately higher ROE (Return on Equity), resulting in global debt trap and extreme inequality in income and wealth distribution. Islamic finance if used properly by reforming the existing financial architecture and regularity environment can provide a sustainable basis for higher economic growth by encouraging private enterprises in Muslim and other countries by reducing deceit and corruption and increasing social capital through building trust. This will make the world a better place for humanity and avoid the impending threats from environmental and manmade disasters. This paper is based on secondary sources of information collected from publications of papers, research monograph, books and author's own works done at Manchester Business School (MBS), Manchester, UK, 1974-77.

Key words: Accounting Methodology, Islamic Finance, Debt Culture, Income Inequality, Paradigm Shift

I. INTRODUCTION

Islamic Finance (IF) is said to have made good progress over the last two-three decades especially in the Islamic world where majority of the population

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are Muslims. However growth in IF has been rather slow relative to the overall global finance. So far perhaps it has not attained more than 5% of the global financial flows given that the population in the Islamic world exceeds 20% of the world population of 6 billion.

So far the literature on the subject has been concerned mostly for identifying the types of activities that are covered under Sharia laws such as Mudaraba, Muajjal, Salam sale, Ijrah, Musharaka, Sukuk etc. " Islamic banks provide such facilities by applying trading mode and very negligible amount has been provided by applying Musharaka and Mudaraba contracts."[i] There is also a premature argument as to the concept of profit maximization in Islamic Commercial Banking vis-a-vis social welfare responsibilities.[ii]

The confiscatory and destructive nature of the conventional banking that brought the near collapse of the financial system in 2008 gave impetus to IF. The Islamic world was less affected in the financial crisis originated in USA. There after Islamic finance has drawn attention of the western countries especially for long term funds- Sukuk bonds. The conventional banking system with extremely high leverages have earned very high return on equity and is primarily responsible for creating the inequity in income distribution against the poor(1% vs 99% syndrome) all over the world. This is the result of an exploitative nexus between dominant business owners, highly paid executives, tax avoiding legal and accounting environment and political cronyism.

This researcher has been aware of the nexus mentioned above ever since his doctoral studies at Manchester Business School (MBS), UK, 1974-1977[iii]. The period of high inflation in the industrialized countries created some awareness on the methodological short-comings of the historic cost accounting system and some adjustments were proposed and adopted to solve the problem, e.g. the Sandilands Committee Report in UK, 1975[iv]

It was noted that "as for direct financing by banks is concerned, share of Profit and Loss Sharing (PLS) based modes of financing is very negligible, primarily due to non-conduciveness of business environment." [v] The most important non-conducive business environment is the way conventional measure of profit is estimated under GAAP and methodological deficiencies that encourage over reporting of profit by not charging full cost of asset use and also its transfer to tax havens to avoid paying applicable taxes by corrupt means. That is, profit is not measured in accordance with an economic concept, such as the Hicksian concept of income. Under that concept "income is that part of the growth in the value of the assets that can be withdrawn from the enterprise without making it better-off or worse off."[vi] A somewhat closer methodology of the concept of economic profit could be "cash flow earnings or "free cash flow" that underlies valuation of enterprises for investment. Discretions allowed under conventional accounting methodologies and the scope given to policy makers to manipulate profit is quite pervasive. Even the practice of tax deductibility allowed for interest on loans is a mechanism to increase income of the rich depositors in conventional banks and government borrowing to finance budget deficits at high rate of interest in a linked manner as shown below.

1.1 Public Debt and Related Issues

This culture of debt financing by governments and companies has put the world financial system in what is termed as The Global Debt Trap.[vii] Just to note as an example how the US public debt increased over the last five/six years to $19.00 trillion from $10 trillion in 2010. In 2007 public debt as a percentage of GDP was 2.7% and it rose to 10.7% in 2010 and 8.9% in 2011 in USA.[viii] Failing banks were bailed out by public money. Banks were also allowed to earn interest on Treasury Bills in a risk free manner by an act passed by the Bush government knowing the upcoming financial meltdown in USA. Reportedly $30.0 billion was earned by banks in that process. Since the financial crisis the USA and other industrialized countries have followed a monetary policy of Quantitative Easing (QE) in which liquidity in banks was increased by the process of "buying back government debts". That resulted in bringing down interest rates closer to zero and helped to restrict further rise in public debt. By the end of 2014 the size of combined debts of house hold, corporation and government amounted to over 150-250% of GDP of USA, UK and Japan. Japan is the most heavily indebted country in the world. The QE mechanism has brought interest close to zero or even negative in Germany and Japan. This is the result of accumulation of financial wealth in the hands of limited number of families comprising old bourgeoisie class who have been joined by corporate elites, mostly in banks. [ix] He showed how R>G for a long time where R= ROE (Return on Equity) and G= growth rate in GDP. In that famous book Picketty suggested progressive taxation on income and wealth tax to minimize the gap between the rich and the poor (9 op cit.)

That kind of a financial architecture provides the foundation for interest based lending and borrowing. This needs to be changed for Islamic Financing to flourish globally and for sustained economic growth in equitable manner.

II. OBJECTIVE OF THE PAPER

This paper is aimed at presenting the methodological deficiencies of conventional accounting and suggest to bring a paradigm shift in profit calculation and tax policies to encourage full disclosure of economic profit or loss. This will set a level-playing field for all banks, conventional and Islamic and reduce the level of corruption in the corporate world in all countries and improve standard of living for the masses. The current system of financing industry and trade is simply not tenable as it is leading to higher level of concentration of wealth, destruction of the physical environment and human values through increasing natural disasters and manmade poverty of the masses.

Why slow growth of IF: Review of a study in Pakistan

The authors cited above Hanif and Iqbal conducted a survey of professionals in 2010 "to get input of the market about lesser popularity of Musharaka (more like a company with unlimited liability of the shareholders) and documented following hindrances in the way of Musharaka financing" in Pakistan. The findings are reproduced below: [x]

TABLE 1

HURDLES IN THE WAY OF MUSHARAKA FINANCING IN DESCENDING ORDER AT SCALE OF ZERO TO FOUR

Rankings	Factors	Mean	CV
01	Dominance of conventional banks	3.07	0.37
02	Risk of Musharaka Financing	2.70	0.43
03	Profit Manipulation	2.50	0.48
04	Lack of trust and confidence in 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

Source: Hanif and Iqbal, 2010

To increase Musharaka financing professionals suggested among other things modification of accounting methods to align with sharia law for financing, favorable regulation for Musharaka financing and general uplift in moral values of society towards honesty and transparency.[xi]

It may be mentioned that the dominance of conventional banking is due to the provision of tax deductibility of interest on loans as an expense that reduces cost of capital of enterprise. The mean score of 3.07 out of 4 indicates that to be the biggest hurdle with CV of 0.37. The deductibility of interest paid on loans is legal in all countries. The leverage thus allows equity multiplier and higher RoE.

Banks normally have Return on Assets of 1.0-2.0 %. However RoE realized is much higher 10-15% through equity multipliers.

Cost of capital from debt and equity

The discriminatory treatment of interest paid on loans for tax purposes has created the rising debt culture in all countries. It was argued long time back to put the two sources on the same footing.

To put debt and equity on equal footing it was stated by the famous Accounting Professor of Harvard University, Anthony R.N. "like interest on debt dividends paid to shareholders should be made tax deductible for corporations." [xii] That would make corporate executive less powerful in investment making and encourage them to raise equity from the capital market rather than internally through retained earnings. That practice of subsidizing cost of capital through tax allowance for interest on bank loans was started long time back to allow supposedly small depositors in banks to participate in investment in industry and trade. It is no longer necessary as small investors can now buy shares in mutual funds (at least they should be encouraged to do that for higher returns) rather than earn low fixed rate of interest on bank deposits. This has allowed dominant shareholders and bank executives to magnify their incomes manifold. It may be mentioned that in capital budgeting Discounted Cash Flow (DCF) method does not require interest on loan in project funding as a charge as Internal Rate of Return (IRR) include the returns to both debt and equity. [xiii] Simon Beningo.

The culture of debt

Further, borrowing by governments from banks at high rates of interest to meet budget deficits as a result of low tax revenue of governments. In Bangladesh BD, for example, interest expense was 13% of national revenue budget in 2015 and it is rising year after year. Official statistics indicate the number of high income people in Bangladesh to be over 20 million out of total 150 million. It is a poor country with per capita income of $1400 only. The total number of people paying income tax is less than 1.5 million! Governments in Pakistan and Bangladesh are weak and represent mostly the richer classes and they do not raise tax revenues to avoid conflict with the political and business elites. Rather encourages rising public debt from the richer class which again leads to rising concentration of wealth in a risk free manner. [xiv] Budget of the Government of Bangladesh 2015.

Accounting methodological deficiency

In the same manner poor accounting and auditing standards help to dodge tax payments that are well known in the Islamic countries such as Bangladesh, Pakistan, India and other Muslim countries in Africa. Technically there are two sources of accounting faults. One the charging of depreciation on historic cost of the asset and FIFO (First in First Out) method of inventory costing. It was demonstrated that even in the absence of inflation historic cost depreciation under estimates economic depreciation (annual capital charge) by 63% if cost of capital was 10% per year and the life of the asset was 10 years.[xv] Hence replacement cost of assets is not recovered in product prices and new capital is raised from the market to maintain production capacity. FIFO method also results in higher accounting profit when there is rising prices and/or real growth in production and sales. "In short when accounting profit is rising earnings measured in cash flow terms was declining creating shortage of funds and forcing companies to borrow."[xvi] In the Table above high taxes on enterprises as a hindrance scored 1.7 only. This is perhaps due to misunderstanding by the respondents on the magnitude of income tax on accounting profit rather its cash flow consequences. It is low because companies try to adopt corrupt means to reduce actual tax burdens on cash flow terms by manipulation of profit as shown in the table scoring 2.5 out of 4.0.

The Long Divergence of Middle East: good or bad

The upshot of the discussion above is that there is high degree of failings in the moral values and ethical standards globally that is inconsistent with Islamic values. Islamic Finance (IF) cannot actually thrive under such biased, fraudulent and demoralizing environment. Reading an important book by Timur Kuran, The Long Divergence,[xvii] one gets an impression that Islamic Laws and culture held back the Middle East when the western societies made rapid progress with favorable legal system that encouraged formation of corporations in banking and non-banking business sectors since golden years, after the 10th century (Kuran 2011). However a critical look into the way the west has reached its present heights in materialistic achievements going against the main dictums of major religions warrants rethinking that the Islamic world might have done better than the west maintained Islamic values under the colonial rules. Islam requires believers to have peace in this world and the eternal bliss after death by living by the code of Islam. There is little doubt that in the long term Islam and IF will prevail to bring humanity to the destiny predicated in the holy book- Al Quran. We must restate our beliefs in what is said in the Quran, particularly the last sentence in Sura Fateha. May Allah keep us on to the path of those who are blessed and avoid the path followed by those who have gone astray (Duallin) (Jews and Christians).

Emerging of new alternate models of financing

We know the failure of the traditional banking models to reach the masses. MFIs (micro finance institutions) led by Grameen Bank of Bangladesh has revolutionized not only the flow of funds among the poor but also ownership structure by the poor borrowers against the big banks with little or no defaults in lending. Muhammad Yunus the pioneer of the movement of the banks for the poor is now propounding the Social Business model targeting to solve social problems by small business enterprises with small savings.[xviii] Mobile phone and related technologies are expanding the horizon of banking to the same group by offering on –line services threatening the traditional banking model. Fintech clubs started in Silicon Valley and London are bypassing the banks and offering investment financing at much lower costs.[xix] It is time now that we set the architecture of IF right on the moral values and ethical norms. We need a paradigm shift as new knowledge is created by revolution as propounded by Kuhn.[xx]

To do that we should work on the following lines of actions by the World Bank group that has organized the conference on Islamic Finance in Morocco 2016. We need bold and systematic reforms as follows:

1. Accounting system in enterprises should be designed on cash flow basis. If they continue to use conventional accounting they should estimate "free cash flows" after adjustmentswhich is the underlying basis for valuation of securities and assets in general.
2. Governments should be convinced to recognize the new system for IFIs and projects financed by them on Musharaka method.
3. Estimated cost of capital for both equity and debt should be treated as allowable expenses for tax purposes for all enterprises be they are financed by Islamic Financial Institutions (IFs) or not. Tax laws need be changed.
4. Annual capital charge method should be applied to estimate depreciation allowances for fixed assets purchased by the enterprises funded by IFIs.
5. Books of accounts maintained at enterprises should be transparent and full disclosure principles be adopted for investors. Software-based continuous auditing models be introduced instead of periodic audits.
6. Governments in Islamic countries should encourage expansion of IFIs, rather than hold them down under one pretext or other. Governments should start borrowing from IFIs through Sukuk bonds.

7. IMF(International Monetary Fund) should try to change tax policies to raise more revenues through direct taxes rather than VAT (Value Added Tax). IMF should also lower limits of public borrowing to 2-3% of GDP from existing 4-5%.

8. IFIs should target products and markets to solve social problems such as water supply and sanitation, transportation, health and education, agriculture, housing, green energy etc.

9. While Sharia Councils are guiding the laws in IFIs the World Bank group should form a task force or consultative group in each country for the fundamental changes listed above and some others.

10. The World Bank group should set a time-frame of progress for the next three years for IFIs expansion globally.

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