

GOVERNMENT OF PAKISTAN
SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN

Islamabad, the 24th August, 2005.

NOTIFICATION

S.R.O 865(I)/2005.— In exercise of the powers conferred by sub-section (3) of section 234 of the Companies Ordinance, 1984 (XLVII of 1984), read with clause (c) of section 43 of the Securities and Exchange Commission of Pakistan Act, 1997 (XLII of 1997), the Securities and Exchange Commission of Pakistan is pleased to direct that the Islamic Financial Accounting Standard 1, annexed to this notification, issued by the Institute of Chartered Accountants of Pakistan, shall be followed in regard to the financial statements prepared in the context of historical cost convention while accounting for Murabaha transactions undertaken by a bank as defined by the said Standard:

Provided that the Commission may, of its own motion or upon an application made to it, grant exemption to any company or any class of companies from compliance with all or any of the requirements of the aforesaid Standard.

ISLAMIC FINANCIAL ACCOUNTING STANDARD

IFAS 1 MURABAHA

**The Institute of Chartered
Accountants of Pakistan**

ISLAMIC FINANCIAL ACCOUNTING STANDARD

IFAS 1 MURABAHA

1. Background

- 1.1 Since early eighties banks and similar financial institutions (referred to as "bank(s)" in the Standard) in the Islamic countries have been faced with the problem of financing different sectors of economy through modes which do not contravene the injunctions of *Shariah* regarding *riba* or interest.
- 1.2 One of the most popular modes used by banks in Islamic countries to promote *riba* free transactions is Murabaha. The ratio in which this instrument is being used varies from bank to bank.
- 1.3 Basically Murabaha is a particular type of sale. Ideal mode of financing according to *Shariah* would be Mudarabah or Musharakah. However, in the perspective of the current economic set up there are certain practical difficulties in using Mudarabah and Musharakah instruments in every type of financing. Therefore, the contemporary *Shariah* experts have emphasized on Murabaha basically as a trading mode of transaction but in the contemporary context, the use of Murabaha subject to certain conditions on deferred payment basis has been allowed as a permissible mode.
- 1.4 It should be emphasized here that the instrument of Murabaha should be used as a transitory step taken in the process of the Islamization of the economy, and its use should be restricted only to those cases where the Mudarabah and Musharakah are not practicable.
- 1.5 The second important point is that the Murabaha transaction does not come into existence by merely replacing the word "interest" by the words "profit" or "mark-up". Unless basic conditions as laid down by *Shariah* are fully observed, a Murabaha is not valid. In fact, it is the observance of these conditions, which can draw a clear line of distinction between the interest-bearing loan and a trading transaction of Murabaha. If any of these conditions is not met, the transaction ceases to be Murabaha according to *Shariah*.
- 1.6 The accounting treatment of Murabaha and its disclosure and presentation in the financial statements also varies from bank to bank.
- 1.7 Such diversity of accounting treatment and disclosure has reduced the utility of financial statements of such banks to the users of such statements.
- 1.8 Hence there is a need to formulate an accounting standard regarding

Murabaha to be observed in the presentation of financial statements of banks and to promote their widest possible acceptance and observance.

1.9 Definitions

Murabaha : Murabaha is a particular kind of sale where seller expressly mentions the cost he has incurred on the commodities to be sold and sells it to another person by adding some profit or mark up thereon which is known to the buyer.

Thus Murabaha is a cost plus transaction where the seller expressly mentions the cost of a commodity sold and sells it to another person by adding mutually agreed profit thereon which can be either in lump-sum or through an agreed ratio of profit to be charged over the cost, thus resulting in an absolute price.

Inventories : Inventories are assets held for sale under Murabaha transactions in the ordinary course of business.

2. Basic *Shariah* Principles and Features of Murabaha

Basic principles governing Murabaha can be divided into three categories. Principles regarding sale, deferred payment and other principles.

2.1 Principles regarding sale

2.1.1 "Sale" is defined in *Shariah* as " the exchange of a thing of value by another thing of value with mutual consent".

2.1.2 The subject matter of sale must be existing at the time of sale.

Thus, a thing, which has not yet come into existence, cannot be sold. If a non-existent thing has been sold, though by mutual consent, the sale is void according to *Shariah*.

Example: A sells the unborn calf of his cow to B. The sale is void.

2.1.3 The subject matter of sale must be in the ownership of the seller at the time of sale, and he must have a good title to it.

Thus, what is not owned by the seller cannot be sold. If he sells something before acquiring its ownership, the sale is void according to *Shariah*.

Example: A sells to B a car, which is presently owned, by C, but A is hopeful that he will buy it from C and shall deliver it to B subsequently. The sale is void.

2.1.4 The subject matter of sale must be in the physical or constructive possession of the seller when he sells it to another person.

Examples: i) A has purchased a car from B. B has not yet delivered it to A or to his agent. A cannot sell the car to C. If he sells it before taking its delivery real or constructive from B, the sale is void.

ii) A has purchased a car from B. B has placed the car in a garage where A has free access and B has allowed him to take the delivery real or constructive from that place whenever he wishes. The car is in the constructive possession of A. If A sells the car to C without acquiring physical possession, the sale is valid.

2.1.5 The gist of the principles mentioned in paras 2.1.2 to 2.1.4 is that a sale under Murabaha arrangement is not valid under Shariah principles unless a thing or commodity:-

- is in existence
- is owned by the seller.
- is in the physical or constructive possession of the seller.

2.1.6 The major difference between an actual sale and a mere promise to sell is that an actual sale cannot be effected unless the above three conditions are fulfilled. However one can promise to sell something, which is not yet owned or possessed by him. This promise initially creates just a moral obligation on the promisor to fulfill his promise, which is normally not legally enforceable.

But the actual sale will have to be effected after the commodity comes into the possession of the seller. This will require separate offer and acceptance, and unless the sale is effected in this manner, the legal consequences of the sale shall not follow.

2.1.7 The sale must be prompt and absolute. Thus a sale attributed to a future date or a sale contingent on a future event is void. If the parties wish to effect a valid sale, they will have to effect it fresh when the future date comes or the contingency actually occurs.

2.1.8 The subject matter of sale must be a property of value. Thus, a thing having no value according to the usage or custom or trade cannot be sold or purchased. Further the subject matter of sale must be specifically known and identified to the buyer.

Explanation: The subject matter of sale may be identified either by pointation or by detailed specification, which can distinguish it from other things not sold.

Example: There is a building comprising of a number of apartments built on the same pattern. A, the owner of the building says to B " I sell one of these apartments to you". B accepts it. The sale is void

unless the apartment intended to be sold is specifically identified or pointed out to the buyer.

And lastly it should not be a thing, which is forbidden (Haram) by *Shariah*.

2.1.9. The delivery of the sold commodity to the buyer must be certain and should not depend on a contingency or chance.

Example: A sells his car stolen by an anonymous person and the buyer purchases it under the hope that he will manage to recover it. The sale is void.

2.1.10 The absolute certainty of price is a necessary condition for the validity of a sale. If the price is uncertain, the sale is void.

Example: A says to B, "if you pay within a month, the price is Rs.50/. But if you pay after two months, the price is Rs.55/- B agrees without absolutely determining one of the two prices. In this case as the price remains uncertain the sale is void, unless anyone of the two alternatives is settled by the parties at the time of concluding the transaction.

2.1.11 The sale must be unconditional. A conditional sale is invalid, unless the condition is recognized as a part of the transaction according to the usage of or custom of trade.

Example: (1) A buys a car from B, with a condition that B will employ his son in his firm. The sale is conditional, hence invalid.

(2) A buys a refrigerator from B, with a condition that B undertake its free service for 2 years. The condition, being recognized as a part of the transaction, is valid and the sale is lawful.

2.1.12 In case of imports the issuance of bill of lading in favour of bank would be considered constructive possession.

2.2 Principles regarding deferred payment

2.2.1 A sale in which the parties agree that the payment of price shall be deferred is called a "*Bai'Mu'ajjal*".

2.2.2 *Bai'Mu'ajjal* is valid if the price and due date of payment is fixed in an unambiguous manner.

2.2.3 The due time of payment can be fixed either with reference to a particular date, or by specifying a period of time, but it cannot be fixed with reference to a future event, the exact date of which is

unknown or is uncertain. If the time of payment is unknown or uncertain, the sale is void.

- 2.2.4 If a particular period is fixed for payment, like one month, it will deem to commence from the time of delivery, unless the parties have agreed to otherwise.
- 2.2.5 The deferred price may be more than the cash price, but it must be fixed at the time of sale.
- 2.2.6 Once the price is fixed, it cannot be decreased in case of earlier payment, nor can it be increased in case of default.
- 2.2.7 In order to ensure the buyer pays the installments promptly, he may be asked to promise that in case of a default, he will pay certain amount of penalty for a charitable purpose. Such penalty shall not constitute bank's income and shall be utilized for charitable purposes only.
- 2.2.8 If a commodity is sold on installments, the seller may put a condition on the buyer that if he fails to pay any installment on its due date, the remaining installments will become due immediately.
- 2.2.9 In order to secure the payment of price, the seller may ask the buyer to furnish a security whether in the form of a mortgage or in the form of a lien or a charge on any of his existing assets.
- 2.2.10 The buyer can also be asked to sign a promissory note or a bill of exchange, but such promissory note or bill or any evidence of indebtedness cannot be assigned or transferred on a price different from its face value.

2.3 Other Principles regarding Murabaha

2.3.1 Murabaha would be valid in case a commodity is to be imported and its exact cost is unknown but the seller (bank), who is importing the commodity, and the eventual buyer (client) have agreed to some profit or margin of profit which could be on FOB or C&F cost or on the final landed cost. Further, the elements of cost to be incurred by the bank and to be included in the calculation of any of these costs have been agreed to beforehand by the client.

2.3.1.1 It is not necessary that the bank should bear full cost of import. It may make itself responsible for FOB or C&F cost only and all other duties, levies and importation charges or any part thereof may be borne by the client.

2.3.1.2 The FOB or C&F cost may be fixed beforehand with reference to a fixed or forward rate of conversion or only the foreign currency cost may be

agreed to initially and the conversion to the local currency may be left to actual rate prevailing on the date of payment for import.

- 2.4 The essential of Islamic Modes of Financing relating to Murabaha issued by Shariah Board of the State Bank of Pakistan enclosed as Appendix "A" are an integral part of the Standard.

3.0 Modalities of Murabaha

- 3.1 The Murabaha should fulfill all the conditions necessary for a valid sale, i.e.:-

- The thing or commodity is in existence.
- It is owned by the seller.
- The bank must have a good title to the commodity before it sells it to its client.
- The commodity must come into the possession of the bank, whether physically or constructive, in the sense that the commodity must be at its risk, though for a short period.

- 3.2 For a Murabaha transaction, the bank itself may purchase the commodity and keep it in its own possession, or purchase the commodity through a third person appointed by the bank as agent, before bank sells it to the customer. However it is also allowed that bank makes the customer its agent to buy the commodity on its behalf. In this case the client first purchases the commodity and takes its possession as such on behalf of the bank. Thereafter, he purchases commodity from the bank for a deferred price. His possession over the commodity in the first instance is in the capacity of an agent of his bank. In this capacity he is only a custodian while the ownership vests in the bank and the risk of the commodity is also borne by the bank as a logical incidence of the ownership. But as soon as the client purchases the commodity from the bank, the ownership, as well as the risk, passes to the client.

- 3.3 As mentioned earlier, the sale cannot take place unless the commodity comes into the possession of the seller, but the seller can sign an "agreement to sell" after the bank has acquired ownership title to the goods though the commodity is not in its possession.

- 3.4 Having regard to the Shariah principles of the Murabaha a bank can use the Murabaha by adopting the following procedure:-

3.4.1 The client and the bank sign an " agreement to sell " whereby the bank promises to sell and the client promises to buy commodity up to a maximum amount of purchases at a profit margin of X percentage or amount over cost.

3.4.2 The bank appoints the client as his agent for purchasing the commodity on its behalf, and an agreement of agency is signed by both the parties.

- 3.4.3 The client purchases the commodity on behalf of the bank and takes its possession as an agent of the bank.
- 3.4.4 The client informs the bank that he has purchased the commodity on its behalf and has taken possession thereof, and at the same time, makes an offer to purchase it from the bank at profit margin over cost as agreed to in the " agreement to sell " referred to in 3.4.1.
- 3.4.5 The bank accepts the offer and the sale is concluded whereby the ownership as well as the risk of the commodity is transferred to the client. An invoice shall be raised by the bank in respect of the commodity sold to the client.
- 3.4.6 Another very important point to be followed is that the Purchase Order, Material Receiving Report and Delivery Challan, by whatever name called, should be in the name of the bank.
- 3.4.7 Finally the payment for the commodity purchased may be made directly by the bank to the supplier or through the agent.
- 3.5 The purchase of the commodity from the client himself on "buy back" agreement is not allowed in *Shariah*.
- 3.6 The above-mentioned procedure of the Murabaha is a complex transaction where the parties involved have different capacities in different stages.
 - 3.6.1 At the first stage, the bank and the client agree to sell and purchase commodity in future. This is not an actual sale. It is just a promise to effect a sale in future on Murabaha basis. Thus at this stage the relationship between the bank and the client is that of a promisor and a promisee.
 - 3.6.2 At the second stage, the relationship between the parties is that of a principal and an agent.
 - 3.6.3 At the third stage, the relationship between the bank and the supplier is that of a buyer and a seller.
 - 3.6.4 At the fourth and fifth stage, the relationship of seller and buyer comes into operation between the bank and the client and thereby relationship of a debtor and creditor emerges.

4. Standard Accounting Practice

- 4.1 Scope -This Standard should be applied to financial statements prepared in the context of historical cost convention in accounting for Murabaha transactions undertaken by a bank.
- 4.2 Cost of inventories should comprise all costs of purchases and other costs

incurred in bringing the inventories to their present location and condition.

- 4.3 Inventories remaining unsold with the bank on the balance sheet date shall constitute bank's inventory and shall be valued in accordance with International Accounting Standard applicable to inventories and shown under "Other Assets".
- 4.4 The financial statements of a bank should disclose all the information prescribed by International Accounting Standard applicable to inventories.
- 4.5 In case the inventories were acquired by the bank for a client who has eventually defaulted on his promise to purchase the inventories, it shall be valued in accordance with International Accounting Standard applicable to ~ inventories.
- 4.6 Mutabaha receivable shall be recorded by the bank at the invoiced amount and disclosed as such in the balance sheet.
- 4.7 Profit Recognition
 - (a) Purchases and sales under Murabaha and the resultant profit should be accounted for on the culmination of Murabaha transaction;
 - (b) However, the profit on that portion of sales revenue not due for payment should be deferred by accounting for by a debit to "Unearned Murabaha Income" account with the corresponding credit to "Deferred Murabaha Income" account and shown in the balance sheet as a liability.

5. Effective date

This standard shall be effective for financial statements of banks for the financial periods beginning on or after 1-01-2006.

THE INSTITUTE OF CHARTERED ACCOUNTANTS OF PAKISTAN

SHARIAH ESSENTIALS ISSUED BY SHARIAH BOARD
OF
THE STATE BANK OF PAKISTAN

This appendix is an integral part of the IFAS-1 'Murabaha'


Murabaha (Agreed profit margin sale with cash or deferred payment of price)

- I) Murabaha means a sale of goods by a person to another under an arrangement whereby the seller is obliged to disclose to the buyer the cost of goods sold either on cash basis or deferred payment basis and a margin of profit included in the sale price of goods agreed to be sold.
- II) Goods to be traded should be real goods but not credit documents.
- III) Being a sale transaction, it is essential that the commodities which are the subject of sale in a Murabaha transaction, must be existing, owned by the seller and in his physical or constructive possession. Therefore, it is necessary that the seller must have assumed the risks of ownership before selling the commodities to the buyer/customer.
- IV) Murabaha, like any other sale, requires an offer and acceptance which will include certainty of price, place of delivery, and date on which the price, if deferred, will be paid.
- V) In a Murabaha transaction, the appointment of an agent, if any, the purchase of goods by or for and on behalf of the bank and the ultimate sale of such goods to the customer shall all be transactions independent of each other and shall be so separately documented. An agreement to sell, however, may embody all the aforesaid events and transactions and can be entered into at the time of inception of relationship. The agent would first purchase the commodity on behalf of his principal i.e. financier and take its possession as such. Thereafter, the client would purchase the commodity from the financier, through an offer and acceptance. According to Sharia it is sufficient in respect of the condition of 'possession' that the supplier from whom the bank has purchased the item, gives possession to the bank or its agent in such a manner that subject matter of the sale comes under the risk of the bank. In other words, the commodity will remain in the risk of the financier during the period of purchase of the commodity by the agent and its ultimate sale to the client (agent/buyer) and its possession by him.
- VI) The invoice issued by the supplier will be in the name of the financier as the

commodity would be purchased by an agent on behalf of such financier. It is preferable that the payment for such commodities should be made by the financier directly to the supplier.

- VII) Once the sale transaction has been concluded, the selling price determined can not be changed.
- VIII) It can be stipulated while entering into the agreement that in case of late payment or default by the client, he shall be liable to pay penalty calculated at percent per day or per annum that will go to the charity fund constituted by the bank. The amount of penalty cannot be taken to be a source of further return to the bank (the seller of the goods) but shall be used for charitable purposes including the projects intended to ameliorate economic conditions of the sections of the society possessing little or nothing i.e. needy people/peoples without means.
- IX) The banks can also approach competent courts for award of solatium which shall be determined by the Courts at their discretion, on the basis of direct and indirect costs incurred, other than opportunity cost. Also, security or collateral can be sold by the bank (seller) without intervention of the court.
- X) The buyer may be required to furnish security in the form of pledge, hypothecation, lien, mortgage or any other form of encumbrance on asset. However, the mortgagee or the charge-holder shall not derive any financial benefit from such security.
- xi) A Murabaha contract cannot be rolled over because the goods once sold by the bank become property of the client and, hence, cannot be resold.
- xii) Buy-back arrangement is prohibited. Therefore, commodities already owned by the client cannot become the subject of a Murabaha transaction between him and the same financier.
- xiii) The 'promissory note or bill of exchange or any evidence of indebtedness cannot be assigned or transferred on a price different from its face value.

[No. 9(1) PSPD/PS/2004]


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