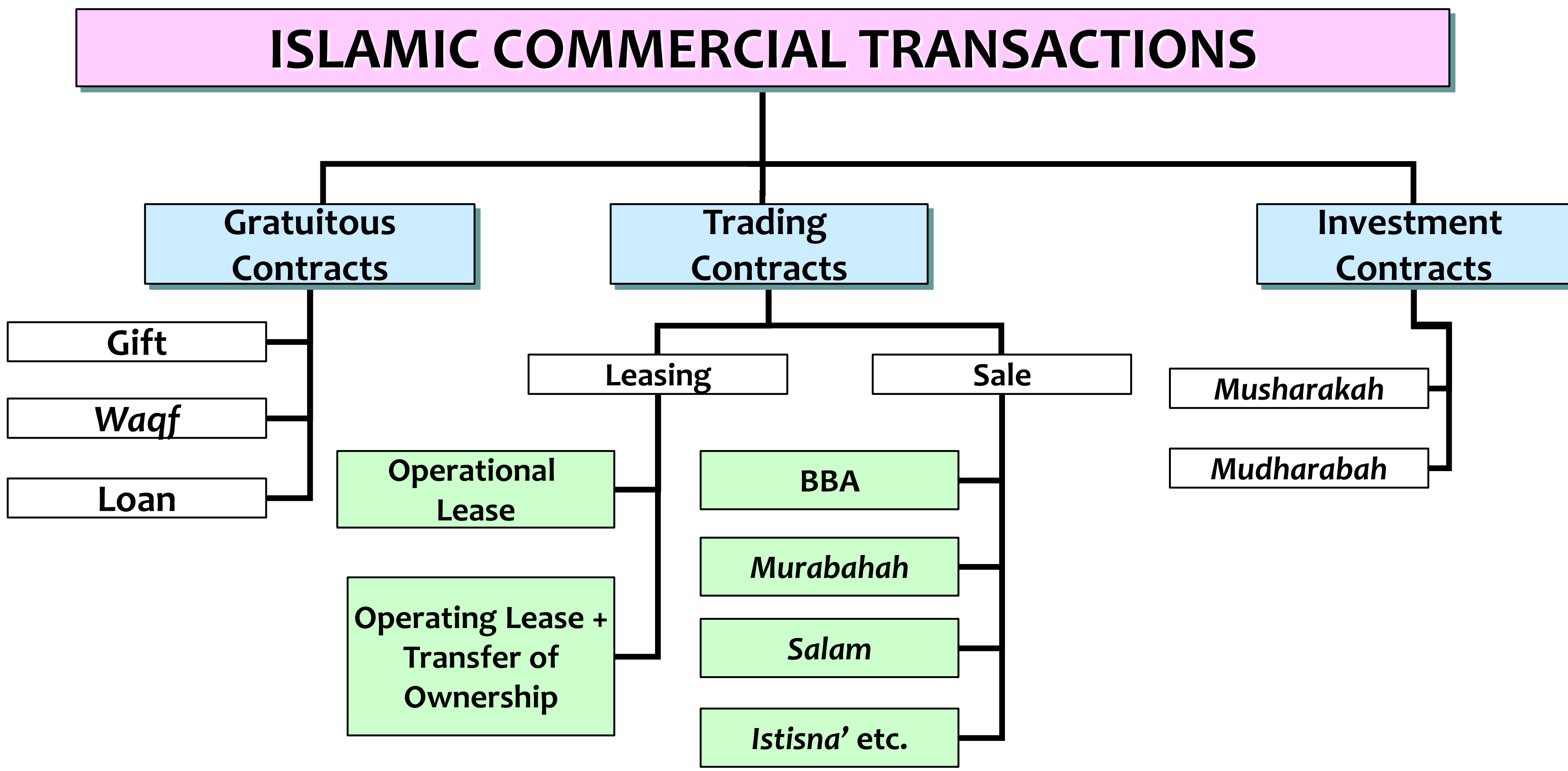
ACCOUNTING FOR ISLAMIC BANKS: MURABAHAH FINANCING

Dr Ros Aniza Mohd Shariff
Department of Accounting, KENMS, IIUM

INTAC Workshop Series
on Islamic Accounting,
9-10 August 2016.

TYPES OF CONTRACTS



Nature of Asset Based Financing Transactions

Financing involving exchange of goods

- *Murabahah or Bai Bithaman Ajil* (BBA)
- *Salam* & Parallel *Salam*
- *Istisna'* & Parallel *Istisna'*

Financing involving exchange of services

- *Ijarah*
- *Ijarah Muntahiah Bittamleek*
- *Al Ijarah Thumma Al Bay'* (AITAB)
- *Al Wakalah* (Agency)

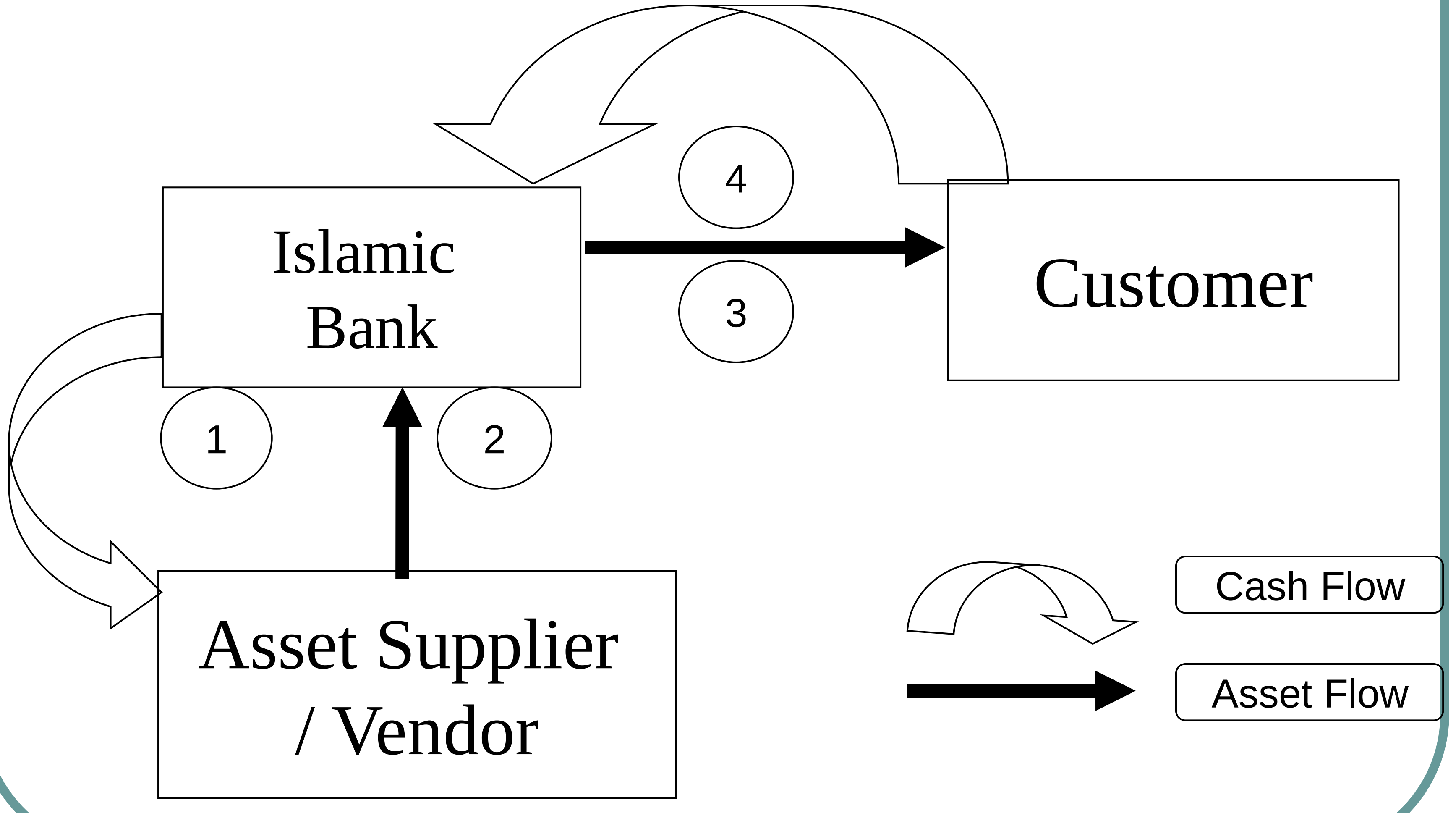
Nature of Asset Based Financing Transactions

- Two types of *Murabahah*:
  - *Murabahah*
  - *Murabahah* to the Purchase Orderer
- A *Murabahah* is defined as the sale of goods at cost plus agreed mark up.
- The purchaser should be informed of his cost of purchase and the profit amount.

PRINCIPLES OF *MURABAHAH* FINANCING

- Cost of capital/financing should be disclosed
- ‘Usury free’ activities
- Transparency of facilities
- Right of orderer (customer) to have recourse to bank or cancel the contract.
- Advance payment or deposit is allowed

Murabahah


Islamic Bank
Customer
Asset Supplier / Vendor
1
2
3
4
Cash Flow
Asset Flow

Stages for *Murabahah*

1. The Islamic bank buys the goods for *Murabahah* sale from the vendor and pays for the goods.
2. The vendor delivers the goods to the Islamic bank.
3. The Islamic bank enters into a *Murabahah* contract with customer and delivers the goods.
4. The customer pays the goods (Price= Cost + Pre-determined mark-up) to Islamic Bank.

Nature of *Murabahah* to the Purchase Orderer.

- Murabahah to the Purchase Orderer involves three parties, namely, the purchase orderer (customer), the purchaser (bank) and the seller.

- Involves intermediary due to lack of expertise or need for credit facility.

MURABAHAH TO THE PURCHASE ORDERER

- If the purchaser (bank) accepts the request of the orderer, he should purchase the asset and conclude a valid sale contract between him and the supplier.
- Offer the asset to orderer (customer), accept and establish a sale contract
- It is permissible to pay *hamish jiddiyyah* when signing the agreement but before the purchaser (bank) purchases the asset

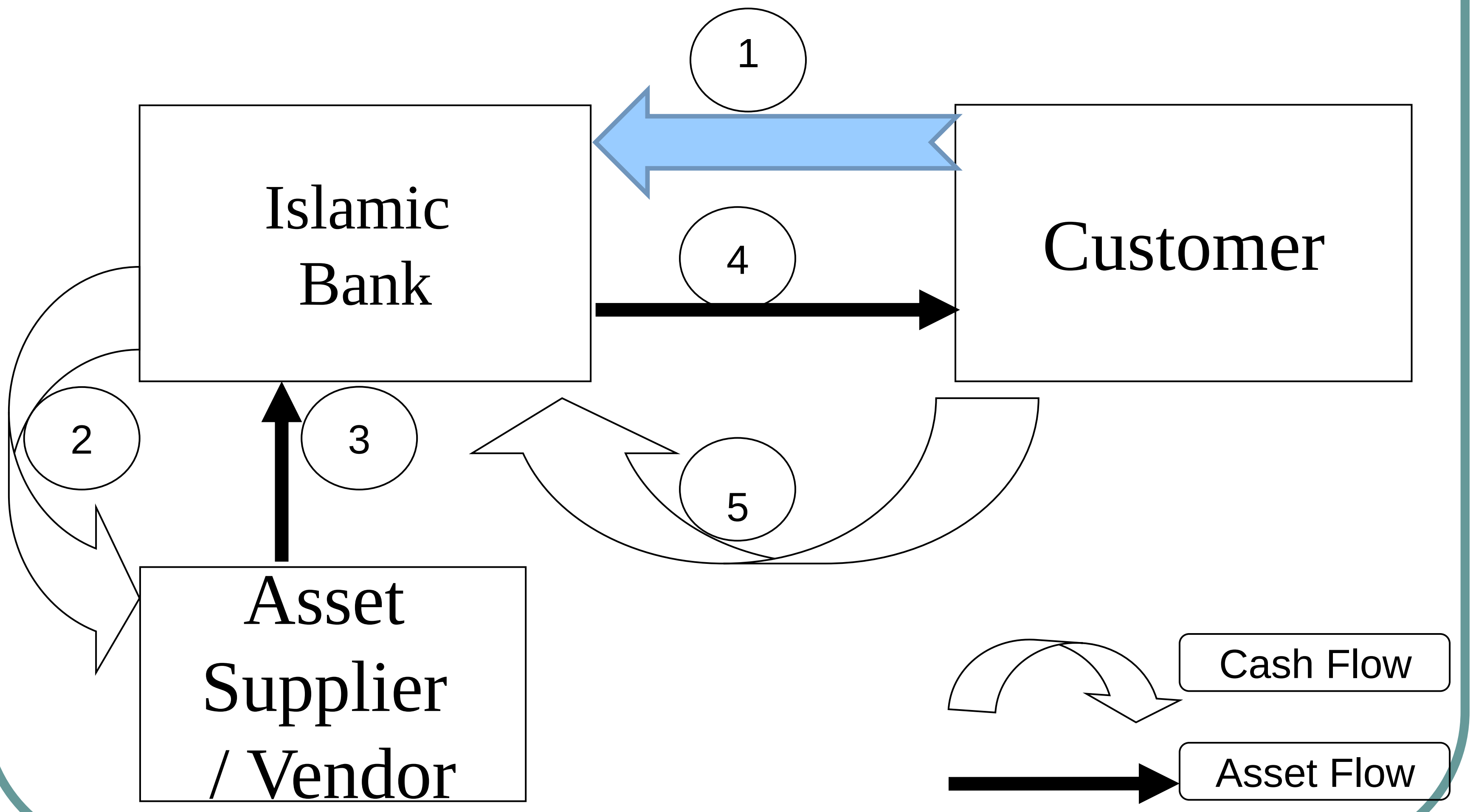
MURABAHAH TO THE PURCHASE ORDERER

- *Hamish jiddiyyah*: amount paid by the orderer (customer) upon a request from the bank to make sure that the orderer is serious in his demand for the asset
- **If the contract is binding:** If the orderer declines to purchase the asset, the actual damage incurred by the bank should be reimbursed from *hamish jiddiyyah*. If not enough to cover the damage, the balance is to be asked from the customer
- **If contract is not binding:** *Hamish jiddiyyah* returned to the customer

MURABAHAH TO THE PURCHASE ORDERER

- *Urboun* – an amount of money paid in advance to the bank and if the customer concludes the deal and takes the asset, the urboun will be treated as part of the price paid in advance, otherwise the *urboun* will be retained by the bank

Murabahah to the Purchase Orderer



Stages involved in *Murabahah* to the Purchase Orderer.

1. The customer orders the Islamic bank to purchase goods, which it promises to buy from the Islamic bank giving it some profit.
2. The Islamic bank buys and pays for the goods from the vendor.
3. The vendor delivers the goods to the Islamic bank.
4. The Islamic bank executes a *Murabahah* contract of sale with the customer and delivers the goods.
5. The customer pays for the goods on an instalments basis to the Islamic bank.

EXAMPLE

Salman made a non-binding promise to an Islamic bank that he would buy a car from the bank through a *Murabahah* transaction. Based on that promise, the bank collected *hamish jiddiyyah* of RM5,000 from him, and bought a car from vendor for RM30,000 in cash. After the car is delivered to the Islamic bank. Mr ABC decided not to buy the car. The Islamic bank then sold the car to another customer, Mr XYZ for RM28,000 in cash.

JOURNAL ENTRIES

Dr. Murabahah Financing
Cr. Cash (cost of purchase)
Cr. Unearned Income (profit)
(Recognition of Murabahah Financing Asset)

Dr. Cash / Receivable
Cr. Murabahah Financing
(Repayment received from customer)

Dr. Unearned Income
Cr. Profit & Loss a/c
(Income recognition at the end of each period)

MEASUREMENT OF *MURABAHAH* FINANCING

- Upon Acquisition of Assets:
  - **With obligation**: Assets should be measured at lower of historical cost or impaired value. (not to over value – prudence & protect the customer)

  - **Without Obligation**: Assets should be measured at cash equivalent value. (reflects current values & protect the bank/financier)
  - A provision should reflect any decline between the acquisition cost and cash equivalent value.

MEASUREMENT OF *MURABAHAH* FINANCING

- Price discount if obtained after acquisition should not be treated as revenue but to reduce the cost of the relevant goods unless agreed by SSB.

- Upon Financing the customer:
  Murabahah receivables should be recorded (by the Bank) at face value (cash equivalent value) less provision for doubtful debts.

INCOME RECOGNITION OF *MURABAHAH* FINANCING

- Profits are recognized at time of contracting for cash or credit transaction not exceeding the current financial period.

- If credit period > one financial period with a single or several installment payments, the recognition methods are:
  - Accrual Basis Method
  - Cash Basis Method

INCOME RECOGNITION OF *MURABAHAH* FINANCING

- Accrual Basis Method recognizes profit based on a proportionate allocation of profits whether cash is received or otherwise.
- Cash Basis method recognizes profit as and when the installments are received and requires the approval of SSB.

- Principle of matching expenses with income is applied.
- **Deferred profits (unearned) shall be offset against *Murabahah* receivables** in the statement of financial position.

POLICY ON PENALTY

- Penalty imposed on any procrastination (failure to repay) in payment (mutual agreement or court action) is a form of revenue or allocation to charitable fund
- In the case of insolvency, the bank has no authority to ask client to pay for penalty

ILLUSTRATION OF MURABAHAH FINANCING

An Islamic Financial Institution provides a financing of RM 100,000 at a constant rate of return of 10% for a period 5 years and requires an annual installment payment of RM 30,000.

Prepare an extract of the balance sheet & income statement at the beginning and end of year 1.

Workings:

Unearned income = 5x(30,000) – 100,000 =

RM 50,000

EXTRACT OF BALANCE SHEET

	Year 0	YEAR 1
	RM	RM
Murabahah Financing	150,000	120,000
Unearned Income	(50,000)	(40,000)
Net Receivable	100,000	80,000

EXTRACT OF INCOME STATEMENT

	Year 1
	RM
Murabahah Income	10,000

Working: Income = 10% of RM100,000

DEFERRED PAYMENT SALE (BAI BITHAMAN AJIL – BAI’ MUAJJAL)

JURISTIC CONSIDERATIONS

- The basis for the legitimacy of deferred payment sale is that it is covered by the rules of ordinary sale which is mentioned in the Quranic verse: ‘But Allah has permitted trade’
- The increase in deferred payment sale is part of the price of commodity which can be valued at any price, whereas money can only be valued by similarity and that no increase may be charged in the exchange thereof

JURISTIC CONSIDERATIONS

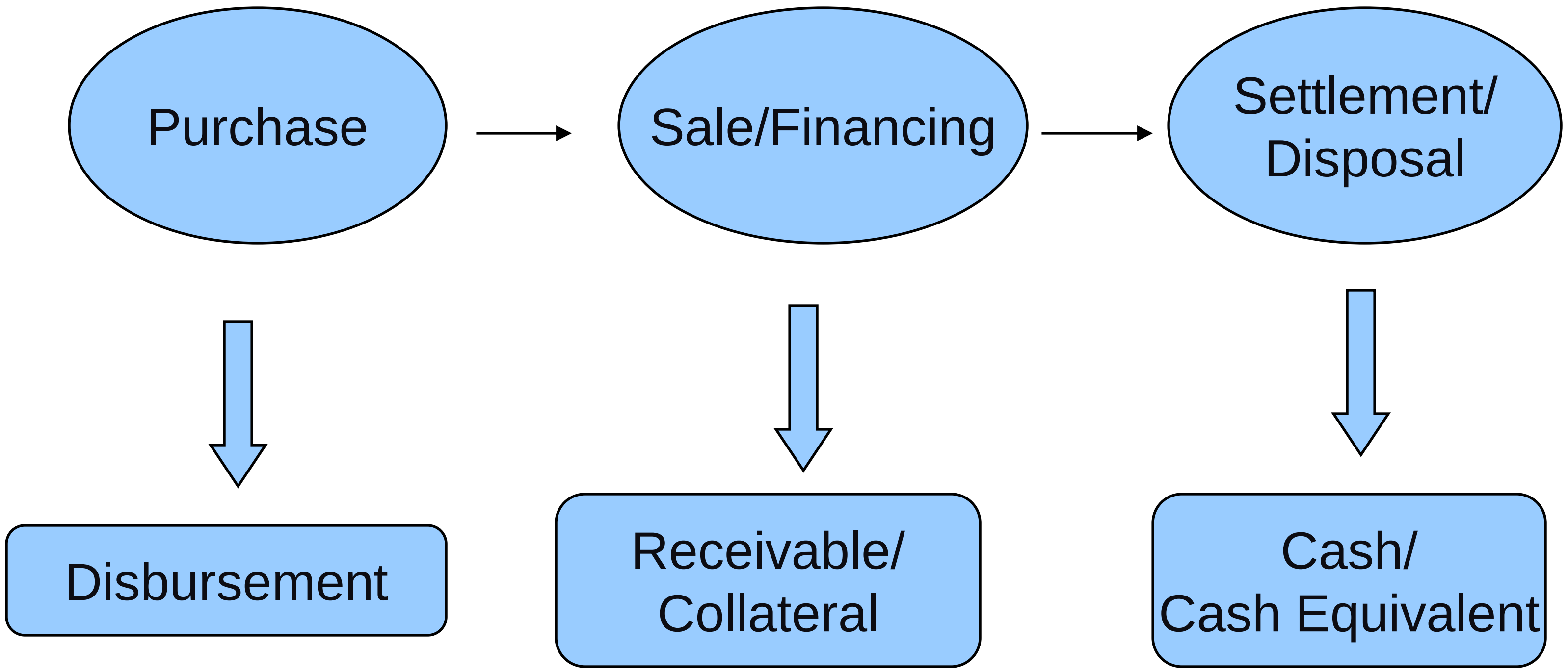
- Ownership of the assets by the purchaser is already established by the contract that is concluded through offer and acceptance of the parties to the contract.
- The delivery or possession of the asset is considered as an effect of the contract.

Risks and rewards relate to ownership of the contract.

The basis for the conditional option is the Hadith of the Prophet, peace be upon him, that says, addressing Hibban bin Munqidh, ‘When you enter into a sale contract, stipulate that there is no cheating and I have an option for three days’.

The option gives whoever stipulates it the right to revoke the contract at his own discretion. In this case, the contract of sale is considered valid provided the option is not exercised.

RECOGNITION OF DEFERRED PAYMENT SALE FINANCING



RECOGNITION OF PURCHASED ASSET

- Asset available for deferred payment is recognised upon purchase for full amount or piecemeal basis at historical cost in 'Investments in assets available for deferred payment sale'
- In case of purchase with IFI option to revoke, payments made to suppliers shall be classified as advanced payments.

ASSET MEASUREMENT OF *BAI' MUAJJAL*

- Fair value measurement at balance sheet date

REVENUE RECOGNITION OF DEFERRED PAYMENT SALE

- Revenue is recognised upon completion of contract
- Profits are recognised on accrual basis
- Profit shall be proportionately allocated over the contract period

RECOGNITION OF RECEIVABLES

- Recognised at the completion of the contract, and measured at their face value
- At the end of the financial period, receivables should be measured at cash equivalent value, which is the amount of debt outstanding at the end of the financial period less provision for doubtful debts

ACCELERATED PAYMENT AND LATE PAYMENT CHARGES

- Any accelerated payment by the debtor could be dealt in two ways
  - IFI consider reducing the deferral profit
  - IFI require full settlement with rebate

Any penalty charges for delinquent accounts to be recognised in charity and presented in Statement and Uses of Zakat and Charity Funds

DISCLOSURE REQUIREMENT

- Profit allocation method during the contract period
- Movements of receivables on deferred payment sale including deferred profits and provision for doubtful debts
- Finance policies on deferred payment sale as well as fair value of securities (collateral) of the sale
- Whether it has applied the option to revoke contracts in the purchase of assets available for deferred payment sale

COMPARATIVE DIFFERENCES BETWEEN *MURABAHAH* AND DEFERRED PAYMENT SALE

Murabahah	**Deferred payment sale**
Pre-determined mark up	No pre-determined mark up
Obliged to disclose mark-up	Disclosure of mark – up is not obligatory
Sale plus mark-up – repayment can be deferred or lump-sum	Repayment is deferred
Customer may opt not to purchase (no obligation)	Customer obliged to purchase
2 contracts executed at 2 different times – need to recognize asset temporarily	2 contracts executed at the same time – receivable is created

Exercise 1

Aini wanted to buy a car and asked BIMB to purchase for her the car. The cost of the car was RM 120,000. The profit margin for the bank is 5% and the financing was for 5 years. She paid 10% of the cost price as *Hamish Jiddiah* and concluded the purchase.

Exercise 2

Fatin wanted to buy a van and asked BIMB to purchase for her the van. The cost price of the van was RM 100,000. The profit margin for the bank is 4% and the financing was for 7 years. She paid 8% of the cost price as *Hamish Jiddiah* but two days later she decided not to continue with the purchase. The bank then sold it to another customer for RM 120,000.

Exercise 3

Nadzmi wanted to buy a machine and asked BIMB to purchase for him the machine. The cost price of the machine was RM 150,000. The shipping cost for the machine was RM 20,000 and the port handling expenses was RM 5,000. The profit margin for the bank is 9% and the financing was for 6 years. He paid 15% of the cost price as *Hamish Jiddiah* and concluded the purchase.

Exercise 4

Nurul wanted to buy a set of furniture and asked BIMB to purchase for her the furniture. The cost price of the furniture was RM 250,000. The shipping cost for the machine was RM 30,000, the insurance cost was RM 2,500 and the port handling expenses was RM 15,000. The profit margin for the bank is 6% and the financing was for 8 years. She paid 12% of the cost price as *Hamish Jiddiah* and concluded the purchase. However, Nurul had not paid the second year installment. The bank charged 3% for late payment fee.

The end

- Thank you for listening...
- Syukran
- Terima Kasih