The Institute of Chartered Accountants of Pakistan

CA PAKISTAN

Accounting Standards for Islamic Financial Transactions in Pakistan

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1. Accounting for Islamic Financial Transactions in Pakistan

The paper outlines the current standards and practice for financial reporting and disclosure of Islamic financial transactions in Pakistan and the limitations under IFRS.

2. Islamic Finance Transactions

Islamic financial transactions are primarily based on either or combination of:

- Trade-based contracts;
- Lease based contracts; and
- Profit and loss sharing based, or participatory contracts.

3. Accounting Approaches

The differing approaches to accounting for Islamic financial transactions globally can generally be attributed to opposing views on two main points of contention:

(a) the acceptability of reflecting a time value of money in reporting an Islamic financial transaction; and

(b) the conventional approach of recognising and measuring the economic substance of a transaction, rather than its legal form.

4. Accounting - IFRS & IFAS (Local)

The table below covers the accounting treatment of the basic Islamic financial products currently offered in the Pakistan market under local Islamic Financial Accounting Standards (IFAS) and the possible treatment and limitations under International Financial Reporting Standards (IFRS).

	Product	IFRS	IFAS (Local)
1	**Trade Based - deferred payment** 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[1].	Applying IAS 18 *Revenue*/ IFRS 15 *Revenue Contracts with customers*, IAS 16 *Property Plant & Equipment* and IAS 2 *Inventories*, respectively it is necessary to separately identify and account for the "finance" element.	IFAS 1 Murabaha: Treats it as trading transaction ▪ Advance payments made to supplier or customer (as agent) is recorded in other receivables and no return is recorded thereon.

[1] IFAS 1 Murabaha - Definition

	Product	IFRS	IFAS (Local)
		Limitation: Recognising the financing effect / recognising profits from a deferred payment sale based using the effective interest method.	▪ Inventory is normally sold immediately after purchase. However, if it is kept for some reason, it is accounted for at lower of cost and NRV. ▪ Murabaha sale and receivable, both are recognized at gross amount i.e. cost + profit, just like a normal sales transaction. ▪ Profit recognition is deferred over the term of payment, using “Unearned Murabaha Income” and “Deferred Murabaha Income” accounts.
2	**Trade Based - deferred delivery** **Salam** Sale whereby the seller undertakes to supply the specific goods to a buyer at a future date in consideration of a price fully paid in advance at the time the contract of sale is made. **Istisna** Kind of sale where a commodity is transacted before it comes into existence. It means to order a manufacturer to manufacture a specific commodity for the purchaser.		There is no separate IFAS for Salam and Istisna, guidance is given in the State Bank of Pakistan ‘*Essentials and Model Agreements for Islamic Modes of Financing*’, the accounting practice is as follows: ▪ Advance paid for Salam (Salam Capital) to be accounted for as advance, and no return to be recorded thereon. ▪ Once the goods are delivered, inventory to be accounted for at lower of cost and NRV. ▪ When goods are sold, either directly or by the Agent on Bank’s behalf,

	Product	IFRS	IFAS (Local)
			the Sale to be accounted for at Gross amount less Agent's Commission (if any). ▪ Total profit to be recognized immediately, at the time of sale. Similar accounting treatments shall apply to the Istisna with Wakala and Wakala tul Istithmar based products in which the goods are purchased by the bank and then sold in the market.
3	**Ijarah** Is a contract whereby the owner of an asset, other than consumable, transfers its usufruct to another person for an agreed period for an agreed consideration.[2]	Ijarah based transactions, in essence are considered to be operating lease (IAS 17 *Leases)* because the "risk and reward" is not transferred to the lessee which is also a Shariah condition for the permissibility of such transactions. **Limitation:** IAS 17 would treat Ijarah as finance lease. operating lease treatment is favoured to (a) accentuate the lessor's ownership of the leased asset, and (b) avoid reporting the resultant financing element.	▪ **IFAS 2 Ijarah** ▪ Ijarah asset to be recorded as property, plant and equipment, but may classify it as "Financing and Investing Assets". ▪ Depreciation to be calculated in line with IAS – 16. Annuity method of depreciation is not allowed. ▪ Depreciation term shall generally be equal to the lease term, if the asset is expected to be sold after that. ▪ Residual value may be based on the expected selling price to the customer.

[2] IFAS 2 *Ijarah*

	Product	IFRS	IFAS (Local)
			▪ No rental can be accounted for before the asset is delivered to the customer. ▪ Repairs undertaken, and other expenses are recognized as expense.
4	**Diminishing Musharaka (DM) (Shirkatul Milk)** is a form of co-ownership in which two or more persons' share the ownership of a tangible asset in an agreed proportion without intention to engage in common business with respect to such assets and one or more of the co-owners undertake to buy in periodic installments the proportionate share of the other co-owner(s) until the ownership / title to such tangible asset is completely transferred to the purchasing co-owner(s). Legal title may rest with either party or may be held jointly.[3]		IFAS 4 *Diminishing Musharaka* exposure draft was issued in February 17, 2017. ▪ DM arrangement is a hybrid transaction comprising three different contracts including i) Musharaka Agreement, ii) Rental/ Ijarah Agreement and iii) Undertaking for buying units gradually over time. ▪ The full value of asset held by bank and its client (lessee) jointly under DM is shown in the books of the client and the bank's share is shown as redeemable capital. On periodical payment for the purchase of asset, the redeemable capital will decrease. ▪ The lessee will get tax benefit by way of depreciation, and rental paid, which is equivalent to

[3] Exposure Draft IFAS 4 *Diminishing Musharaka*

	Product	IFRS	IFAS (Local)
			finance cost in a conventional financing. ▪ On the other hand bank (the lessor) will record in its books the DM transaction as 'DM' shown under 'Investment and Financing Assets', and rental received as 'Return on DM'.
5	**Deposits / accounts based on participation**	If we strictly follow the definition of equity and liability, according to IFRS, we can identify that the same needs to be classified as equity, because they carry the characteristics of equity. Though most regulators treat them as liability as is the case under the Banking Companies Ordinance. **Limitation:** Classification of Shirkah-based placements and accounts. ▪ The entity does not guarantee the return of capital contributed; such Shirkah items do not constitute a liability under the present *Framework* which states that "an essential characteristic of a liability is that the entity has a present obligation". ▪ The nature of Shirkah is so distinct from either liabilities or equity that the creation of another element of the financial statement would be required - '*quasi-equity*'.	**IFAS 3 Profit and Loss Sharing on Deposits** Funds of unrestricted investment / PLS deposit account holders shall be presented as redeemable capital.

	Product	IFRS	IFAS (Local)
		▪ The IASB framework currently only names three elements of the statement of financial position.	
6	Sukuk means an instrument of equal value representing undivided share in ownership of the identified tangible assets, usufruct and services or in the ownership of the assets of particular projects or special investment activity[4]. Sukuk are also referred to as Islamic or Shariah compliant Bonds. **Sukuk Structures:** ▪ Asset Backed Sukuk ▪ *Ijara* (Sale and Leaseback) Sukuk ▪ *Musharaka* (Joint Venture) Sukuk ▪ Purchase Undertaking Agreements	Sukuk are treated by Investors and Issuers as "Investments" and "Financial Liabilities" respectively and accounted for under IAS 32, IAS 39, IFRS 7 and IFRS 9;	There is no separate IFAS for Sukuk, guidance has been taken from AAOIFI, IFRS, market practices and Securities Exchange Commission of Pakistan (SECP) "*Sukuk (Privately Placed) Regulations, 2017*".

Most of the differences stem from the refutation of fundamental financial reporting concepts, namely time value of money and substance over form; consequently, leading to the repudiation of some IFRS requirements.

[4] SECP "*Sukuk (Privately Placed) Regulations, 2017*"