



Routledge Studies in Accounting

FINANCIAL REPORTING FOR ISLAMIC FINANCIAL INSTITUTIONS

**ACCOUNTING STANDARDS, INTERPRETATION AND
APPLICATION**

Abdul Rauf Mahar, Ayesha Bhatti,
Muhammad Junaid Ashraf and Asfand Zubair Malik



Financial Reporting for Islamic Financial Institutions

Mainstream accounting rules, namely International Financial Reporting Standards (IFRS), used in conventional banking, employ financial logics and principles which are at odds with Shariah and therefore unsuitable for reporting the results of Islamic banks. This book is an effort to explain the Islamic accounting principles and practices of Islamic financial institutions and juxtapose them to mainstream accounting principles in a simple and practical manner.

The book begins with an overview of the Islamic finance environment, the rationale for Islamic accounting, and a brief introduction of AAOIFI (Accounting and Auditing Organization for Islamic Financial Institutions), the professional body responsible for the issuance of Islamic accounting standards. The main features of the AAOIFI Conceptual Framework and its comparison with IFRS Framework are covered in Chapter 2. Chapters 3–9 cover the accounting treatment of the major Islamic finance products including trade-based (*Murabaha*, *Salam*, and *Istisna'a*), rental-based (*Ijarah*), and risk-sharing-based products (*Mudaraba* and *Musharakah*). Given the significance and complexity of Islamic bonds (*Sukuk*) for the Islamic finance industry, Chapter 10 discusses the basic accounting and reporting issues vis-à-vis *Sukuk*, leaving more complex issues for advanced texts on the topic. *Zakah* accounting (charity) and provisions and impairments are covered in Chapters 11 and 12.

The chapters are arranged so that they start with a discussion of the product itself, followed by the AAOIFI accounting treatment, and ending with the IFRS perspective. Each chapter begins with the learning objectives and a cover story and closes with a summary of the concepts discussed in the chapter. To facilitate the learning of readers, each chapter contains a glossary of the terms introduced as well as multiple-choice questions at the end. In addition, each chapter includes practical insights and concept checks to enhance and test the understanding of the readers.

This book will be a useful guide for students, academics, and practitioners concerned with the subject of financial reporting in Islamic Institutions.

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**Abdul Rauf Mahar, Ayesha Bhatti,
Muhammad Junaid Ashraf and
Asfand Zubair Malik**

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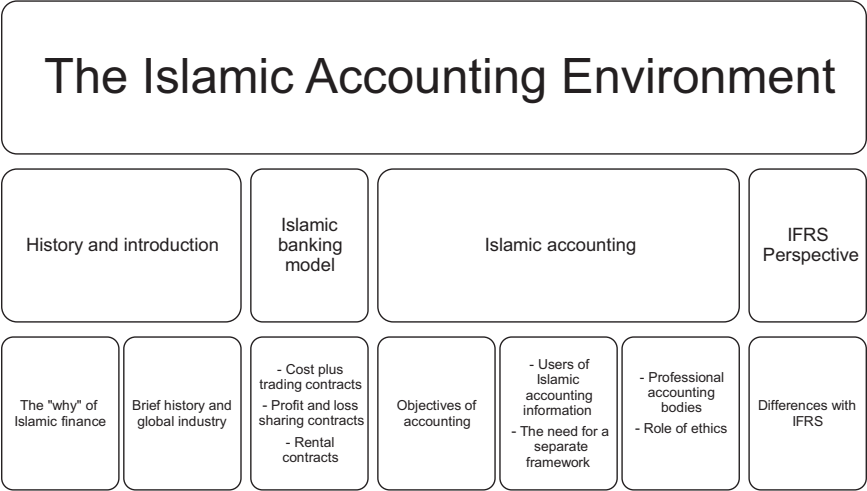
1 The Islamic Accounting Environment

Learning Objectives

After going through this chapter, you should be able to:

- 1 Describe the need and rationale for Islamic finance.
- 2 Understand the basic Islamic banking model, instruments, and users and contrast it with conventional banking.
- 3 Describe the role of *Shariah* supervision and the professional bodies for Islamic accounting and financial reporting.
- 4 Understand the role of ethics for accountants and auditors of Islamic financial institutions.

Chapter Preview



Cover Story

In the heart of Bangladesh lies a thriving Islamic finance sector that is empowering communities and promoting financial inclusion. Despite the lack of a comprehensive legal and regulatory framework, this sector has grown exponentially, with eight full-fledged Islamic banks and several conventional banks offering Islamic products through their Islamic banking branches and windows.

The Islamic Bank Bangladesh Limited (IBBL) has successfully implemented a scheme to support Muslims in rural areas who were left out of conventional microfinancing. The scheme was considered a breakthrough in addressing rural poverty and increasing financial inclusion in the country. IBBL's success story can be traced back to its unique approach of combining Islamic finance principles with microfinance. By leveraging on the strong demand for *Shariah*-compliant financial products among the country's Muslim population, IBBL was able to provide much-needed financial services to those who were previously excluded.

Apart from microfinance, the country's central bank, Bangladesh Bank, has also taken measures to improve the regulatory framework and liquidity management for the entire Islamic finance sector. In 2009, the bank issued guidelines for conducting Islamic banking, while in 2011, it launched the Islamic Interbank Fund Market to improve the liquidity of the sector.

These measures have been instrumental in supporting the growth of Islamic finance in Bangladesh, enabling it to become one of the countries in Asia with an Islamic banking industry of systemic significance. With a market share of at least 15% of the total banking sector assets, Islamic finance is no longer just a niche sector but a key player in the country's financial system.

The success of Islamic finance in Bangladesh is a testament to the power of financial innovation and inclusion. By leveraging on the country's strengths and addressing the needs of its citizens, Islamic finance has been able to create new opportunities and support economic growth. As the sector continues to evolve, Bangladesh will likely remain a leader in Islamic finance, paving the way for other countries to follow suit (Asian Development Bank, 2023).

1.1 Introduction: The “Why” of Islamic Finance

Islamic banking, often referred to as interest-free or *Shariah*-compliant banking, is a system of financial intermediation in which transactions are conducted while ensuring that they comply with Islamic principles. Islamic law (known as *Shariah*) strictly prohibits certain types of activities. For example, the charging or receiving of interest (known as *Riba*) is completely disallowed. *Riba* is the charging of a stipulated benefit on a loan contract and under Islamic law, renders any such transaction as *Haram* (prohibited). Islamic economists argue that the charging of interest leads to inequality and injustice in society, especially for the economically disadvantaged classes. People take loans for many reasons, but they can be broadly classified into

two categories: personal and business needs. Economically disadvantaged segments of society often need to borrow money for personal needs like medical treatment for a family member, children's education, and so on. Islam strictly forbids charging any benefit, predetermined or otherwise, on loans extended to borrowers for their personal needs. People or institutions with wealth are expected to lend money to the needy without any expectation of a return over and above the principal amount of the loan. Islam promises to them a worthwhile return in the life hereafter.

For a business need, the conventional banking model favours capital over business effort in one important area, that is, risk-sharing. Irrespective of business gain or loss, the lender expects to be repaid the loan with interest. This arrangement shields the money provider from all business risks and thus tilts the risk balance in favour of capital. Admittedly, if the return from business is more than the rate of interest, the borrower will get higher returns, but this is not always the case. Especially for small and new businesses, any business shock combined with a fixed interest amount can send the business into bankruptcy. Contrast this situation with the scenario of a rich and successful businessman approaching the bank for a loan. He has multiple profitable businesses and a loss in one business can be easily compensated by profits from another. So, interest-based lending favours people with money and is unfair to those who either are needy or only bring their hard work and business ingenuity to the table.

Shariah, therefore, prohibits all interest-based transactions because they are considered to cause distributive injustice to the economically weak parties in the contract. Instead, Islam proposes trading-based and risk-sharing transactions where all parties to the contract are willing to share in the profits and losses arising from the venture. Embedded in the Islamic economic model is therefore a moral principle of equity and fairness for all individuals within the society. If financing arrangements are tied to speculation about chance occurrences, they can make them unfair for one party and are therefore also disallowed by *Shariah*.¹ For example, an economic arrangement which states that the lender will share the profits or losses with the borrower on the purchase and sale of a commodity *only* if the price of a commodity will not fall below a certain amount within the next six months will be considered unacceptable by *Shariah*.

1.2 The Global Islamic Finance Industry

Recent years have witnessed phenomenal growth in the global Islamic finance industry. Figure 1.1, for example, suggests that between 2012 and 2020, the industry almost doubled its asset base.

Islamic Financial Institutions or IFIs are those financial institutions that operate in line with the *Shariah*. Different segments within the industry have contributed to this growth in Islamic banking and IFIs, Islamic insurance (known as *Takaful*), and Islamic bonds (known as *Sukuk*) being the three largest segments. Other segments include other Islamic financial institutions

4 *The Islamic Accounting Environment*

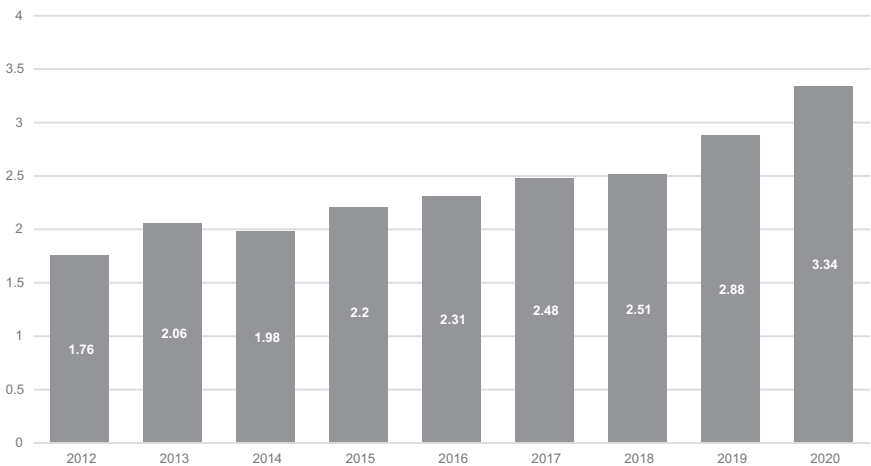


Figure 1.1 Growth of the Islamic Finance Industry (USD Trillion)

Source: Refinitiv, 2022.

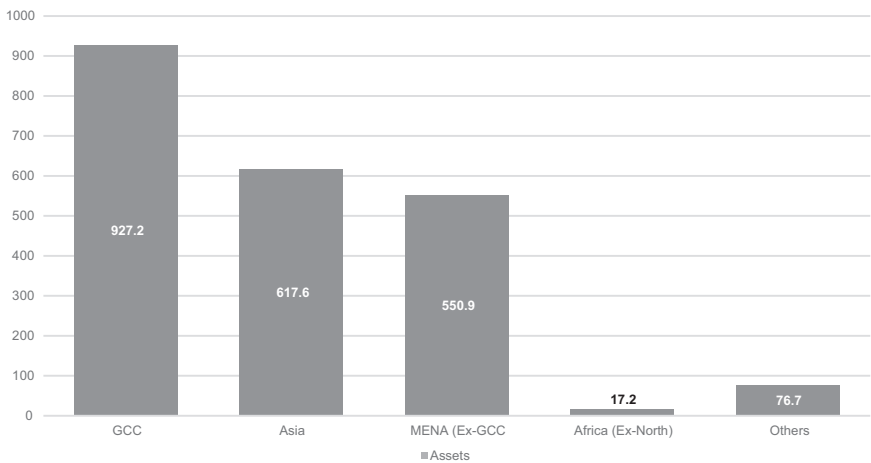


Figure 1.2 Global Islamic Finance Service Industry by Region (USD Billion)

Source: IFSB, 2019.

(OIFIs), which comprise investment or microfinance companies and Islamic funds. Overall, Islamic banking assets make up 6% of global banking assets (Mordor Intelligence, 2023).

In geographic terms (as shown in Figure 1.2), the market is segmented into the Gulf Cooperation Council (Saudi Arabia, Kuwait, UAE, Qatar, Bahrain, and Oman), the Middle East and North Africa (Iran, Egypt, and the rest of MENA), Asia, and others (Malaysia, Indonesia, Brunei, Pakistan, rest of South Asia, and Asia-Pacific), and Europe (the United Kingdom, Ireland, Italy, and the rest of Europe). The top three national markets in terms of assets are

Iran, Saudi Arabia, and Malaysia, which aggregate 63% of the global Islamic banking assets. Morocco is currently the fastest-growing market in which the total Islamic banking assets doubled in 2019. Globally, growth in the industry is set to continue, and Islamic banking assets are projected to reach USD 2.44 trillion by 2024 (Mordor Intelligence, 2023).

Box 1.1 Practical Insight: Malaysia's *Sukuk* Market

Malaysia is a pioneer and leader in the global *Sukuk* market, having established the world's first *Sukuk* issuance in the 1990s. Since then, the country has remained a significant player in the industry, with over 60% of global *Sukuk* issuances originating from Malaysia in recent years. This success is attributed to a supportive regulatory environment and the establishment of the Malaysia International Islamic Financial Centre (MIFC), which has attracted international investors to the country's *Shariah*-compliant financial products (Franklin Templeton, 2023).

Box 1.2 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) In Islamic banking, charging or receiving of interest is completely prohibited.
- 2) Conventional banks favour effort over capital.
- 3) *Shariah* prohibits all interest-based transactions because they are considered to cause distributive injustice to the economically weak parties.
- 4) Embedded in the Islamic economic model is a moral principle of equity and fairness for all individuals within the society.
- 5) Recent years have witnessed a decline in the global Islamic finance industry.

Solution:

- 1) True.
- 2) False. Conventional banks favour capital over effort by tilting the risk equation in favour of the former.
- 3) True.
- 4) True.
- 5) False. Recent years have witnessed growth in the global Islamic finance industry.

1.3 Primary Islamic Banking Instruments

Centuries of conventional banking naturalised interest to a point where it became almost inconceivable that banks can make money without charging any interest or other form of charges.² This was the challenge for Islamic banks which not only had to offer convenience and simplicity to their customers but in doing so had to ensure that they were *Shariah*-compliant and financially viable. The creation of various *Shariah*-compliant debt or equity instruments helped them in achieving these apparently contradictory objectives. These instruments took the form of trading (sale) contracts, partnership (profit- and loss-sharing) contracts, and rental contracts. Each is discussed in the following sections with simple examples.

1.3.1 *Trading Contract*

If someone needs to borrow money to purchase household appliances, one option is to borrow money from a conventional bank with fixed interest. If the borrower is unable to pay the loan instalments on the due dates, then further interest will be charged as a penalty. The basis of repayment is the amount of money lent and the time it remains with the borrower.

Alternatively, one could visit an Islamic bank. The bank will agree to provide the required household appliances by purchasing them and then selling them to the customer at a profit on instalment terms, that is, based on a *Murabaha* contract. The bank cannot benefit from any late payment penalty. To create disincentives for customers to make wilful defaults on loan repayment, a penalty amount may be agreed upon with the customer from the outset. However, any amount charged as a penalty is given to charity by the bank to remain *Shariah* compliant. Since the bank is not going to financially benefit from late payment charges, there is every reason for the bank to forgo penalising unwilful delays in repayments, provided the charity clause is not triggered.

1.3.2 *Partnership Contract*

Banks operate on a simple principle. Depositors put their money in banks and are given a return based on a fixed interest rate. Banks take this money and lend it to borrowers at an interest rate which is higher than the interest rate that the bank pays to the depositors. The difference between interest charged and paid, also known as the *spread*, is the banks' income. In this banking model, loans are not tied to business performance. Even if the conventional bank suffers a loss, it is still liable to pay the agreed-upon interest to the depositor. Similarly, the bank is entitled to charge and recover an interest income from its borrowers, irrespective of their business performance.

On the other hand, if a depositor entrusts an Islamic bank with a certain sum of money, he or she is given the option to enter into a *Mudaraba*

contract with the bank, where the bank would assume the role of a *Mudarib* (fund manager), and the depositor would take up the role of *Rab al-Maal* (capital provider). The amount is further reinvested by the bank through *Shariah*-compliant instruments with various customers of banks, who could share profits and losses with the bank in agreed-upon ratios.³ The bank would, in turn, share its profits with the depositor, that is, *Rab al-Maal* in predetermined ratios. Losses, if any, shall be borne by the depositor (unless the loss is due to the negligence of the *Mudarib*). Since returns are not fixed, both parties actively participate in the (re)investment and share the resulting profits in pre-agreed ratios.

1.3.3 Rental Contract

Imagine that an individual needs an automobile but does not have the funds to buy it. She visits a conventional bank and is given the option to enter into a lease agreement. This will give her the right to use the automobile in exchange for lease payments calculated on the basis of the loan extended and the interest charged on it. All the risks and rewards associated with the ownership of this automobile are transferred to the customer as soon as she receives the physical possession. For example, in case there is a loss/damage to the automobile, it must be borne by the customer. In addition, the bank has the authority to unilaterally terminate the lease agreement and demand immediate payment of the remaining loan amount. Needless to say, the bank will also charge a penalty in case of delays in lease payments.

On the other hand, if she visits an Islamic bank, she can enter into an *Ijarah* contract. This enables her to use the automobile in exchange for making rent payments. The ownership rights and risks would remain with the bank unless the lessee buys the automobile from the bank by making the agreed-upon payments. Neither the bank nor the customer has the right to terminate the contract without the consent of the other party, thus making it a binding contract. Moreover, the bank cannot charge any penalty for late payments.

1.3.4 Other Islamic Instruments

In addition to the aforementioned contracts, Table 1.1 lists the most commonly used instruments by Islamic banks, classified according to their nature.

Figure 1.3 shows another classification of commonly used Islamic financial instruments by contract type.

1.4 Comparison Between Conventional and Islamic Banking

Some of the key differences between conventional and Islamic modes of banking are summarised in Table 1.2.

Table 1.1 Commonly Used Instruments by Islamic Banks

<i>Types of contracts</i>	<i>Brief overview of the structure</i>
Trade contracts	
<i>Salam</i>	A forward contract in which a sale of an item is made before it is produced.
<i>Istisna'a</i>	A forward contract where a sale of an item is made before it is manufactured/constructed.
<i>Murabaha</i>	It is a sale contract where parties agree on the cost-plus-profit for the item being sold.
Partnership contracts	
<i>Musharakah</i>	A joint venture where two or more parties invest their capital and then share the profit/loss as per the agreed-upon ratio.
<i>Mudaraba</i>	A profit/loss-sharing contract where one involved party invests the capital (<i>Rab al-Maal</i>) and the other involved party provides their management skills (<i>Mudarib</i>). Both these parties share the profit and loss in the agreed-upon ratio.
Rental contracts	
<i>Ijarah</i>	A rental lease agreement (similar to an operating lease agreement in a conventional mode of finance) with an agreed-upon rent and period.

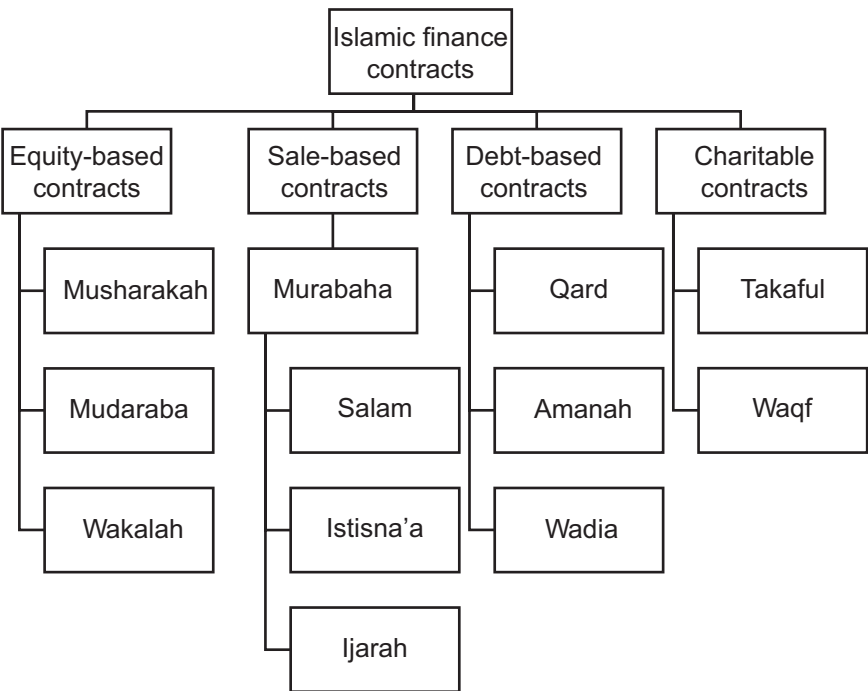


Figure 1.3 Commonly Used Financial Instruments in Islamic Banks

Source: Diagram by the authors.

Box 1.3 Practical Insight: The Growth of Islamic Banking

Islamic banking has grown rapidly over the past few decades, with assets exceeding USD 4 trillion in 2021. The growth of Islamic banking can be attributed to increasing demand for *Shariah*-compliant products and services, as well as regulatory frameworks that support the industry. Going forward, experts predict that Islamic banking will continue to grow, driven by increasing demand from consumers seeking ethical and socially responsible financial products (Refinitiv, 2023a).

Box 1.4 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) In Islamic leasing, when an asset is leased, the ownership of the asset is transferred to the customer who now must bear the complete risk and reward associated with the asset.
- 2) In *Mudaraba* contract, both the *Mudarib* and the *Rab al-Maal* share the losses.
- 3) Concepts such as *Gharar* (uncertainties of time/price), *Maysir*, and *Qimar* (gambling) are generally prohibited in Islam as these involve speculation.
- 4) If a depositor entrusts an Islamic bank with a certain sum of money, he generally enters into a *Mudaraba* contract with the bank, where the bank would assume the role of a *Mudarib* (fund manager), and the depositor would take up the role of *Rab al-Maal*.
- 5) *Ijarah* is a rental lease agreement with an agreed-upon price and period.

Solution:

- 1) False. In leasing, according to Islamic banks, the ownership of an asset remains with the bank who bears the risk and reward associated with the asset.
- 2) False. Losses, if any, are only borne by the *Rab al-Maal* (unless the loss is due to the negligence of the *Mudarib*).
- 3) True.
- 4) True.
- 5) True.

Table 1.2 Key Differences Between Conventional and Islamic Banking

<i>Conventional mode of financing</i>	<i>Islamic mode of financing</i>
Conventional financing draws its roots from capitalism, an economic system characterised by the ownership of private property and maximisation of profit.	Islamic finance is derived from divine rulings, ascertained from religious texts. The main objective is to create a fair and equitable economy in which profit can be pursued subject to various ethical constraints.
Money is both a commodity and a medium of exchange. It can be both sold and rented out at a higher value than its face value.	Money is not a commodity. It is a medium of exchange and a store of value. It cannot itself be sold or traded for a value greater than its face value.
Conventional modes of lending are based primarily on the transfer of risk. Risk is transferred from the lender to the borrower. The lender is guaranteed a fixed predetermined rate of return regardless of the outcome of the venture. If the borrower suffers a loss, the lender is still guaranteed the return.	Islamic modes of financing are focused primarily on risk-sharing models. Risk is shared between the borrower and the lender; profits and losses from the venture are to be divided proportionately and shared by all stakeholders. If the IFI suffers a loss, the customer will share a portion of that loss.
The concept of the time value of money is used to determine the interest charged on capital.	A predetermined profit is charged when goods and services are traded.
Funds disbursed under different financing arrangements do not require any exchange of goods or services.	The disbursal of funds for trading instruments such as <i>Murabaha</i> and <i>Salam</i> requires agreements for the exchange of goods or services.
The relationship between a conventional bank and its customers is fundamentally that of a borrower/lender.	The relationship between an Islamic bank and its customers is that of partner, investor, buyer/seller, trader, and lessor/lessee.
Speculative aspects are permitted within contracts.	The rights and obligations of all parties involved in a transaction are clearly defined in the contract at the outset. <i>Gharar</i> (uncertainty) is prohibited. No matters are left to speculation or chance.
Default or late payment of an instalment attracts additional interest and penalties. This forms quite a sizeable portion of the earnings of a conventional bank.	A penalty is charged to customers to discourage wilful delays. However, this is not a part of the Islamic bank's income. Instead, this is donated to charity.
Conventional banks are not under any moral obligation to engage only in activities beneficial to society.	Islamic banks are permitted to engage only in permissible activities. <i>Shariah's</i> compliance and ethics are at the forefront of any decision-making. Any activity considered detrimental to society is prohibited.

Box 1.5 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) In conventional banking, time value of money is given no significance.
- 2) Money is both a commodity and a medium of exchange in conventional banking.
- 3) The relationship between an Islamic bank and its customers is fundamentally that of a borrower/lender.
- 4) All types of investments are allowed in Islam, including investing in activities like tobacco and alcohol.
- 5) Conventional banks are not under any moral obligation to engage only in activities beneficial to society.

Solution:

- 1) False. The concept of the time value of money is used to determine the interest charged on capital.
- 2) True.
- 3) False. The relationship between an Islamic bank and its customers is that of partner, investor, buyer/seller, trader, and lessor/lessee.
- 4) False. Investments are allowed in Islam if someone is not investing in unlawful activities like tobacco and alcohol.
- 5) True.

1.5 Role of *Shariah* Supervision

An important and noticeable difference in the governance structure of any IFI is the role of the *Shariah* advisor. Since *Shariah* compliance is of paramount importance and adds credibility and integrity to the institutions' operations, all IFIs have a *Shariah* board or advisor to guide them on the permissibility of the different products. Any ambiguity in executing a transaction is vetted by the *Shariah* advisors.

As the number of new and more complex Islamic instruments continues to rise, the role of *Shariah* advisors becomes more critical in the contemporary Islamic banking industry. They are not only responsible for approving all transactions as *Shariah* compliant but also expected to suggest changes to the structure of dubious products to render them Islamically permissible.

Box 1.6 Practical Insight: SGF Requirements for IFIs by State Bank of Pakistan

The State Bank of Pakistan (SBP) instructs IFIs to establish a sound and proper SGF, which includes:

- 1 An effective mechanism for the BOD's oversight of the entity's *Shariah* compliance
- 2 An independent and effective SB appointed as per the criteria set out by SBP
- 3 One member of the SB would work as Resident *Shariah* Board Member (RSBM) to oversee the procedures and processes to be adopted for the implementation of the SB's *Fatawa*, resolutions and guidelines and provide clarification thereon
- 4 An SCD to be set up to assist the SB and serve as a conduit between the SB and the management of an IFI
- 5 *Shariah* compliance review mechanism to assess operative effectiveness of *Shariah* governance and compliance framework devised by the SB and BOD of the IFI
- 6 Establishment of an independent Internal *Shariah* Audit Unit (ISAU)
- 7 A product development (PD) department responsible for the development of new and innovative products and services
- 8 External *Shariah* audit to be undertaken along with the annual audit of the IFI

1.5.1 *Shariah Governance Framework*

Normally, it is the central bank of the relevant country which issues comprehensive guidance in the form of a *Shariah* Governance Framework (SGF) to ensure compliance with *Shariah* principles and to enhance the confidence of stakeholders and the financial markets in the credibility of the IFIs operating within a jurisdiction. Broadly, the SGF aims to clearly define the roles and responsibilities of the various organs of the institution vis-à-vis *Shariah* compliance, including the role of the board of directors (BOD), the *Shariah* Board (SB), the *Shariah* Compliance Department (SCD), the senior management, and the auditors.

Central banks in other countries have issued their own SGFs which provide guidance and instructions on how IFIs should manage their *Shariah* governance structures. For example, Bank Negara Malaysia, the central bank of Malaysia, has issued a similar framework to ensure that all IFIs within the country operate in accordance with *Shariah* principles. This has been achieved through a two-tier approach:

- 1 The *Shariah* Advisory Council (SAC) of Bank Negara Malaysia is the apex authority for promulgating relevant Islamic law for IFIs and their monitoring.

- 2 Internal *Shariah* committees are to be formed in each IFI to advise regarding the management of *Shariah* matters.

1.5.2 Objectives of Financial Accounting for IFIs

Financial accounting aims to identify and record financial data for an entity during a certain time period and communicate this data to its different stakeholders. The identified and recorded data is communicated in the form of financial reports, which include the profit and loss position of the entity for a particular accounting period (income statement), the net worth of the entity (statement of financial position), and the cash flow position (statement of cash flows). Communication of financial results allows different stakeholders to make informed business decisions vis-à-vis the organisation. Figure 1.4 summarises the sequential objectives of financial accounting and reporting.

Stakeholders of IFIs have unique financial information needs. They are primarily associated with an IFI through a faith-based connection and are different from stakeholders of conventional financial institutions, many of whom are interested exclusively in the financial efficiency or performance of a financial institution. The financial reports of Islamic institutions, therefore, need to reflect the *Shariah*-compliant nature of their transactions and dealings. In addition, the very functioning of IFIs and the relationship they have with their customers differ significantly from that of conventional banks. As explained before, conventional banks charge interest on their lending/borrowing transactions whereas Islamic banks do not. The latter is engaged in profit- and loss-sharing mechanisms (*Mudaraba*)⁴ to provide a return to their depositors or trading transactions (*Murabaha*) for the purpose of lending. Furthermore, as the investor base of Islamic banks is growing, the diversity of products and complexities of their structures are also expanding. Since the customers are sensitive to *Shariah* compliance, it is incumbent on the banks to report not only the financial results of their operations but also the manner

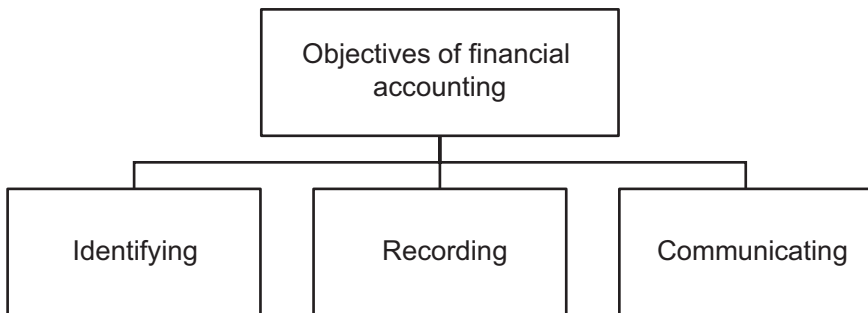


Figure 1.4 Objectives of Financial Accounting

Source: Diagram by the authors.

in which they are conducting their operations to ensure adherence with the principles of *Shariah*.

1.5.3 *The Need for a Separate Accounting Framework*

The prior discussion clarifies that compared to stakeholders of conventional organisations, those engaging with IFIs may have distinct and additional information needs. However, does this necessitate the need for an entirely separate framework of accounting? After all, accounting identifies, records, and classifies financial transactions and then reports these in a specific format to stakeholders. Can religion influence this spectrum of activities in a fundamental manner? Is there a need for a separate set of accounting standards, with distinct accounting treatments and disclosure requirements? Individuals, organisations, and institutions differ in their views on this.

Those who do not consider it necessary to have a separate set of accounting standards argue that the basic information needs of stakeholders are the same in the case of both IFIs and conventional financial institutions. Depositors, for example, need to understand the financial performance of a financial institution to assess if it is maintaining its capital at a sufficient level to provide safety for its depositors. Investors are interested in understanding the ability of a bank to generate a decent return, while regulators are interested in making an assessment that the lending and borrowing operations of a financial institution are within legally permissible financial limits. Globally, the accounting framework widely used is that issued by the International Accounting Standards Board (IASB), namely the International Financial Reporting Standards (IFRS). IFRS is applicable all over the world except for in the United States, where US GAAP (Generally Accepted Accounting Principles) is applied. IFRS is based on a set of principles⁵ and is therefore flexible enough to be used by all types of businesses. There are many benefits of using IFRS globally and across different industries since using a common set of standards enables better comparability of results and performance, as well as increased transparency of reporting. An argument can therefore be made that if compliance with *Shariah* law is an additional information requirement, this can always be catered to through additional disclosures and classifications.

On the other hand, the main arguments given in favour of a separate accounting framework are the following:

- Islamic financial instruments and transactions have a unique nature. Unlike conventional borrowing and lending financial instruments, they are risk-sharing, trade, or rental-based contracts. Hence, they should be recorded and reported in a manner that reflects their true spirit and nature, which is not possible under mainstream accounting standards.
- The *Shariah*-conscious users have unique information needs. For example, the Islamic user will require the valuation of assets to be based on current market values for the determination of *Zakah* (charity) rather

than historical cost. Therefore, whilst accounting, as the tool to provide information to users, might be the same for Islamic or conventional transactions, the information needs of the users are quite different.

- Conventional financial accounting vocabularies, like *financing*, *interest* or *borrowing*, might create confusion and ultimately undermine the confidence of faith-based stakeholders.
- Traditional accounting concepts like *substance over form* may not agree with Islamic regulations where the legal form of a contract and its compliance with *Shariah* is at least as important as the substance of a transaction.

1.5.3.1 Information Needs of Users of Financial Statements of IFIs

The aforementioned arguments firmly establish that the users of financial statements of IFIs have information needs that go beyond the needs of users of financial statements of conventional financial institutions. A brief description of those needs would include the following:

- Information about the institution's *Shariah*-compliant transactions, its economic resources and claims against the institution, its operations, and other financial data to assess the overall financial performance, position, and *Zakah* liability of the institution;
- Information that can assist in evaluating the institution's compliance with *Shariah* principles and rules in all financial and other dealings;
- Information that can facilitate the user in assessing the risks inherent or associated with the IFI and how it manages such risks;
- Information that helps evaluate an IFI's ability to use, safeguard, and enhance the value of its economic resources;
- Information that shows whether the IFI can perform its social responsibilities including the fulfilment of the economic needs of the relevant stakeholders, for example, its employees.

1.6 Professional Bodies for Islamic Accounting and Reporting

1.6.1 AAOIFI

The unique nature of IFIs and the information needs of their stakeholders have given rise to the view that the requirements of Islamic accounting cannot be satisfied through the traditional IFRS Framework for accounting and reporting. To address this gap, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) was developed in 1991. Registered in Bahrain as an international autonomous non-profit-making corporate body, AAOIFI is responsible for the development and issuance of standards for the Islamic finance industry. Currently, AAOIFI has issued more than 100 standards in accounting, auditing, ethics, and governance for the Islamic finance industry. Membership of AAOIFI spreads across more than 45 countries

and includes central banks, regulatory authorities, financial institutions, and accounting and auditing firms (AAOIFI, 2023a).

AAOIFI states the following as its objectives:

- 1 To develop and disseminate accounting, auditing, governance, and ethical thought relating to the activities of IFIs;
- 2 To harmonise the accounting policies and procedures adopted by IFIs through the preparation and issuance of accounting standards;
- 3 To improve the quality and uniformity of auditing and governance practices of IFIs by preparing and issuing auditing and governance standards;
- 4 To promote good ethical practices within IFIs through the preparation and issuance of codes of ethics for these institutions;
- 5 To achieve harmonisation and consistency in the approach of the *Shariah* supervisory boards of IFIs through the preparation, issuance, and interpretations of *Shariah* standards and *Shariah* rules for investment, financing, and insurance;
- 6 To liaise with concerned national regulatory bodies, IFIs, and professional accounting firms to implement the standards, statements, and guidelines published by AAOIFI;
- 7 To offer educational and training programmes in the field of accounting, auditing, ethics, governance, *Shariah*, and other related areas;
- 8 To carry out other activities to gain wider awareness and acceptance of AAOIFI's standards.

1.6.1.1 *AAOIFI Structure*

Figure 1.5 illustrates the organisational structure of AAOIFI. It comprises the General Assembly, the Board of Trustees, the Executive Committee, and the

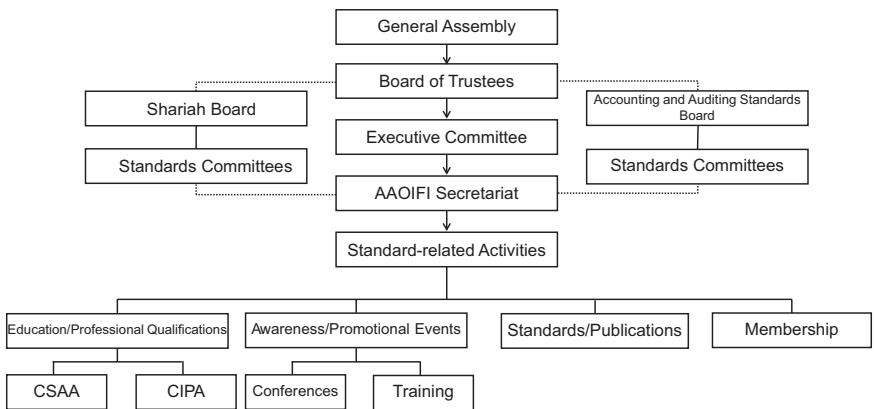


Figure 1.5 AAOIFI Organisational Structure

Source: AAOIFI (2023a).

General Secretariat. Its technical boards include the Accounting Board, the *Shariah* Board, and the Governance and Ethics Board.

1.6.1.2 Accounting, Shariah, Auditing, and Governance Standards

The AAOIFI accounting standards prescribe the recommended accounting treatment for different Islamic finance products and structures. There are more than 30 such standards which have been issued to date.

AAOIFI has also issued around 60 *Shariah* standards dealing with many different types of instruments/transactions and the *Shariah* principles governing them. Adherence to these rules and principles is the very cornerstone of the Islamic finance industry. AAOIFI has, to date, issued six auditing standards (AAOIFI, 2023b). In addition, governance standards have also been issued to guide IFIs on several governance-related issues.

1.6.2 Other Professional Bodies

Whilst AAOIFI plays the dominant role for developing Islamic accounting, auditing and governance standards for the industry, there are many other key stakeholders who help shape the way in which new standards are developed and how they compare and contrast with conventional financial accounting and reporting standards followed in different countries. Some of these bodies are discussed here.

1.6.2.1 IFRS Foundation

The IFRS Foundation is a not-for-profit organisation established to develop a single set of high-quality global financial accounting and reporting standards (IFRS) and to facilitate their adoption. The foundation has a three-tier governance structure (Figure 1.6), and its standard-setting body is the IASB which comprises an independent board of experts.

In 2011, the IASB consulted on topics which should be made a part of its technical agenda. As a result, a consultative group called the Islamic Finance Consultative Group was formed. The group highlights the main challenges encountered while applying IFRS standards to instruments and transactions that fall under the ambit of Islamic accounting.

1.6.2.2 Malaysian Accounting Standards Board (MASB)

The MASB was established under the Financial Reporting Act 1997 (Act) as the standard-setting body of the Financial Reporting Foundation (FRF). The main function of the MASB was the issuance and approval of accounting standards for the preparation of financial statements. The MASB and the FRF make up the frameworks for financial reporting in Malaysia. Initially, MASB had the objective of developing a separate set of Islamic accounting standards. However, after consultation with *Shariah* Advisory Council of Bank Negara, Malaysia, it was eventually decided that the conventional

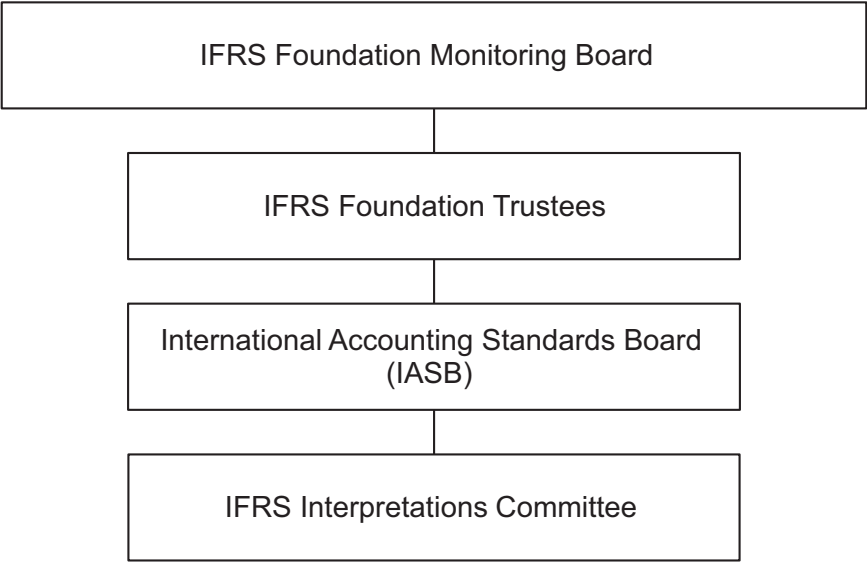


Figure 1.6 Three-Tier Structure of the IFRS Foundation

Source: Diagram by the authors.

accounting concepts and generally accepted accounting principles would be applied to all Islamic financial transactions with additional disclosures to explain the Islamic contracts in more detail.

1.6.2.3 Asian-Oceanian Standard-Setters Group

The Asian-Oceanian Standard-Setters Group (AOSSG) was developed in 2009 as a body comprising 28 countries from the Asian-Oceanian region. The main purpose is to share issues with the implementation of international financial reporting standards (IFRSs) and contributing towards the development of high-quality global standards. The AOSSG has developed an *Islamic Finance Working Group* which provides input to the AOSSG on the applicability of IFRSs to Islamic finance transactions.

Box 1.7 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) Financial accounting aims to identify and record financial data of an entity during a certain time period and communicate this data to its different stakeholders.

- 2) Investors are interested in understanding the ability of a bank to generate a decent return, while regulators are interested in making an assessment that the lending and borrowing operations of a financial institution are within legally permissible financial limits.
- 3) One of AAOIFI's objectives is to promote good ethical practices within IFIs through the preparation and issuance of codes of ethics for these institutions.
- 4) AAOIFI has issued around 500 *Shariah* standards.
- 5) The standard-setting body of the IFRS Foundation is the FASB.

Solution:

- 1) True.
- 2) True.
- 3) True.
- 4) False. AAOIFI has issued around 60 *Shariah* standards.
- 5) False. The standard-setting body of the IFRS foundation is the IASB.

1.7 Role of Ethics for Islamic Finance Professionals

1.7.1 AAOIFI Codes of Ethics

The underlying rationale for the various prohibitions (*Riba*, *Gharar*, and *Maysir*) in Islamic finance emanates from the apparent distributive injustice and inequality created by the conventional banking model. The pursuit of profit is not problematic in Islam; however, excessive greed and profit maximisation at the expense of societal welfare are prohibited. Islam envisions a society where wealth should not accumulate in the hands of a few. Therefore, apart from the categorical prohibitions, *Shariah* also defines various norms and principles for individuals and institutions to follow in their financial and commercial dealings. Ethics is therefore at the heart of the Islamic economic system. AAOIFI has developed a code of ethics for Islamic Finance Professionals (IFPs) which aims to provide comprehensive ethical guidance to those working within the industry.

1.7.2 Code of Ethics for Islamic Finance Professionals

The code sets out the *Adl* (fairness) and *Ihsaan* (generosity) equation, the ethical virtues, and the ethics protocols which together form the conceptual framework for IFPs to understand what is meant by ethics and

how to make ethical decisions. The main objectives of the code are the following:

- To provide an ethical framework for IFPs to apply in their practical lives and ensure that they are following the letter and spirit of *Shariah*;
- To assist IFPs on how to resolve an ethical dilemma;
- To encourage IFPs to follow ethics and become role models of ethical behaviour;
- To reduce operational risks of IFIs, for example, due to non-compliance with *Shariah*;
- To enhance the confidence of all stakeholders in the Islamic finance industry.

1.7.2.1 *Adl and Ihsaan Equation*

The code introduces the *Adl* and *Ihsaan* equation (see Figure 1.7), which sets out the four elements that should be maintained by an IFP.

Adl refers to justice, equity, and fairness and represents the minimum level of ethics to be present in an IFP whilst *Ihsaan* is the concept of going beyond fairness, that is, for stronger groups or parties to be charitable to the weaker economic players to achieve the objectives of the Islamic economic system.

1.7.3 *Ethical Virtues*

The elements of *Adl* and *Ihsaan* are interlinked with certain ethical virtues which should be maintained by all IFPs. These include:

- 1) *Taqwa* – being conscious of *Allah* watching you
- 2) *Tawakul* – placing your reliance upon *Allah* alone
- 3) *Sidq* – integrity
- 4) *Amanah* – trustworthiness
- 5) *Quwwah* – strength and competence
- 6) *Tawasi bil Haq* – preach and encourage people around to follow truth and ethical behaviour

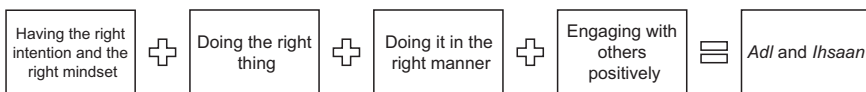


Figure 1.7 *Adl and Ihsaan Equation*

Source: Diagram by the authors.

1.7.4 Ethical Protocols

Four ethical protocols are defined in the code which complement the *Adl* and *Ihsaan* equation and the ethical virtues:

- 1 **Self-accountability protocol:** An IFP shall continuously maintain self-accountability to atone for and self-purify any unethical intention or act committed.
- 2 **Liability avoiding protocol:** An IFP should safeguard and protect himself from becoming liable for an ethics violation committed by him or by his subordinates.
- 3 **Decision-making protocol:** An IFP shall uphold the decision-making protocol to make ethically defensible decisions.
- 4 **Violation escalation protocol:** An IFP should wisely and prudently respond to an ethics violation committed by a colleague.

1.7.5 Farz-e-Kifaya

According to the AAOIFI code of ethics, the discipline of accounting is considered to be a *Farz-e-Kifaya* in Islamic jurisprudence. It means that it is a collective religious obligation of the Muslim community. If a sufficient number of individuals within the community perform the obligation, it is considered fulfilled for everyone. However, if no one fulfils this obligation, everyone in the community is considered sinful.

Farz-e-Kifaya highlights the importance of community cooperation and the shared responsibility of upholding religious obligations. By fulfilling these obligations collectively, the entire community can benefit spiritually and morally.

In the context of accounting, this implies that it is a means to fulfil *Shariah* requirements related to recording transactions, keeping track of financial matters, and allocating rights among claimants. To fulfil these obligations, the Muslim community must have accounting professionals who uphold ethical and professional standards and manage these matters in accordance with Islamic principles (AAOIFI, 2023b).

Box 1.8 Practical Insight: Islamic Finance and Financial Inclusion

Islamic finance has been recognised as a tool for promoting financial inclusion, particularly in Muslim-majority countries where access to finance is limited. Microfinance institutions (MFIs) that offer *Shariah*-compliant products and services have played an important role in expanding access to finance. In the future, Islamic finance is expected to continue to play a significant role in promoting financial inclusion, particularly in developing countries.

22 *The Islamic Accounting Environment*

1.8 Education and Specialisations

There are two main qualifications offered by AAOIFI:

- Certified *Shariah* Advisor and Auditor
- Certified Islamic Professional Accountant

1.8.1 *Certified Shariah Advisor and Auditor (CSAA)*

CSAA was launched in 2006 and has more than 980 fellows around the world. Currently, this certification is in the process of being revamped.

1.8.2 *Certified Islamic Professional Accountant (CIPA)*

This is the flagship certification currently offered by AAOIFI. There are more than 670 CIPA fellows worldwide. CIPA is the only internationally recognised accounting qualification for IFIs.

To attain the CIPA qualification and become a CIPA fellow, a set of examinations must be passed with a one-year practical experience requirement (PER). The benefits of this qualification include greater career opportunities and professional development within a growing industry.

1.9 IFRS Perspective

In *Shariah* law, profit must be generated through legitimate business activities and transactions that comply with Islamic principles. It means that financial transactions involving interest and speculative activities are prohibited. Therefore, IFIs provide financing to the customers using *Shariah*-compliant trading, partnership, and rental contracts.

Under the IFRS framework, the purchases and sales arising under these arrangements are not reflected in the financial statements of IFIs because of the fundamental accounting principle of substance over form (meaning that transactions should be recorded on the basis of their economic substance rather than their legal or *Shariah* form). Instead, only the amount of financing provided and the appropriate portion of profit thereon are reported. This is because the purchases and sales are seen as incidental to the financing provided rather than the primary focus of the transaction.

Further, the income on such types of financing is recognised in accordance with the principles of Islamic *Shariah*. However, suppose any income is received which does not comply with the principles of Islamic *Shariah*. In that case, it is recognised as charity payable if so directed by the *Shariah* advisor of the IFI.

More details of the IFRS perspective on the conceptual framework of AAOIFI and accounting treatment of different *Shariah*-compliant contract under FAS are discussed in detail in relevant chapters of this book.

1.10 Chapter Summary

- Islamic banking, often referred to as interest-free or *Shariah*-compliant banking, is a system of financial intermediation in which transactions are conducted to ensure that they comply with Islamic principles. (LO 1)
- Recent years have witnessed phenomenal growth in the global Islamic finance industry. Different segments within the industry have contributed to this growth, including Islamic banking, Islamic insurance (known as *Takaful*), and Islamic bonds (known as *Sukuk*) being the most popular segments. (LO 1)
- Islamic modes of financing are primarily focused on trade, partnership, and rental-based contractual relationships. The main objective is to create a fair and equitable economy in which profit can be pursued subject to various ethical constraints. (LO 2)
- Financial accounting aims to identify and record financial data for a business entity and communicate this data to the different stakeholders through financial reports in a manner that fairly represents the financial results of the entity during the accounting period. (LO 2)
- In the case of IFIs, there are many users of accounting information, including existing and potential investors, that is, equity holders, creditors, participatory stakeholders, debtors, employees of the institution, regulators, rating agencies, central *Shariah* boards, and other government agencies. (LO 2)
- Common information needs of users include information about the institution's transactions, compliance with *Shariah* principles, its financial position and performance, and risks. Such information needs surely justify a separate accounting framework for IFIs. (LO 2)
- AAOIFI is responsible for the development and issuance of standards for the Islamic finance industry. Currently, AAOIFI has issued more than 100 standards in accounting, auditing, ethics, and governance for the Islamic finance industry. Membership of AAOIFI spreads across more than 50 countries and includes central banks, regulatory authorities, financial institutions, accounting, and auditing firms. (LO 3)
- The code of ethics for Islamic Finance Professionals (IFPs) has been developed by AAOIFI to provide comprehensive ethical guidance to those working within the industry. (LO 4)
- Those wishing to pursue a professional career in the industry can choose from two qualifications which are currently offered by AAOIFI, that is, Certified *Shariah* Advisor and Auditor and Certified Islamic Professional Accountant. (LO 4)

1.11 Key Terms and Definitions

- **Gharar:** Any transaction or contract of probable nature where the materialisation of the contract is not certain at the time of contract and is contingent upon uncertain future events.

- **Ijarah:** A rental lease agreement (similar to an operating lease agreement in a conventional mode of finance) with an agreed-upon rent and period.
- **Islamic Financial Institutions (IFIs):** Financial institutions that operate in line with *Shariah* principles and rules.
- **Istisna'a:** It is a contract whereby the purchaser asks the seller to manufacture a specifically defined product using the seller's raw materials at a given price.
- **Mudaraba:** It is a partnership in profit between capital and work. This partnership arrangement can be made between investment account holders and the Islamic bank, or between the Islamic bank and business owners.
- **Murabaha:** Sale of goods with an agreed-upon profit markup on the cost. *Murabaha* sale is of two types. In the first type, the Islamic bank purchases the goods and makes them available for sale without any prior promise from a customer to purchase them. In the second type, the Islamic bank purchases the goods ordered by a customer from a third party and then sells these goods to the same customer.
- **Musharakah:** A form of partnership between the Islamic bank and its clients whereby each party contributes to the capital of partnership in equal or varying degrees to establish a new project or share in an existing one. Profits are shared on an agreed-upon basis, but losses are shared in proportion to the contributed capital.
- **Qard:** Interest-free loan.
- **Riba:** The charging of a stipulated benefit on a loan contract and under Islamic law, renders any such transaction as *Haram* (prohibited).
- **Salam:** Purchase of a commodity for deferred delivery in exchange for immediate payment according to specified conditions or sale of a commodity for deferred delivery in exchange for immediate payment.
- **Shariah:** Islamic law.

1.12 Review Questions

- 1 Which of the following statements about Islamic banking is not true?
 - a) Interest (known as *Riba*) is prohibited.
 - b) Conventional interest is considered by scholars to result in inequality and injustice in society.
 - c) Trading-based and risk-sharing transactions are impermissible.
 - d) Speculation-based transactions are considered to be unfair.
- 2 Which of the following statements is true?
 - a) *Murabaha*, an equity instrument, is a sales contract in which the asset is sold by the bank to the customer at cost-plus-profit.
 - b) *Salam* is a forward contract where a sale of an item is made before it is produced.

- c) *Musharakah* is a rental lease agreement (like an operating lease agreement in a conventional mode of finance) made for a pre-set price and period.
 - d) *Istisna'a* is an equity instrument where a futures contract is made for the sale of an item before it is manufactured/constructed.
- 3 Which of the following statements is true?
- a) Money is a commodity as well as a medium of exchange in a conventional mode of financing.
 - b) Money is not a commodity and is a medium of exchange and store of value in the Islamic mode of financing.
 - c) In Islamic finance, the concept of the time value of money is used to determine the profit charged on traded goods and services.
 - d) In the conventional mode of financing, funds disbursed under different financing arrangements do not require the exchange of any sort of goods or services.
- 4 The relationship between an Islamic bank and its customers is that of a:
- a) Partner/investor
 - b) Buyer and seller
 - c) Lessor/lessee
 - d) All of the above
- 5 In general, financial accounting can be broken down into the following steps:
- a) Identifying and recording economic transactions
 - b) Recording and communicating economic transactions
 - c) Identifying, recording, and communicating economic transactions
 - d) None of the above
- 6 Which of the following statements is true regarding the information needs of users of an IFI's financial statements?
- a) They require information about the institution's *Shariah*-compliant transactions.
 - b) They require information that can assist in evaluating the institution's compliance with *Shariah* principles and rules in all financial and other dealings.
 - c) They require information to be able to assess the risks inherent or associated with the IFI and how it manages such risks.
 - d) All of the above.
- 7 The standards-setting body of the IFRS Foundation is
- a) International Accounting Standards Board (IASB)
 - b) IFRS Foundation Monitoring Board
 - c) IFRS Interpretations Committee
 - d) IFRS Foundation Trustees

8 The *Shariah* governance framework

- a) Gives comprehensive guidance to ensure compliance with *Shariah* principles
- b) Helps to enhance the confidence of stakeholders and the financial markets in the credibility of the IFIs operating within a jurisdiction
- c) Defines the roles and responsibilities of the various organs of the institution vis-à-vis *Shariah* compliance
- d) All of the above.

9 Which of the following statements is not true?

- a) AAOIFI is responsible for the development and issuance of standards for the Islamic finance industry.
- b) All IFIs across the world are required to follow the accounting standards issued by AAOIFI.
- c) AAOIFI aims to harmonise the accounting policies and procedures adopted by IFIs.
- d) AAOIFI aims to improve the quality and uniformity of auditing and governance practices of IFIs.

10 Under AAOIFI code of ethics, accounting is:

- a) A necessary evil
- b) Required only for larger organisations
- c) A *Farz-e-Kifaya*
- d) Important for investment decision-making by investor

Notes

- 1 Different technical *Shariah* concepts for example, *Gharar*, *Maysir*, and *Qimar* cover uncertainty and speculations in contracts. These concepts will be explained in the coming chapters.
- 2 For example, late payment charges, fines, or penalties on violation of loan contracts.
- 3 As will become clear later, a bank can also enter into rental or sale/purchase contracts with its customers. However, Islamic banks are not allowed to charge interest-based returns under any circumstances.
- 4 *Mudaraba* is a profit-and-loss-sharing account where one party provides the capital (*Rab al-Maal*) and the other party provides its management expertise (*Mudarib*). The profits are shared in the agreed-upon ratio; in case of loss, *Rab al-Maal* loses her/his capital, whereas *Mudarib* loses her/his management effort.
- 5 Rather than US accounting standards which are rule based and cater to specific situations and businesses.

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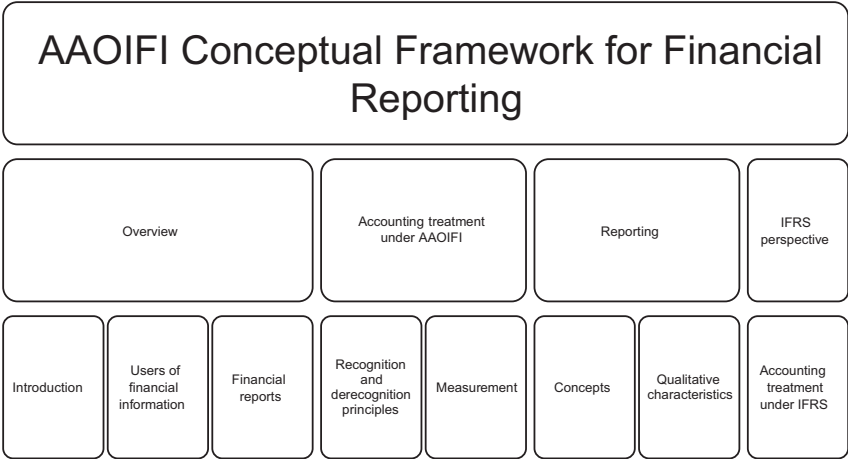
2 AAOIFI Conceptual Framework for Financial Reporting

Learning Objectives

After going through this chapter, you should be able to:

- 1 Describe the AAOIFI accounting framework, users of financial information, and financial reports.
- 2 Understand the recognition and measurement principles of financial accounting and reporting for IFIs.
- 3 Understand the concepts of financial accounting and reporting for IFIs, qualitative characteristics of accounting information, and the main considerations in providing useful financial information.
- 4 Understand the main differences in the accounting framework under IFRS and AAOIFI.

Chapter Preview



Cover Story

AAOIFI, an international organisation based in Bahrain, was established in 1990 with the aim of developing and promoting accounting, auditing, governance, and *Shariah* standards for Islamic finance. The organisation's mission is to develop and promote standards that are consistent with the principles of *Shariah* and that are accepted by the Islamic finance industry globally.

In the early 2000s, AAOIFI developed a series of *Shariah* standards for Islamic finance, covering various aspects of the industry such as accounting, auditing, governance, and *Shariah* compliance. The development and publication of these standards were major milestones in the development of Islamic finance. The *Shariah* standards developed by AAOIFI were accepted by a large number of IFIs and widely used in the Islamic finance industry. This helped to promote consistency and transparency in the industry and also helped to improve the overall quality of Islamic finance products and services. Additionally, AAOIFI's *Shariah* standards were also recognised by various regulatory and supervisory bodies around the world, including the Central Bank of Bahrain, the Central Bank of Malaysia, and the Islamic Financial Services Board.

In 2020, AAOIFI issued new *Shariah* standards for risk management in Islamic finance, which aimed to enhance the risk management practices of Islamic financial institutions (IFIs). The new standards covered various aspects of risk management, including credit risk, market risk, liquidity risk, and operational risk. In addition to the issuance of the new standards, AAOIFI also provided training and education on the new standards to IFIs and other stakeholders in the industry. This helped to ensure that the new standards were widely understood and implemented by IFIs and also helped to improve the overall level of risk management in the Islamic finance industry.

The issuance of these new standards was a major achievement for AAOIFI that helped to further establish the organisation's authority and acceptance among IFIs.

2.1 Introduction

2.1.1 Objectives and Rationale for a Separate Framework

The Conceptual Framework was revised in 2020 and the updated version replaced the prior framework which was in existence since 2010. The Framework not only harmonises accounting treatments across entities but also results in user confidence in the consistency of accounting standards with *Shariah* principles and rules. The Conceptual Framework aims to:

- 1 Promote harmonisation by providing a basis for selecting the most appropriate accounting treatment permitted by AAOIFI Financial Accounting Standards (FAS);

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- 2 Serve as a guide for the development of future AAOIFI FAS;
- 3 Assist in dealing with similar transactions, other events, or conditions not dealt with by FASs developed by AAOIFI;
- 4 Assist users of financial statements in interpreting the information contained in financial statements prepared in conformity with AAOIFI FAS;
- 5 Assist national standard-setting bodies in developing national accounting standards;
- 6 Serve as a guide to subjective judgements made by management while preparing financial statements and other financial reports;
- 7 Provide information about the approach adopted by AAOIFI while formulating the FAS for those interested in the work of AAOIFI.

2.1.2 Hierarchy for the Selection and Application of Accounting Policies

The Conceptual Framework sets out a hierarchy for the selection and application of appropriate accounting policies for an entity. This hierarchy is broken down into four levels.

Box 2.1 Practical Insight: AAOIFI's Acceptance

The AAOIFI standards have been widely accepted by IFIs and regulators around the world. For example, the Central Bank of Bahrain requires all IFIs operating in the country to comply with AAOIFI standards, and the standards have also been adopted by regulatory bodies in countries such as Malaysia, Pakistan, and Saudi Arabia (AAOIFI, 2023).

Box 2.2 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why it is false.

- 1) The AAOIFI Conceptual Framework serves as a foundation for the development of all current and future accounting standards developed by AAOIFI.
- 2) Management judgement should be applied first when selecting accounting policies.
- 3) In case there is a conflict between the Conceptual Framework and *Shariah* principles, the provisions of the Conceptual Framework will prevail to determine the appropriate accounting policy.

- 4) Amongst others, some of the items covered by the Conceptual Framework are recognition and measurement criteria, accounting concepts and assumptions, and qualitative characteristics of accounting information.
- 5) The accounting rules and principles as given in the Conceptual Framework are derived from *Shariah* rules.

Solution:

- 1) True.
- 2) False. The hierarchy given in Figure 2.1 states that management judgement is to be applied last in the selection of accounting policies.
- 3) False. In case of any apparent conflict, then the requirement to follow *Shariah* principles and rules prevails to determine the appropriate accounting policy.
- 4) True.
- 5) True.

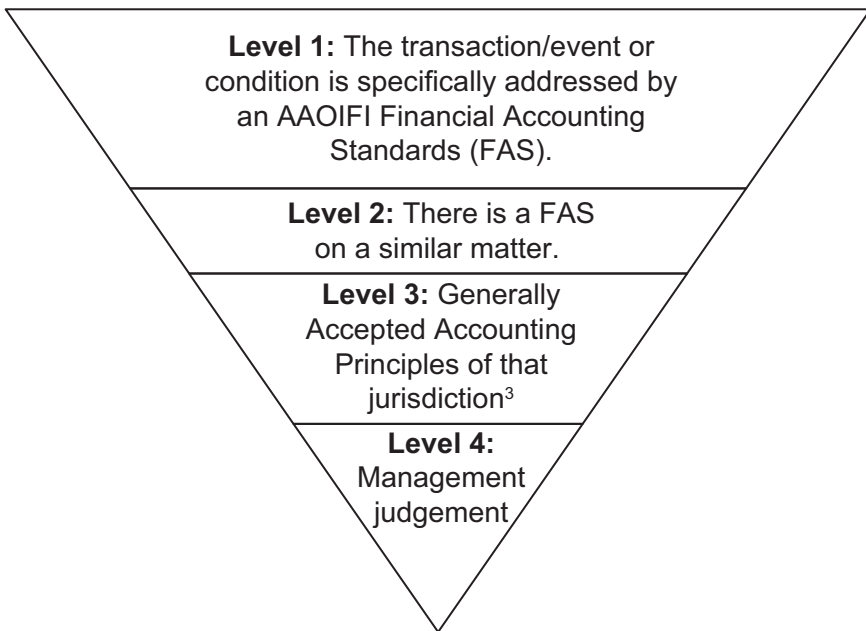


Figure 2.1 Selection of Accounting Policies¹

Source: Diagram by the authors.

2.2 Users of Financial Information

2.2.1 Primary and Secondary Users

In the updated framework, AAOIFI has classified the users of financial information into two categories: primary and secondary.

- 1 Primary users include existing and potential investors, including both the equity holders and the **participatory stakeholders** and creditors.
- 2 Secondary users include (but are not limited to) debtors, employees, regulators and other government agencies, rating agencies, central *Shariah* boards, and any other parties dealing with the institution.

Previously, no distinction was made between primary and secondary users, so this is a new addition to the 2020 framework. Notably, central *Shariah* boards were not explicitly mentioned previously as users of financial information. Their addition also emphasises the importance of the *Shariah* compliance dimension in the financial reports of IFIs.

2.2.2 Common Information Needs of Users

Different users of financial information often have conflicting needs. The framework clarifies that the purpose of general-purpose financial statements is not to accommodate the information needs of all users. Instead, the framework identifies certain common information needs of the users and focuses on ensuring these are covered by the general-purpose financial statements.

Some of the common information needs of the users are the following:

- 1 Information about the transactions, economic resources, and claims against the institution or on any specific economic resources of the institution;
- 2 Information on the operations and other financial data to assess the overall financial performance and position of the institution;
- 3 Information to assist in evaluating the institution's compliance with *Shariah* principles and rules in all financial and other dealings; and
- 4 Information to assist users in assessing the inherent or associated risks of the institution, its financial position or its operations, and the institution's approaches to managing such risks.

Further information identified by the Framework includes:

- 1 Information to help evaluate the institution's ability to:
 - a) effectively utilise the economic resources available to it such that the resources are both safeguarded and their value increases, at reasonable rates;
 - b) carry out its social responsibilities; and
 - c) provide for the economic needs of those who deal with the institution.

- 2 Information through which the employees can evaluate their relationship and future with the institution in terms of how their rights are safeguarded and their managerial and productive skills and capabilities are developed.
- 3 Information enabling the determination of *Zakah* and details of how prohibited earnings were recorded and dealt with by management.

2.3 Financial Reports

2.3.1 General-Purpose Financial Statements

The framework defines two categories of reports to cater to the needs of financial statement users: general-purpose financial statements and special-purpose reports.

General-purpose financial statements are the main output of the financial accounting system of an institution. They cater to the needs of a wide range of users and provide a true and fair view of the performance of an entity during the period. General-purpose financial statements comprise primary statements as well as explanatory notes including accounting policies. On the other hand, special-purpose reports are targeted at identified users with their scope of the level of disclosures being highly specific as per the need of the identified user.

2.3.1.1 Primary Statements

Primary statements provide information to assist users of the financial statements in their decisions regarding the institution:

- Statement of Financial Position (Balance Sheet)
- Statement of Income and Other Comprehensive Income
- Statement of Income and Attribution Related to **Quasi-Equity**
- Statement of Changes in **Owners' Equity**
- Statement of Cash Flows
- Statement of Changes in Off-Balance Sheet Assets Under Management
- Statements Relating to *Takaful*/Insurance Operations

1 Statement of Financial Position (Balance Sheet)

- a) Shows economic resources, claims on the institution, and claims on specific economic resources;
- b) Helps evaluate the financial structure, liquidity position, quality of assets, and solvency;
- c) Helps predict how future cash flows will be distributed.

2 Statement of Income and Other Comprehensive Income

- a) Shows changes in economic resources and claims due to past financial performance;

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- b) Gives information about revenue, expenses, and net income during a period.

3 Statement of Cash Flows

- a) Provides information about the institution's cash flows during a period;
- b) Helps users to understand and interpret current and future cash flows;
- c) Provides information about financing transactions of the institution;
- d) Helps understand and interpret changes in the financial structure, condition, and solvency position.

2.3.1.2 Explanatory Notes

Financial statements should entail additional information which will help users analyse and interpret the financial data provided within the statements. This information should cover circumstances such as any transactions or events that have affected or may affect the institution both financially and non-financially. There should also be details about commitments, contingencies, and uncertainties regarding the outcome of any dispute that can possibly have a material impact on the financial statements. Moreover, the notes shall include accounting policies that have been applied while preparing these financial statements along with information about alternative accounting treatments allowed under FASs for a certain transaction or event. This will help users identify changes in accounting policies and accordingly gauge the relevance of such policies in relation to a certain event, condition, or transaction.

2.3.1.3 Limitations of General-Purpose Financial Statements

The general-purpose financial statements cannot provide all the information required by all categories of users. Some of the main limitations as specified by the Conceptual Framework include the following.

- 1 The focus of financial accounting is to record and report the financial effects of transactions. The information which cannot be easily or reliably measured monetarily, therefore, falls outside the domain of financial accounting, such as evaluating the ability of the institution to achieve its objectives.
- 2 Financial accounting does not differentiate between the institution's performance and managerial performance. External factors, beyond the control of management, often impact the performance of the organisation.
- 3 Financial accounting data is historical in nature, yet this is often used to predict the future or make future decisions between alternative courses of action.
- 4 Financial accounting is, to a large extent, based on estimates, judgements, and models of the financial effects of transactions rather than the actual depictions of those transactions.

- 5 Cost–benefit considerations: financial accounting and reporting have a cost (monetary and otherwise) associated with them. Therefore, only the common information needs of primary users are catered for.

Box 2.3 Practical Insight: AAOIFI Adoption by State Bank of Pakistan

In 2022, the State Bank of Pakistan (SBP) incorporated four additional *Shariah* standards from AAOIFI into its regulations. These standards include Salam and Parallel Salam, Istisna’a and Parallel Istisna’a, Combination of Contracts, and Irrigation Partnership (Musaqat), with some clarifications and modifications. Strengthening *Shariah* compliance in the Islamic banking industry aligns with SBP’s 3rd Strategic Plan for Islamic Banking Industry 2021–25. The SBP has been gradually adopting AAOIFI’s *Shariah* standards to promote international best practices and elevate the local Islamic banking sector. With the adoption of these four standards, the SBP has now implemented a total of 20 AAOIFI *Shariah* standards while efforts to adopt the remaining standards are ongoing (The Express Tribune, 2022).

2.3.2 Elements of Financial Statements

The elements of the financial statements are the broad classes of similar transactions, other events, or conditions. The main elements are assets, liabilities, quasi-equity, owners’ equity, and income and expenses (including gains and losses). The framework also defines net return on quasi-equity as the return attributable to quasi-equity holders and off-balance sheet assets under management as assets for which the institution has a fiduciary responsibility but not control. The basic definitions of the main elements are detailed in Figure 2.2.

Box 2.4 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) An asset is defined as a present or future economic resource controlled by the entity that will result in future economic benefit.
- 2) The elements of the financial statements include assets, liabilities, quasi-equity, owners’ equity, income, and expenses.
- 3) The gross increase in assets or decrease in liabilities or a combination of both during the period covered by financial statements is recorded as an expense for the institution.

- 4) Income is the decrease in assets and/or increase in liabilities resulting from investment, trading, rendering of services, or any other profit-oriented activity.
- 5) Quasi-equity holders have the right over the institution including the special rights that holders of owners’ equity have.

Solution:

- 1) False. An asset is a present economic resource controlled by the entity because of a past transaction or event which will result in future economic benefit.
- 2) True.
- 3) False. The gross increase in assets or decrease in liabilities or a combination of both during the period covered by financial statements is recorded as an income for the institution.
- 4) False. Income is an increase in assets and/or reduction in liabilities resulting from investment, trading, rendering of services, or any other profit-oriented activity.
- 5) False. Quasi-equity holders have rights limited to only the underlying asset/business, not over the entire institution. They do not have rights that are associated with owners’ equity only.

Assets
<ul style="list-style-type: none">• A present economic resource controlled by the entity as a result of a past transaction or event;• Will result in future economic benefit.
Liabilities
<ul style="list-style-type: none">• A present obligation (legal or constructive), other than quasi-equity, arising as a result of a past transaction or event;• Will result in an outflow of economic benefits;• A future commitment (only if it is onerous).
Quasi-equity
<ul style="list-style-type: none">• Represents participatory contributions received by an institution on a profit-sharing basis;• Primary characteristics of equity since fund providers have residual claim in underlying assets / business;• Certain characteristics of liabilities i.e. has maturity or put option of redemption / liquidation;• Other specific features include:• Fund holders' rights restricted to underlying assets / business, not to the entire institution;• Do not have certain rights associated with equity.
Owners' equity
<ul style="list-style-type: none">• Residual interest in assets of institution after deduction of liabilities and quasi-equity
Income
<ul style="list-style-type: none">• Consideration received for the transfer of goods or services to the customer;• Increase in assets and/or reduction in liabilities resulting from investment, trading, rendering of services or any other profit-oriented activity.
Expenses
<ul style="list-style-type: none">• Decrease in assets and / or increase in liabilities, excluding investments by or distributions / withdrawals to the owners / quasi-equity holders.

Figure 2.2 Elements of Financial Statements

Source: Diagram by the authors.

2.4 Recognition and Derecognition Principles

2.4.1 Assets and Liabilities

Assets and liabilities should be recognised when the criteria specified in Table 2.1 are satisfied. For example, in the case of assets, the main principle for recognition is “control”. Control means that the risks and rewards of ownership of an asset lie with the party recognising the asset. Control includes the right to variable returns (profit or losses) from the use of the assets and the right to affect (use and enjoy) the benefits of these returns through its power over the assets. The “risk and rewards” condition is an important *Shariah* rule required for many sales-based Islamic financial instruments. For example, the chapters on *Murabaha* (Chapter 3), *Salam* (Chapter 4), and *Istisna’a* (Chapter 5) will illustrate this aspect further.

Changes in any conditions resulting in an asset or liability no longer meeting the prescribed recognition criteria result in its derecognition or removal from the financial statements. For example, the derecognition of an asset might occur when/if:

- 1 Control of an asset is transferred to a third party, for example, through sale or gift. It is important that in the case of a trading transaction, following the sale of the asset, the entity should not have involvement with the asset since this would cause an adverse *Shariah* implication.
- 2 No future economic benefits are expected from the asset, for example, if it is expired, impaired, destroyed, and so on.

Table 2.1 Chapters of the Frameworks

<i>IFRS framework</i>	<i>AAOIFI framework</i>
Chapter 1: The Objective of general-purpose financial reporting	Chapter 1: Objectives, authoritative status, and applicability
Chapter 2: Qualitative characteristics of useful financial information	Chapter 2: Definitions
Chapter 3: Financial statements and the reporting entity	Chapter 3: Users, objectives, and limitations of financial information
Chapter 4: The elements of financial statements	Chapter 4: Financial accounting process
Chapter 5: Recognition and derecognition	Chapter 5: Financial statements and the reporting institution
Chapter 6: Measurement	Chapter 6: Qualitative characteristics of financial information
Chapter 7: Presentation and disclosure	Chapter 7: <i>Shariah</i> principles and rules used as a foundation for the Conceptual Framework
Chapter 8: Concepts of capital and capital maintenance	Chapter 8: Effective date and transitional provisions

Derecognition of a liability occurs once it is settled, transferred, or extinguished (waived or no longer considered payable contractually or constructively). For recognition and derecognition of liabilities, there are examples in various chapters such as *Murabaha* (Chapter 3), *Salam* (Chapter 4), and *Istisna'a* (Chapter 5).

2.4.2 *Income*

Income for an institution comprises the amount expected to be received in exchange for goods and services. There are five basic steps which should be followed for recognising income:

- 1 Identify the contract with a customer;
- 2 Identify the performance obligation;
- 3 Determine the transaction price;
- 4 Allocate the transaction price to the performance obligations;
- 5 Recognise the income as soon as performance obligations are met.

The basic principle for income recognition is that it should be recognised when it is earned (see Figure 2.3). The following conditions should be satisfied:

- 1 The institution has earned the right to receive income.
- 2 There is an obligation on the other party to make payment to the institution of a determinable amount.
- 3 The amount of income should be known and collectable with reasonable certainty.

2.4.3 *Expenses*

In general, an expense should be recognised if it has occurred. The occurrence of an expense relates it to the income earned and recognised in that period. An expense that has no direct relationship with the income but is related to the *period* in which the income is recognised falls into the following two categories:

- 1 Expenses which provide benefits in one period but are not expected to provide reasonably measurable benefits in future periods, for example, management compensation and bonuses, other administrative expenses which are difficult to allocate to specific services performed by the institution or specific assets acquired by it. Such expenses are therefore recognised when incurred.
- 2 Expenses which are expected to benefit multiple periods. Such costs should be allocated in a rational and systematic manner to the periods expected to benefit, for example, the cost of fixed assets is allocated through depreciation over the useful lives of the assets (Figure 2.4).

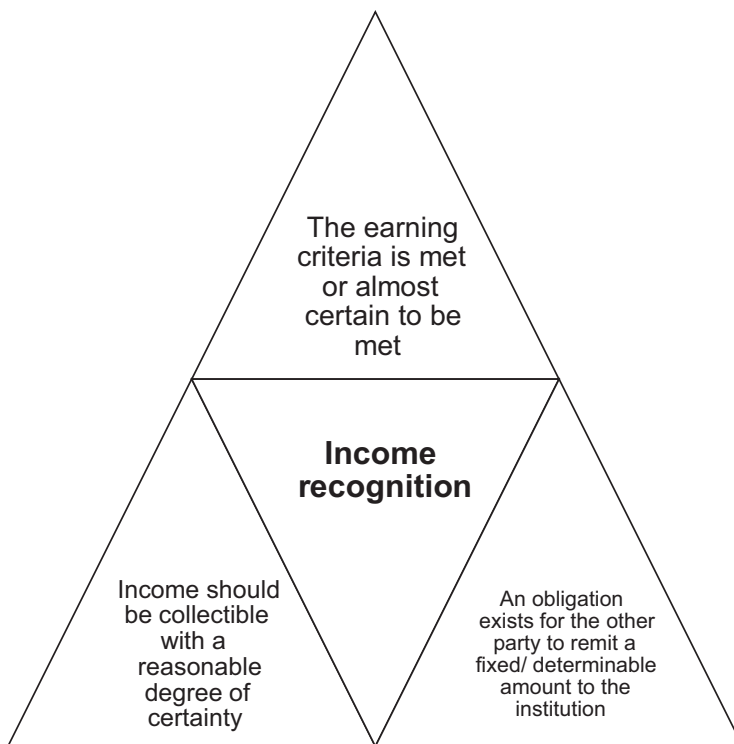


Figure 2.3 Income Recognition Criteria

Source: Diagram by the authors.

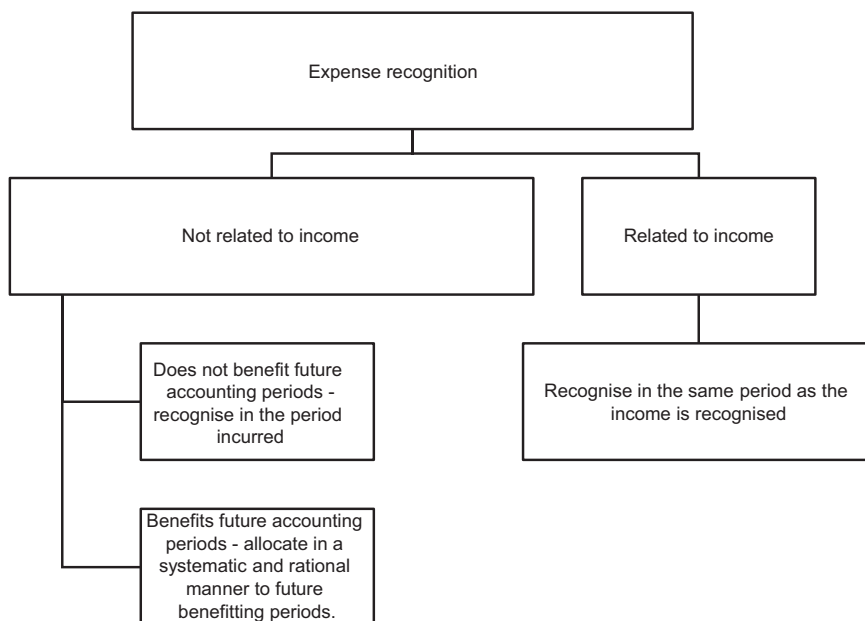


Figure 2.4 Expense Recognition Criteria

Source: Diagram by the authors.

Box 2.5 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) If the control of the asset is transferred to another party via a sale transaction, or if there are no future economic benefits expected from the use or disposal of the asset, then it can be derecognised.
- 2) Income can be recognised even if you have not earned it yet.
- 3) If there is substantial evidence provided about the appreciation/depreciation of assets and liabilities, we can recognise unrealised gains and losses arising due to such revaluation.
- 4) Expenses are always recognised in the period they are incurred.
- 5) For income to be recognised, its collection should be reasonably certain.

Solution:

- 1) True
- 2) False. It is highly important for an institution to properly know the income amount and recognise income only when it is earned, which means that either the institution has earned the right to receive income or there is an obligation on the other party to make payment to the institution.
- 3) True.
- 4) False. An expense which is expected to benefit multiple periods should be allocated systematically to those periods.
- 5) True.

2.5 Measurement

Measurement refers to the amount at which elements of financial statements are recognised in the institution's balance sheet. The basis used for measurement depends on the element and the circumstances in which measurement is taking place. For example, assets can be measured at acquisition cost, net realisable value, cash equivalent value to date, replacement cost, or any other attribute which would result in relevant information for the users. Two important bases of measurement are historical cost and fair value.

2.5.1 Historical Cost

The historical cost of an asset refers to cash or its cash equivalent paid or received or the fair value of the consideration given to acquire the asset. The historical cost of a liability is the amount received by the institution when the liability was incurred or cash or cash equivalents that are expected to be paid.

The historical cost of an asset or liability remains the same in the books of accounts and is easily verifiable due to the availability of transaction records.

2.5.2 Fair Value

Fair value is the price that is expected to be received while selling an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.

Fair value at the date of acquisition refers to the price paid by the institution to purchase the asset in an arm's length transaction. When an asset is acquired through non-reciprocal transfer, the fair value is the market value at which a similar asset is exchanged in an arm's length transaction between unrelated parties.

For a *Shariah*-conscious investor, this measurement method is particularly important due to *Zakah* obligations, which require a valuation to be based on fair value. This will be further illustrated in Chapter 11 *Zakah*.

Box 2.6 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) The measurement attribute used by the entity should be that which results in the most relevant information to the users.
- 2) When deciding to use fair value, entities should ensure consistency in the use of the same valuation experts.
- 3) Historical cost is generally easily verifiable due to the availability of transaction records.
- 4) Historical cost of an asset refers to the amount received by the institution when the liability was incurred or cash or cash equivalents are expected to be paid.
- 5) Fair value is the market value at which a similar asset is exchanged in an arm's length transaction between unrelated parties.

Solution:

- 1) True.
- 2) False. The institution should be consistent in the use of valuation methods.
- 3) True.
- 4) False. The historical cost of a liability refers to the amount received by the institution when the liability was incurred or cash or cash equivalents are expected to be paid.
- 5) True.

2.6 Concepts of Financial Accounting and Reporting for IFIs

2.6.1 *The Reporting Institution*

Financial statements are prepared for a reporting institution. This is often a separate legal institution; however, it may be an entity which is not a separate legal entity, for example, *Sukuk*, covered later in the book, is not a separate legal entity.

2.6.2 *Accounting Unit Concept*

The Conceptual Framework is based on the principle that the economic activities associated with the institution must be identifiable and expressed as the institution's assets, liabilities, quasi-equity, owners' equity, and income and expense separately from those of its owners. For example, assets, liabilities, equity, income, and expense of a *Sukuk* issued by an organisation must be separately identifiable from those of other assets, liabilities, income, and expenses of the organisation in question.

2.6.3 *Going Concern Concept*

When recording financial transactions and preparing an entity's financial statements, it is assumed that the institution will continue in the foreseeable future as a going concern, and there is no intention to liquidate the institution or close its operations.

2.6.4 *Periodicity Concept*

An Islamic financial institution's life can be divided into reporting periods under the periodicity concept to prepare financial reports for stakeholders. This makes it easier for users to evaluate the institution's financial situation and performance on a regular basis and evaluate the bank's and other parties' financial duties and rights.

2.6.5 *Accrual and Matching Basis*

The accrual concept allows an institution to prepare financial statements that provide interested parties with information that can help them evaluate the performance of the institution during a period. Financial accounting effects of transactions and other events are recognised and recorded in the accounting records when they occur and are reported in financial statements of the period to which they relate, irrespective of related cash payment or receipt.

The institution's net income or loss for a period can be determined by matching income and gains with expenses and losses that relate to that period in accordance with the basic principles of accounting recognition as well as *Shariah* rules.

2.6.6 Purchasing Power of the Monetary Unit

Monetary units of a given currency are used as a common denominator to express the basic elements of financial statements. However, this might raise questions regarding the stability of measurement units owing to sudden changes in their purchasing power, for example, inflation or deflation. For this reason, purchasing power stability for monetary units is assumed.

2.6.7 Control

An institution can be considered to have control over an asset or a business if it has ownership and bears substantially all the associated risks and rewards incidental to the asset or business. The following two conditions must be satisfied for establishing control:

- 1 It is directly exposed to or has the right to variable returns (whether gains or losses) from the asset or business.
- 2 It can affect the returns through its power over the asset or business.

Box 2.7 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) An institution can still be considered to have control over assets if they do not have ownership of the asset.
- 2) When a reporting institution is a legal entity, the boundary of financial statements is determined by the information needs of primary users.
- 3) All economic activities associated with an institution, as a separate institution, need to be identified as they can be expressed as institutions' assets, liabilities, quasi-equity, owners' equity, and income and expense as per the accounting unit concept.
- 4) According to the going concern concept, the financial statements of the institution are prepared on the assumption that there is no intention to liquidate the institution or close the operations.
- 5) Accrual concept is that financial accounting effects of transactions and other events are recognised and recorded in the accounting records when they occur.

Solution:

- 1) False. An institution can be considered to have control over assets or business if they have the ownership and thus bear the associated risk and reward.

- 2) False. When reporting institution is not a legal entity, the boundary of financial statements is determined by the information needs of primary users of financial statements.
- 3) True.
- 4) True.
- 5) True.

2.7 Qualitative Characteristics of Financial Information

High-quality information should be relevant to the information needs of the users, transparent, timely, reliable, and understandable. In addition, financial information should allow comparison of the financial performance and condition of different entities and should result in faithful representation. While other qualitative characteristics are self-explanatory, the concept of faithful representation requires further elaboration.

2.7.1 Faithful Representation

Faithful representation requires that the information should have three important qualities: true and fair view, substance and form, and neutrality.

2.7.1.1 True and Fair View

The financial statements should present fairly the financial position, performance, and changes in the financial position of an institution.

2.7.1.2 Substance and Form

The concept of “substance over form” is understood in mainstream accounting to mean that all transactions should be presented in a manner which is consistent with their economic reality and intent rather than the apparent legal form, which can be, at times, misleading.

The substance-over-form requirement becomes even more critical in Islamic accounting where the intent of the action is considered extremely important. Actions are said to be judged on the basis of the intentions of the actors. At the same time, *Shariah* also demands that contracts should comply with their legal Islamic form; that is, the procedure adopted should be *Shariah* compliant and approved by *Shariah* scholars. Therefore, Islamic financing transactions must follow the substance as well as the respective legal form and should be compliant with *Shariah* principles and rules. This concept is termed “uniformity of substance and form”. It is due to this difference in approach, as we will see later in the book, that leasing (*Ijarah*) is treated as an operating lease under AAOIFI and as a financing lease under IFRS.

However, as will be seen in subsequent chapters, further challenges may arise in recording economic transactions, when there is a difference in the economic substance and apparent legal form of a transaction. Although uniformity of substance and form is important, AAOIFI recognises that there may be instances where substance overrides form or vice versa, depending on the requirement of underlying *Shariah* principles. Many controversies associated with Islamic finance arise because of the disturbing similarity of the economic substance of Islamic contracts with their conventional counterparts, even though the legal forms of the two may be different. This would not be acceptable to *Shariah*-conscious users. In case of ambiguity, guidance should be sought as to which approach, legal form or economic substance, gives a more faithful representation of the transaction.

2.7.1.3 Neutrality

Accounting information should be free of any biases and should cater to the common information needs of its users rather than favouring a particular group of users.

Box 2.8 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) The primary characteristics of accounting information are relevance and faithful representation.
- 2) Faithful representation requires that the information should have three important qualities: true and fair view, substance and form, and uniformity.
- 3) The concept of 'uniformity of substance and form' means that the substance as well as the respective legal form should be compliant with *Shariah* principles and rules.
- 4) Adequate disclosure means that financial statements should contain all material and non-material information necessary to make them useful to their users.
- 5) One misuse of prudence is the creation of hidden reserves or excessive provisions just to show the greater financial strength of the institution.

Solution:

- 1) True.
- 2) False. Faithful representation requires that the information should have three important qualities: true and fair view, substance and form, and neutrality.
- 3) True.

- 4) False. Adequate disclosure means that financial statements should contain all material information necessary to make them useful to their users.
- 5) True.

2.7.2 Considerations in Providing Useful Financial Information

The two most important considerations in providing financial information to users of financial statements are *materiality* and *cost*. Information is material if its omission or misstatement can affect the decisions that users make based on the presented financial information. Materiality has a quantitative and a qualitative dimension. The quantitative dimension means that an omission or a misstatement is of such a quantitative magnitude that users would err in making an informed decision based on it. At times, the materiality of an omission or a misstatement is linked with not its quantitative but its qualitative dimension. For example, a *Shariah*-conscious investor's decision to invest in a beverage firm with billions of dollars of sales will change even if the entity trades in a single bottle of alcohol.

Providing financial accounting information entails certain costs. It should be ensured by the management of all Islamic entities that the benefits of providing financial information to the intended users exceed the costs of providing the information.

2.8 IFRS Perspective

2.8.1 Structure and Applicability

The main objective of the IFRS Framework is to set out the fundamental concepts of financial reporting and guide the standard setters on how to develop future standards in a consistent manner. This is similar to the AAOIFI Framework, and therefore it is hardly surprising that the basic structure of the chapters and content coverage in both frameworks have considerable similarity with the exception of one or two chapters. The chapters covered in each of the frameworks are given in Table 2.1. It can be seen that Chapter 8 of the IFRS Framework which covers the concepts of capital and capital maintenance is not a part of the AAOIFI Framework. Similarly, Chapter 7 is unique to the AAOIFI Framework which covers in detail the *Shariah* rules and principles used as a foundation for the Conceptual Framework. The AAOIFI Framework is based on the *Shariah* standards, and in case any conflict between the two arises, it is the *Shariah* rules and principles which must prevail (principle of *Shariah* compliance override). The IFRS Framework is not in line with *Shariah* rules and principles. Therefore, there are certain accounting principles and concepts which differ between the two frameworks, for example, using time value of money principles for discounting future cash flows and the concept of substance over form.

The IFRS Framework is a guide for the accounting and reporting of all types of entities (including even *Shariah*-compliant entities); however, the AAOIFI Conceptual Framework provides guidance on the accounting and reporting of only *Shariah*-compliant transactions in *Shariah*-compliant or conventional institutions.

2.8.2 Users

The IFRS Framework refers to the “primary users” who are the existing and potential investors, lenders and other creditors who are reliant on the general-purpose financial reports for most of their financial information needs. It does not use the term “secondary users” like its AAOIFI counterpart. Whilst the definition of primary users is similar under both frameworks, the AAOIFI user base is broader since the secondary users include many other categories not covered by IFRS. One can argue that by recognising many secondary users other than financial investors, AAOIFI has adopted a more holistic and sustainable approach to the financial governance of entities as compared to the IFRS Framework, which is allegedly too narrow in its approach to prioritising financial investors. As a result, a small but financially affluent minority benefits extraordinarily whereas the public interest (which is a part of the IASB charter) is compromised.²

2.8.3 Financial Reports and Elements of Financial Statements

Various additional financial statements prescribed in the AAOIFI Framework are not a part of the conventional framework. For example, the statement of income and attribution related to quasi-equity, statement of changes in off-balance sheet assets, and statements relating to *Takaful* operations are not specifically mentioned under the IFRS Framework.

The elements of the financial statements, that is, assets, liabilities, equity, income, and expenses, overlap in both frameworks. Complications arise because Islamic banks often receive funds from depositors on a profit-and-loss-sharing basis (referred to as *Mudaraba* Investment Accounts). Their accounting treatment creates a dilemma since the funds have some (but not all) characteristics of both liabilities and equity. Under the IFRS-based accounting treatment, such funds are normally classified as liabilities. However, AAOIFI, recognising their complex nature, has created another element for the reporting of these deposits: quasi-equity. There is no such element given under the IFRS Framework.

2.8.4 Measurement Bases

2.8.4.1 Historical Cost

- The AAOIFI definition of historical cost is simple and brief. However, the IFRS Framework goes into considerable detail when defining historical

costs for assets and liabilities. Certain aspects are not permissible under *Shariah*. For example, the IFRS Framework permits updating the historical cost for, amongst other things, the accrual of any interest to reflect the financing component of the asset or liability.

- For financial assets and financial liabilities, IFRS permits the use of amortised costs to measure historical costs. The amortised cost of a financial asset or financial liability reflects the estimates of future cash flows, discounted at a rate determined at initial recognition. This may be subsequently adjusted if required. Though the use of such amortised costs was not considered in line with *Shariah*, some of the updated AAOIFI Financial Accounting Standards have permitted its use for reporting purposes.
- For Islamic financial transactions, there is an inclination towards determining the current value (fair value) of the assets/liabilities due to the obligations of the users. For example, *Zakah* and inheritance calculations are based on current values, and therefore this information is particularly important for a *Shariah*-conscious user.

2.8.4.2 *Current Value*

- IFRS also permits the use of current value as a measurement basis. The current value measurement basis includes:
 - Fair value;
 - Value in use for assets and fulfilment value for liabilities; and
 - Current cost.
- IFRS has a broad, hierarchical definition of what constitutes fair value. Three levels are defined for determining fair value. Levels 1 and 2 require considering the quoted prices for identical or similar assets or liabilities. These approaches are permissible under AAOIFI. However, in case it is not possible to use Levels 1 or 2 due to unavailability of data, then under Level 3, other techniques may be adopted to compute fair value, including cash-flow-based measurement techniques in which estimates of future cash flows, time value of money, a risk premium, or discount may be applied on the basis of current interest rates to compute a proxy market value. Even though there is no actual charging of interest, such techniques are generally not permitted under *Shariah*.
- The value in use is the present value of the cash flows, or other economic benefits, that an entity expects to derive from the use of an asset and its ultimate disposal. The fulfilment value is the present value of the cash, or other economic resources, that an entity expects to be obliged to transfer as it fulfils a liability. Both bases require the discounting of future cash flows to present value.

2.8.5 Substance Over Form

The IFRS Framework requires that the substance of a transaction be faithfully represented for financial information to be useful. If the substance and legal forms differ, then only reporting the legal form would not faithfully represent the economic phenomenon; hence, there is a clear preference for substance over form. AAOIFI stresses the importance of “uniformity of substance and form” which essentially means that both are important.

2.8.6 Time Value of Money

As mentioned earlier, a key difference between IFRS and AAOIFI concepts lies in the use of the time value of money concepts. The time value of money and discounted cash flow techniques based on interest rates are applicable under IFRS for current value measurements as well as determining the amortised cost of some financial assets and liabilities. There is no actual charging of interest and the use of the interest rate is only intended to help approximate a market price. AAOIFI standards have historically disallowed the use of discounted cash flow techniques since they require the use of interest rates, and under *Shariah* principles money is considered to be only a medium of exchange and not a factor of production. According to certain schools of thought, receivables cannot be discounted or finance costs/interest cannot be accrued on liabilities due in the future. However, some of the updated AAOIFI Financial Accounting Standards (e.g., FAS 28 *Murabaha* and other deferred payment sales and FAS 32 *Ijarah*) have allowed the use of such techniques for reporting purposes.

Box 2.9 Practical Insight: Do Islamic Financial Institutions Have a Choice Between IFRS and AAOIFI?

The accounting standards that an Islamic Financial Institution (IFI) needs to adhere to when reporting its financial transactions depend largely on the laws of the country in which it is registered. For instance, within the European Union, publicly listed companies are obligated to prepare their consolidated accounts in accordance with International Financial Reporting Standards (IFRS). However, in countries like Bahrain and Qatar, IFIs are required to follow the accounting standards established by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI).

IFRS is the predominant accounting standard used worldwide, with the exception of the United States, which employs its own standards, the US GAAP. Additionally, all countries within the Gulf Cooperation Council (GCC), except Bahrain and Qatar, are expected to adopt IFRS.

Box 2.10 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) IFRS focuses on reporting the economic substance of the transaction undertaken; AAOIFI's primary aim is to see that IFI's accounting practices follow *Shariah* rules and principles.
- 2) Time value of money can be used as the primary accounting model for estimations of fair values, provisions, reserves etc.
- 3) A deferment of a profit already legitimately earned is acceptable, which results in a more equitable, fair, and just distribution of profits amongst stakeholders.
- 4) A profit to be accrued on a transaction to be executed on a future date is eligible for recognition.
- 5) Leasing (*Ijarah*) is treated as an operating lease under AAOIFI and as a financing lease only under IFRS.

Solution:

- 1) True.
- 2) False. The time value of money can be used for estimations of fair values, provisions, reserves, etc., but not as the primary accounting model.
- 3) True.
- 4) False. A profit to be accrued on a transaction to be executed on a future date is not eligible for recognition.
- 5) True.

2.9 Chapter Summary

- The users of financial reports of IFIs are likely to have unique information requirements; hence the reporting framework must cater to their needs. AAOIFI serves as the foundation for the development of all current and future FAS by the AAB and provides appropriate guidance on the selection and application of accounting policies in case any particular transaction or event is not addressed by a specific standard. (LO 1)
- The Conceptual Framework broadly classifies two categories of users: primary and secondary. Primary users are the existing and potential investors, that is, equity holders, creditors, and participatory stakeholders whilst secondary users include debtors, employees, regulators, rating agencies, central *Shariah* boards, and other government agencies. (LO 1)

- The main objective of financial accounting and reporting is to provide information to the users of financial statements about the financial condition, performance, and *Shariah* compliance of an institution. (LO 1)
- The primary statements which should be produced by an IFI include:
 - 1 Statement of Financial Position (Balance Sheet)
 - 2 Statement of Income and Other Comprehensive Income
 - 3 Statement of Income and Attribution Related to Quasi-Equity
 - 4 Statement of Changes in Owners' Equity
 - 5 Statement of Cash Flows
 - 6 Statement of Changes in Off-Balance Sheet Assets Under Management
 - 7 Statements Relating to *Takaful*/Insurance Operations (LO 1)
- The main elements of financial statements are assets, liabilities, quasi-equity, owners' equity, and income and expenses (including gains and losses). (LO 1)
- Recognition means the determination of the exact timing for accounting for income, expense, gains and losses, assets, and liabilities in the financial statements. Measurement basically refers to the amount at which elements of financial statements are recognised in the institution's balance sheet. (LO 2)
- Qualitative characteristics include relevance and faithful presentation; supplementary characteristics involve decision usefulness, transparency, timeliness, understandability, reliability, comparability, and prudence. (LO 3)
- The main considerations when reporting financial information are materiality and cost. (LO 3)
- The main objective of the IFRS Framework is the same as that of the AAOIFI Framework, that is, to set out the fundamental concepts of financial reporting and guide the standard setters on how to develop future standards in a consistent manner. The main difference is that the AAOIFI Framework has an additional aim of ensuring adherence to *Shariah* rules and principles. (LO 4)

2.10 Key Terms and Definitions

The definitions and meanings of these terms where available have been taken from AAOIFI's Conceptual Framework and respective accounting standards. Where it was not available in AAOIFI Framework, we used other accounting frameworks like IFRS and US GAAP.

- **Asset:** A present economic resource controlled by an institution as a result of a past transaction, an event, or a condition and gives it a future economic benefit.
- **Control:** When an institution has substantially all risks and rewards incidental to ownership of such asset or business, duly meeting both

conditions; it is directly exposed to variable returns (negative or positive) from its involvement with such assets or business, and it has the ability to affect those returns through its power over assets or business.

- **Expense (including loss):** Gross decreases in assets or increases in liabilities or a combination of both during the period covered by financial statements of the institution, excluding investment by (or distribution to) owners or investment (or withdrawal) by quasi-equity holders.
- **Fair value:** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
- **Historical cost:** The purchase price or the cost of acquisition of an asset plus any other costs incurred by the institution, for example, customs duties and other taxes on purchases, transport and loading charges, *Takaful*, and any other expenses directly related to the asset.
- **Income:** The transfer of promised goods/services to customers in an amount that reflects the consideration to which the institution is entitled in exchange for those goods/services. Second, the gross increases in assets or decreases in liabilities or a combination of both during the period covered by the financial statements resulting from investment, trading, or the rendering of services and other profit-oriented activities of the institution like investment management of off-balance sheet assets under management.
- **Liability:** A present obligation (legal or constructive) other than a quasi-equity that is enforceable against the institution resulting in the outflow of economic resources. Liability results from a past transaction, event, or condition. A future commitment is not considered a present obligation for the purpose of this definition unless it is considered onerous.
- **Owners' equity:** The residual interest in the assets of the institution after deducting all the liabilities and the quasi-equity.
- **Participatory stakeholder:** Has a contractual agreement with the institution to share the profit, losses, and residual interest in the net assets of the underlying assets or business.
- **Quasi-equity:** An element of the financial statements that represents participatory contributions received by an institution on a profit-sharing or participation basis. It has primary characteristics of equity, certain characteristics of a liability, as well as some special features.
- **Shariah principles and rules:** Comprises the *Shariah* principles and rules defined by the following hierarchy, as appropriate:
 - The *Shariah* standards are issued by Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).
 - The regulations issued by the respective jurisdiction's regulator insofar as these entail the regulatory *Shariah* requirements.

- The rulings of the central *Shariah* board for the jurisdiction (if there is one).
- The requirements of the applicable Financial Accounting Standards (FAS) as issued by AAOIFI, insofar as these entail *Shariah*-related requirements.
- Approvals and rulings are given by the *Shariah* supervisory board of the institution.

2.11 Review Questions

- 1 Which of the following statements is true about why AAOIFI Framework was introduced?
 - a) AAOIFI Framework was introduced because there was no existing framework for banking industry.
 - b) AAOIFI Framework was introduced to enable the development of a common accounting and reporting framework for IFIs and promote harmony in accounting treatments.
 - c) AAOIFI Framework was introduced for specific reporting demands of certain countries.
 - d) AAOIFI Framework was introduced as IFRS was no more useful for reporting IFIs.
- 2 Which of the following are considered to be common information needs of users?
 - a) Information about the institution's transactions, its economic resources and claims against the institution or on specific economic resources, its operations and other financial data assisting to assess the overall financial performance and position of the institution.
 - b) Information that can assist in evaluating the institution's compliance with *Shariah* principles and rules in all financial and other dealings, through reflecting on the nature of similar transactions, other events, or conditions by virtue of their recording and reporting.
 - c) Information that can assist the user in assessing the risks inherent or associated with the institution, its financial position, or its operations and as to how the institution approaches to manage such risks.
 - d) All these options are correct.
- 3 Faithful representation of financial information includes which of the following?
 - a) Relevance, Neutrality, Substance and Form, Transparency
 - b) Materiality, Prudence, Consistency, Relevance
 - c) Neutrality, True and Fair View, Substance and Form
 - d) Quasi-Equity, Prudence, True and Fair View, Consistency

- 4 Which of the following statements is the correct definition for net return on quasi-equity?
- Return attributable to holders of owners' equity during the period covered by the financial statements.
 - Profit earned by the IFI during the period covered by financial statements.
 - Return attributable to quasi-equity holders during the period covered by the financial statements.
 - Profit distributed to shareholders during the period covered by financial statements.
- 5 Which of the following options shows the correct hierarchical level for selection and application of accounting policies in ascending order (4 being the first step)?
- The management's judgement if in line with the Conceptual Framework and the *Shariah* principles and rules
 - FAS on Similar Matters
 - Generally accepted accounting principles as applicable in the respective jurisdiction, insofar as these are not against the Conceptual Framework and *Shariah* principles and rules.
 - FAS specifically addressing the respective transaction, other event or condition, or another pronouncement issued by AAOIFI.
 - FAS on Similar Matters.
 - Generally accepted accounting principles as applicable in the respective jurisdiction, insofar as these are not against the Conceptual Framework and *Shariah* principles and rules.
 - The management's judgement if in line with the Conceptual Framework and the *Shariah* principles and rules.
 - FAS specifically addressing the respective transaction, other event or condition, or another pronouncement issued by AAOIFI.
 - The management's judgement if in line with the Conceptual Framework and the *Shariah* principles and rules.
 - Generally accepted accounting principles as applicable in the respective jurisdiction, insofar as these are not against the Conceptual Framework and *Shariah* principles and rules.
 - FAS on Similar Matters.
 - FAS specifically addressing the respective transaction, other event or condition, or another pronouncement issued by AAOIFI.
 - FAS specifically addressing the respective transaction, other event or condition, or another pronouncement issued by AAOIFI.
 - Generally accepted accounting principles as applicable in the respective jurisdiction, insofar as these are not against the Conceptual Framework and *Shariah* principles and rules.

- (iii) The management's judgement if in line with the Conceptual Framework and the *Shariah* principles and rules.
 - (iv) FAS on Similar Matters.
- 6 The AAOIFI Conceptual Framework includes the following chapters, except:
- a) Users, objectives, and limitations of financial information
 - b) Concepts of capital and capital maintenance
 - c) Financial accounting process
 - d) Financial statements and the reporting institution
- 7 General-purpose financial statements comprise
- a) Primary statements and explanatory notes including accounting policies
 - b) Primary statements only
 - c) Statements of cash flows and explanatory notes
 - d) Special-purpose reports, explanatory notes including accounting policies
- 8 Derecognition of an asset might occur when:
- a) The control of an asset is transferred to a third party, for example, through sale or gift.
 - b) No future economic benefits are expected from the asset.
 - c) The institution has earned the right to receive income from the asset.
 - d) Both a and b.
- 9 Which of the following statements is true?
- a) Historical cost of an asset refers to the amount received by the institution when the liability was incurred, or cash or cash equivalents are expected to be paid.
 - b) When deciding to use fair value, entities should ensure consistency in the use of the same valuation experts.
 - c) Matching is when income and gains are reported in the same period as expenses and losses.
 - d) The periodicity concept refers to the preparation of periodic financial statements.
- 10 The AAOIFI Conceptual Framework defines the following elements of the financial statements:
- a) Assets, liabilities, quasi-equity, owners' equity, and income and expenses
 - b) Assets, liabilities, owners' equity, and income and expenses
 - c) Assets, liabilities, quasi-equity, and income and expenses
 - d) Assets, liabilities, quasi-equity, owners' equity, and profits

Notes

- 1 Provided these do not contradict the Conceptual Framework or *Shariah* rules and principles.

- 2 One example of such a commentary is *Financialisation and the Conceptual Framework: An Update* by Ying Zhang, Jane Andrew, 2021, published in April 2021 in *Critical Perspectives on Accounting*.

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3 Murabaha and Deferred Payment Sales

Learning Objectives

After going through this chapter, you should be able to:

- 1 Describe the nature of *Murabaha* and other deferred payment sales.¹
- 2 Understand the steps in *Murabaha* contracts.
- 3 Describe the accounting entries, presentation, and disclosure requirements for the *Murabaha* transaction under FAS 28: *Murabaha* and Other Deferred Payment Sales.
- 4 Understand the main differences in the accounting treatment of *Murabaha* under IFRS and AAOIFI frameworks.

Chapter Preview

Murabaha and Deferred Payment Sales							
Nature and features		Accounting Treatment under AAOIFI			Reporting	IFRS Perspective	
Introduction to Murabaha	Other deferred payment sales	Initial recognition	Subsequent measurement	Recognition of gain/loss	Presentation and disclosure	Accounting treatment under IFRS	

Cover Story

Pakistan is a developing country that requires significant external financing to support its economic growth. However, as an Islamic country, it seeks to adhere to *Shariah*-compliant financing principles, including the prohibition of interest. In July 2021, the government of Pakistan secured a USD 350 million *Murabaha* financing facility arranged by Ajman Bank and the Commercial Bank of Dubai. The facility was oversubscribed by more than 75%, reflecting a strong demand from local, regional, and international investors.

The *Murabaha* financing mechanism is a cost-plus-profit arrangement that complies with Islamic finance standards and is commonly used in consumer financing. In a *Murabaha* facility, banks sell a real and marketable asset to the customer, who can either use it or resell it to generate funds.

The *Murabaha* financing deal for Pakistan was hailed as a landmark transaction by both Ajman Bank and the Commercial Bank of Dubai. The oversubscription of the facility by investors highlights the growing appetite for *Shariah*-compliant financing instruments and demonstrates the potential for Islamic finance to support development in emerging economies. The success of the deal also showcases the ability of Islamic banks to provide financing solutions for cross-border counterparties (Ahmad, 2021).

3.1 Introduction to Financing Through Sale Transactions

Suppose you need to borrow money to buy a car. Since this decision represents a serious financial commitment, you want to consider all available options. There are several conventional and Islamic financing choices available that you can use to finance your purchase. If you want to opt for conventional car financing, then you have two financing options: direct lending or dealership financing. In direct lending, you get a loan from a conventional financial institution. The financial institution can be a finance company, a credit union, or a bank. Suppose you decide to get a loan for your new car from a bank. The bank will provide you with a loan after assessing your creditworthiness. You agree to return the principal and the interest amount over an agreed period. If the interest rate is 10% and you have borrowed USD 10,000 for one year, then you will be required to repay USD 11,000 to the bank, that is, USD 10,000 principal amount plus USD 1,000 interest. In dealership financing, you acquire financing through the dealership. You enter a contract with a car dealer whereby the dealer extends you a loan for buying a car from her/him, and you agree to pay back, over some time, the financed amount plus interest on the financed amount. In this case, there is an additional condition that you will buy the car from the very same dealer who is financing the car purchase. Once again, assume that you take a loan of USD 10,000, and the interest rate is 10%. Under the contract, you will be required to pay back the USD 10,000 principal amount and USD 1,000 interest. In each of these two cases, you are getting a loan that you will use for buying a car, and you will have to pay back the principal amount along with interest.

Now let us consider an alternative option to borrowing money from a conventional bank or a car dealer. If you had approached an Islamic bank to borrow money to buy a car, the bank would not have been able to lend you the money in the aforementioned manner since a conventional loan contract with an agreed interest over and above the principal amount is considered to be void in Islam because it has an element of interest in it, and Islam strictly prohibits charging any pre-agreed additional amount (or benefit) on a loan contract. Instead, the Islamic bank would buy the car and immediately sell it to you for a profit on deferred payment terms. So the bank might charge USD 1,000 profit on the USD 10,000 car, with the total amount being payable during the contract. This transaction is a sales transaction whereby an Islamic bank buys an asset from a supplier and sells it to you for a deferred price.

Apparently, this credit sale transaction will create a similar outcome for the client and the bank in financial terms, under normal circumstances. However, there are clear differentiating factors between the two:

- The amount of the *Murabaha* sale (USD 10,000 + 1,000) is fixed.
- In an interest-based financing, the bank loan interest is incremental and cumulative (i.e., it compounds over periods).
- The IFI financing through *Murabaha* has to comply with all *Shariah* standards.
- The IFI is exposed to the risk associated with the acquisition of goods, holding of inventory, and the sale of goods.

3.1.1 Deferred Payment Sale

A deferred payment sale is a type of sales transaction where the payment of the sale consideration is deferred over a fixed credit term – either in instalments or on a lump sum basis. It is a *Shariah* requirement that the price and time of repayment are agreed upon between the parties; otherwise, the sale would be void. A *Murabaha* is a sale of goods by the IFI to the customer with an agreed-upon markup on cost. It may be on a spot/cash basis or deferred payment/credit basis. Under *Murabaha*, the seller expressly mentions the cost price of the asset and adds a profit markup thereon. It is a commonly used contract in Islamic financing and is used to meet various needs of corporate clients as well as for consumer financing. Normally, the IFI purchases the goods ordered by a customer from a third party and then sells these goods to the customer. To mitigate the risk, IFIs will generally purchase the goods only after a customer has made a **promise** to purchase them. Such a promise is not a part of the *Murabaha* contract; however, it is a part of the overall *Murabaha* arrangement (also known as the Master *Murabaha* Financing Agreement).²

IFIs are primarily financial intermediaries. They do not have the expertise and processes to purchase goods for sale purposes. Generally, they do not hold goods in inventory to avoid the risk associated with storing them. Instead, they purchase goods on demand from the spot market and then sell them to clients.

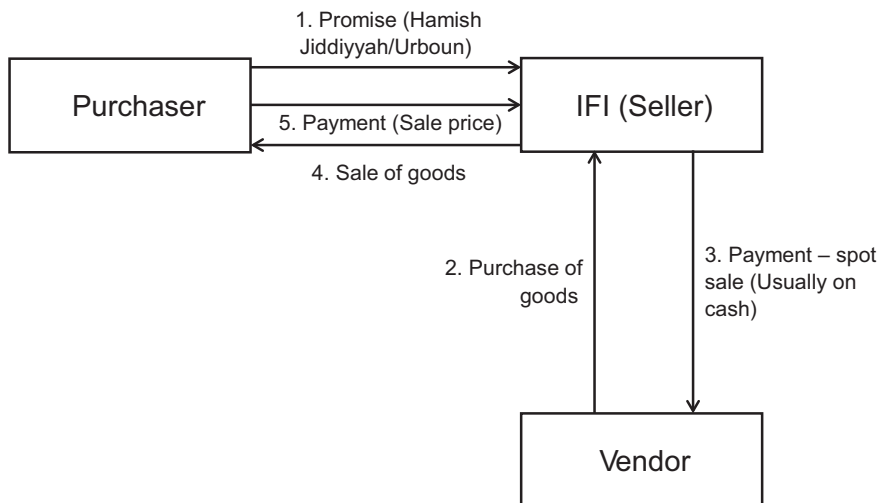


Figure 3.1 *Murabaha* Transaction Flow: Major Stages

Source: Diagram by the authors.

Let's explain a few technical terms used in a *Murabaha* transaction. *Hamish Jiddiyyah* is a security deposit amount which the customer pays the IFI against the fulfilment of the contract. This amount is refundable by the IFI even in case the contract does not get fulfilled. *Urboun* is the amount paid by the customer as a security-cum-advance payment against the sales price, along with a promise to purchase. This may be forfeited in case of a default in the promise to purchase by the buyer.

A *Murabaha* transaction, when executed in contemporary IFIs, typically involves three parties: a vendor, an IFI (acting as a seller), and the bank's customer (the buyer or purchaser).

The following are the steps in a *Murabaha* contract as shown in Figure 3.1:

- 1 A promise is made by the buyer to the seller.
- 2 The IFI buys the goods from a third-party vendor.
- 3 The IFI pays the price of goods to the vendor.
- 4 The IFI signs a *Murabaha* contract with the purchaser and delivers the goods or transfers the ownership.
- 5 The buyer pays for the goods to the IFI over a particular period.

3.1.2 *Murabaha to Purchase Orderer (MPO)*

IFIs usually acquire assets only after getting a binding promise from the customers that they will buy the ordered goods from IFI at the purchase price plus a profit markup. Such a promise is usually bilateral, where both parties

agree to an obligation. If a bilateral promise is obtained from the customer, then the transaction is called *Murabaha* to purchase orderer (MPO), and the purchased item must meet specifications laid out by the customer.

Box 3.1 Practical Insight: *Murabaha* Products of Dubai Islamic Bank

Dubai Islamic Bank offers *Murabaha* products to both individual and corporate customers. These products serve various purposes such as home renovations, acquiring building materials, and machinery. The applicable annual profit rates for these *Murabaha* products range from 7% to 9%, depending on the customer's profile. Clients can obtain *Murabaha* financing of up to AED 4 million. To initiate the process, clients submit project plans and quotations from their chosen suppliers to the bank. The bank then purchases the goods from the suppliers and sells them to the clients at the purchase price plus a profit margin. Clients repay the agreed-upon amount (the purchase price plus the profit margin) to the bank over a period of 12 to 48 months (Dubai Islamic Bank, 2023).

Box 3.2 Concept Check

Identify which of the following five statements are true or false. If a statement is false, discuss why this statement is false.

- 1) A *Murabaha* contract contains two sales transactions: one between the vendor and the IFI and the other between the vendor and the buyer.
- 2) *Hamish Jiddiyyah* will not be refunded by the IFI in case the *Murabaha* contract does not get fulfilled.
- 3) *Murabaha* is considered a trust sale because the buyer is aware of the cost of *Murabaha* assets and the markup profit of the IFI.
- 4) If no promise is obtained from the customer, then the transaction is called *Murabaha* to purchase orderer (MPO).
- 5) The essential first step in a *Murabaha* contract is an expression of interest by the buyer in acquiring an asset through the IFI.

Solution:

- 1) False. There is no direct sale transaction between the vendor and the buyer.

- 2) False. *Hamish Jiddiyyah* is refundable by the IFI even in case the contract does not get fulfilled.
- 3) True.
- 4) False. If a bilateral promise is obtained from the customer, then the transaction is called *Murabaha* to purchase orderer (MPO).
- 5) False. IFIs usually acquire *Murabaha* assets from vendors when customers express their interest in buying those assets. But such an expression of interest is not part of the *Murabaha* contract. However, this is part of the overall arrangement (also known as the Master *Murabaha* Financing Agreement).

3.2 Accounting Treatment in the Seller's Books

FAS 28 *Murabaha* and Other Deferred Payment Sales applies to all *Murabaha* and other deferred payment transactions and lays down the basis for the determination of the accounting treatment for inventories available for sale under the contract and related revenues, expenses, and gains and losses on the sales transaction. This standard also provides the accounting treatment of receivables, early settlement discounts given by an IFI and related matters.

3.2.1 Initial Recognition and Measurement of Inventory

The IFI should recognise the inventory in its books of accounts when it **controls** the inventory, that is, when the IFI acquires substantially all risks and rewards incidental to the asset ownership of the inventory. If inventories are acquired in tranches, this condition should apply to each tranche for the IFI to recognise the inventory.

At the time of acquisition, the inventories should be measured at cost. This includes the acquisition cost and all other **direct costs** incurred by the bank to bring the inventory to its present location and condition. Direct costs include any legal fees associated with acquiring the asset, any commissions paid to the agent (or the customer in the capacity of an agent), any duties and taxes, insurance (*Takaful*), and transportation cost. If the IFI receives purchase discounts, the discount should reduce the cost of the inventory. It should be noted that any transaction costs incurred to negotiate or arrange a *Murabaha* contract (less any reimbursements from the customer) should be charged to the income statement in the period in which they are incurred.

3.2.2 Hamish Jiddiyyah or Urboun

At the inception of the contract, when the customer makes a binding promise to purchase the goods from the IFI, banks normally ask customers to make an initial deposit or an advance payment known as *Hamish Jiddiyyah* or *Urboun* (respectively). *Hamish Jiddiyyah* is the security amount deposited by

Box 3.3 Illustration 3.1 Initial Measurement of Inventory Asset

Berhad Islamic Bank purchased a chip-manufacturing plant under a sales contract from a vendor on Mar 3, 2023. The cost of the car was USD 1,000,000. Other costs related to the plant were:

Transportation to the IFI's premises	USD 25,000
Administrative overheads attributable to the plant	USD 20,000
<i>Takaful</i> -in-transit	USD 10,000
Storage at bank premises (Holding cost)	USD 5,000
Commission paid	USD 5,000
Customs and clearance charges	USD 500

Berhad Islamic Bank received a letter from the vendor on March 5, 2023, stating that they had decided to offer the bank a 2% discount on the original sales price.

Requirement: How will the bank recognise the acquisition of the plant and the discount in its books?

Solution:

Berhad Islamic Bank will recognise the asset in its financial statements on Mar 3, 2023 (date of acquisition of the asset). The cost of the asset is computed as follows:

Inventory Asset Cost = USD 1,000,000 + USD 25,000 (transport) + USD 10,000 (*Takaful*) + USD 5,000 (Commission) + USD 500 (Customs and clearance) = USD 1,040,500

The overheads of the bank (USD 20,000) and the notional amount of storage (USD 5,000) will not be included in the cost of the assets.

The relevant journal entry will be:

	<i>Dr.</i>	<i>Cr.</i>
Mar 3 Inventory (Asset)	1,040,500	
Cash/Bank/Accounts Payable (Asset/Liability)		1,040,500
<i>(To record the purchase of the plant by the IFI)</i>		

The bank will recognise the discount on the date the letter is received from the vendor:

	<i>Dr.</i>	<i>Cr.</i>
Mar 5 Cash/Bank/Accounts Payable (Asset/Liability)	20,000	
Inventory (Asset)		20,000
<i>(To record the reduction in the cost of inventory due to discount)</i>		

Box 3.4 Illustration 3.2 *Hamish Jiddiyyah* and *Urboun*

Hassan, who owns a small garments company, approaches Burj Islamic Bank to ask for financing for a new knitting machine that Hassan will use to expand the operations of his business. The market price of the machine is USD 200,000. After assessing the creditworthiness of Hassan, Burj Islamic Bank has decided to acquire and subsequently sell the requested machine to Hassan at USD 220,000. Hassan has agreed to pay the bank USD 220,000 for the knitting machine over the next six years in instalments. However, before purchasing the requested machine, the bank requires Hassan to make a promise to buy the machine from the bank at the agreed-upon price and to submit USD 20,000 as *Hamish Jiddiyyah* to the bank and USD 5,000 as *Urboun*. Suppose the bank received USD 25,000 from Hassan on Feb 2, 2023.

Requirement: What entry will the bank pass to record this in its books?

Solution:

The bank will pass the following entry:

	<i>Dr.</i>	<i>Cr.</i>
Feb 2 Cash/Bank (Asset)	25,000	
<i>Hamish Jiddiyyah</i> (Liability)		20,000
<i>Urboun</i> (Liability)		5,000
<i>(To record the receipt of Hamish Jiddiyyah and Urboun)</i>		

one party (in this case, the customer) against the fulfilment of a contract or promise. *Urboun* is the amount paid by the intending buyer in a sales transaction as a security-cum-advance payment against the sales price, along with a promise to purchase. Both are treated as liabilities in the books of the IFI on the date of receipt.

In case of a breach of the contract, the terms and conditions relating to the forfeiture of the *Hamish Jiddiyyah* or *Urboun* shall be decided in accordance with the terms of the contract between the parties.

Once the customer purchases the asset, *Hamish Jiddiyyah* will continue to be shown as a liability for the duration of the contract, unless the contract allows for the adjustment of the amount against the receivable. *Urboun*, however, is an advance payment and therefore will be adjusted against the receivable amount.

3.2.3 Subsequent Measurement of Inventory

After initial recognition, FAS 28 requires IFIs to measure inventories at lower of cost and **net realisable value (NRV)**. Any resulting loss should be charged to the income statement in the accounting period in which it was identified.

However, if the bank has a binding promise from a creditworthy customer to purchase the asset at a given price, fluctuations in the value of the asset are not recorded because the risk associated with fluctuation in the inventory asset price shall be borne by the purchaser (customer).

Further, if there are any holding or handling costs, the IFI should charge such costs to the income statement during the period in which these costs are incurred.

3.2.4 Subsequent Measurement of Receivables

Receivables should be reviewed at every period end and measured at their cash equivalent value, that is, face value less provision for doubtful debts.

Box 3.5 Illustration 3.3 Subsequent Measurement of *Murabaha*

Consider Ali, who approached Jamia Islamic Bank to ask for financing for a new delivery vehicle. Ali owns a goods delivery business, and he wants to use the new delivery vehicle to expand his business into two new counties. Jamia Islamic Bank analysed the creditworthiness of Ali and decided to enter into a sales contract with Ali for his new vehicle. The market price of the delivery vehicle that Ali wants to buy is USD 40,000.

- 1) To secure the bank against future losses, the bank has asked Ali to submit 20% of the market price of the vehicle as *Hamish Jiddiyyah* to the bank. Ali submitted the required *Hamish Jiddiyyah* on Mar 3, 2022. The bank has asked Ali to make a binding promise to buy the vehicle from the bank on Apr 2, 2022.
- 2) The bank bought the vehicle from the vendor on Mar 7, 2022. The bank also incurred a cost of USD 450 as legal fees for acquiring the asset.
- 3) The bank received a letter from the car dealership on Mar 12, 2022, stating that the dealership had decided to offer the bank a 10% discount on the original sales price.
- 4) The bank paid USD 300 to a service provider on Mar 15, 2022, who will be holding the vehicle for the bank until its delivery to the customer.
- 5) The bank will recognise an inventory asset holding expense of USD 500 on Mar 15, 2022.

Requirement: Prepare appropriate accounting entries for each transaction.

Solution:

- 1) The bank recognises the *Hamish Jiddiyyah* received from the customer as a liability.

		Dr.	Cr.
Mar 3	Cash/Bank (Asset)	8,000	
	<i>Hamish Jiddiyyah</i> (Liability)		8,000
	<i>(To record the receipt of Hamish Jiddiyyah from the customer)</i>		

- 2) The bank adds the purchase price, purchasing tax, and legal fees to determine the acquisition cost of the vehicle.

		Dr.	Cr.
Mar 7	Inventory (Asset)	40,450	
	Cash/Bank/Accounts Payable		40,450
	<i>(To record the purchase of the inventory asset by the IFI)</i>		

- 3) The value of the vehicle is reduced by the amount of the discount.

		Dr.	Cr.
Mar 12	Accounts Payable (Liability)	4,000	
	Inventory (Asset)		4,000
	<i>(To record the discount received from the car dealer)</i>		

- 4) The bank bears the handling costs and charges these as an expense in the income statement.

		Dr.	Cr.
Mar 15	Expense – Inventory Asset (Expense)	300	
	Cash/Bank (Asset)		300
	<i>(To record the expenses incurred for the handling and maintenance of the vehicle)</i>		

5) The bank will recognise holding costs of USD 500.

		Dr.	Cr.
Dec 20	Inventory Holding Costs (Expense)	500	
	Cash/Bank (Asset)		500
	<i>(To record the inventory holding costs paid to the service provider)</i>		

Box 3.6 Illustration 3.4 Valuation of Receivables

Rayan Islamic Bank has a receivable of USD 3,000 that is due on May 15, 2023. On Nov 12, 2023, the client filed for bankruptcy. Rayan Islamic Bank estimated that it would be able to recover only 70% of the outstanding amount.

Requirement: How should Rayan Islamic Bank treat this in its books? Show the journal entry.

Solution:

Rayan Islamic Bank should record a provision on Dec 31, 2023.

		Dr.	Cr.
Dec 31	Provision for Doubtful Debts (Expense)	900	
	Receivables (Asset)		900
	<i>(To record a provision for doubtful Murabaha receivable)</i>		

If a solvent debtor delays payment, the IFI can demand that the customer pays a charity. This will be recorded separately as charity payable and will not contribute to the IFI's income.

3.2.5 Sale of Inventory and Recognition of Profit

Under Islamic law, a sale contract is valid only if the goods that are to be sold are in constructive³ or physical possession of the seller. Hence, the IFI will record the sale transaction after acquiring the asset and taking it into possession. Once the legal ownership is transferred and possession is given to the client (or their sales agent, as the case may be), the sale will be completed, and a receivable will be recorded at face value.

Box 3.7 Illustration 3.5 Delayed Settlement of Receivables

Salaam Islamic Bank has a receivable of USD 120,000 from a client. The client is unduly delaying the payment. The bank imposed a penalty of USD 100 per day to ensure that he pays as soon as possible. The client made the payment on Mar 15, 2022, which was ten days after the contractual due date. The bank also recovered the penalty due.

Requirement: How should Salaam Islamic Bank treat this in their books? Show the journal entry.

Solution:

Salaam Islamic Bank should recognise the payment of only USD 120,000 against the outstanding receivable. The penalty amount of USD 1,000 should be recognised in the charity payable account (a liability account). The accounting entry will be:

	Dr.	Cr.
Mar 15	Cash (Asset)	121,000
	Receivables (Asset)	120,000
	Charity Payable (Liability)	1,000
	<i>(To record receipt of payment from customer and late payment penalty)</i>	

The customer does not pay the price of the asset on the date of the delivery. This is usually deferred and paid either on a spot basis or in instalment terms. Time plays an important role in determining the markup profit, and generally, the markup on a sales contract increases as the length of the payment period increases. Many IFIs that provide financing calculate their profit or markup by using the current interest rates prevalent in the market as benchmarks. The selling price of the asset, therefore, consists of two parts: the acquisition cost of the asset plus the markup profit. The cost of the asset includes the total acquisition cost (including direct costs) less any discounts received from the vendor. The markup calculation is based on the total financing provided by the IFI (any advance payment received from the customer is deducted first).

3.2.5.1 Profit Recognition

Revenue and cost of goods sold under a deferred payment sales contract should be recognised at the time of the sale transaction. The resulting profit should also be recognised immediately if the payment is due within the current accounting period. However, the profit for a multi-period sales contract

should be proportionately allocated on a time proportion basis. FAS 28 specifies that for multi-period *Murabaha* contracts, the appropriate method to apply the time proportion basis is the **effective profit rate** method based on the implicit profit in the transaction.

The difference between sales revenue and the historical cost of the inventory is the total profit on a sales transaction. According to FAS 28, this profit is deferred through a deferred profit account. However, in a case where the equivalent **cash sale price** of the goods sold is higher than the cost of sales, “the profit to the extent of difference between the cash sale price and the cost of sales shall not be deferred” (FAS 28, paragraph 23). This is effectively the *trading* profit which is recognised immediately and the remaining part, which is to be deferred, is the *financing* profit.

Deferred profit is presented as a contra-asset account against the related receivables. At the end of each accounting period, a proportionate share of profit is amortised and recognised in the income statement using the effective profit rate method. The journal entries for deferring the profit and recognising it subsequently in a multi-period *Murabaha* at the end of each accounting period are illustrated in the following examples.

Box 3.8 Illustration 3.6 Single-Period and Multi-Period Profit Recognition

Habib Islamic Bank sold a generator costing USD 3,200 to a client under a sales contract on Jan 1, 2022. The agreed markup was 20%.

- (a) The payment was due on Dec 1, 2022 (within the same accounting period).
- (b) The payment was due in equal instalments over the next four years. The effective profit rate for this *Murabaha* is 7.71%.⁴

Requirement: How should Habib Islamic Bank record both of these scenarios in their books? Show the journal entries.

Solution:

- a) Habib Islamic Bank should recognise all the profits at the time of sale because the payments are due within the current financial period.

	Dr.	Cr.
Jan 1 Receivables (Asset)	3,840	
Sales Revenue (Revenue)		3,840
Cost of Goods Sold (Expense)	3,200	
Inventory (Asset)		3,200
<i>(To record the Murabaha sales transaction by the IFI)</i>		

b) Habib Islamic Bank should recognise deferred profit at the execution of the contract, and at the end of each financial period, the bank should recognise the profit for that period on an accrual basis (i.e., irrespective of receipt of cash instalments from the client).

		Dr.	Cr.
Jan 1	Receivables (Asset)	3,840	
	Sales Revenue (Revenue)		3,840
	Cost of Goods Sold (Expense)	3,200	
	Inventory (Asset)		3,200
	<i>(To record the Murabaha sales transaction by the IFI)</i>		

After recording the sales transaction, Habib Islamic Bank will pull back the profit figure and recognise it as deferred profit.

		Dr.	Cr.
Jan 1	Profit (Income)	640	
	Deferred Profit (Contra-Asset)		640
	<i>(To record the deferred profit on multi-period sales contract)</i>		

At the end of each accounting period, the bank will recognise a proportionate share of profit through the effective profit rate method. The schedule of payments and periodic profit amount are given here:

Year	Opening net receivable (amortised value)	Profit for the period (@7.71%)	Total outstanding	Murabaha payment	Closing net receivable (amortised value)
1	3,200	247	3,447	960	2,487
2	2,487	192	2,679	960	1,719
3	1,719	133	1,851	960	891
4	891	69	960	960	(0)

Accordingly, the following accounting entry will be processed to record the profit for the first accounting year at the end of the period.

		Dr.	Cr.
Dec 31	Deferred Profit (Contra-Asset)	247	
	Profit (Income)		247
	<i>(To record periodic profit on multi-period sales contract on accrual basis)</i>		

On receipt of the *Murabaha* instalment in cash, the bank will record the following accounting entry. Assuming the instalment was received on Jan 10:

		Dr.	Cr.
Jan 10	Cash/Bank (Asset)	960	
	Receivables (Asset)		960
	<i>(To record the receipt of Murabaha receivables from the client)</i>		

The next illustration shows the bifurcation between trading and financing profit.

Box 3.9 Illustration 3.7 Recognition of Trading and Financing Profit

Mehran Islamic Bank purchased a moulding plant for sale on Jan 3, 2022, for USD 10,000. The equivalent cash price of the plant through a spot sales contract was USD 11,000.

The client mutually agreed to a markup of 25%. The sales contract between the bank and the client was executed on Jan 4, 2022, for a period of five years. The first instalment payment is due on Dec 31, 2022, which is also the accounting period end of the bank.

Requirement: Show how the bank will record the sale and deferred profit in its books.

Solution:

		Dr.	Cr.
Jan 4	Receivables (Asset)	12,500	
	Sales Revenue (Income)		12,500
	Cost of Goods Sold (Expense)	10,000	
	Inventory (Asset)		10,000
	<i>(To record the sale of asset under Murabaha arrangement)</i>		

In line with the requirements of FAS 28, the bank will recognise a profit of USD 1,000 (the difference between the equivalent cash sale price and the historical cost of the asset) immediately. The remaining

profit of USD 1,500 (the difference between the sale price and the equivalent cash sale price) will be deferred and amortised over the contract term using the effective profit rate method. The journal entry for deferring the profit of USD 1,500 would be:

	Dr.	Cr.
Jan 4 Profit (Income)	1,500	
Deferred Profit (Contra-Asset)		1,500
<i>(To record deferred profit on multi-period sales contract)</i>		

After these entries are posted, the receivable balance in the bank's statement of financial position will be USD 11,000 (this is the gross receivable of USD 12,000 less the deferred profit balance of USD 1,500).

The effective rate of interest, in this case, will be 4.42%⁵ Each year a portion of the deferred profit is amortised and recognised in the income statement. The following table shows the calculation of the profit over the five years of the *Murabaha* contract.

Year-end	Opening net receivable (amortised value) (a)	Profit for the period (@4.42%) (b) = (a) x 4.42%	Total outstanding (c) = (a) + (b)	Murabaha payment (d)	Closing net receivable (amortised value) (e) = (c) - (d)
1	11,000	486	11,486	2,500	8,986
2	8,986	397	9,383	2,500	6,883
3	6,883	304	7,187	2,500	4,687
4	4,687	207	4,894	2,500	2,394
5	2,394	106	2,500	2,500	0

Accordingly, the bank will recognise a profit of USD 486 in the first year. The accounting entries to record the year 1 profit and receipt of the first instalment will be as follows:

	Dr.	Cr.
Dec 31 Deferred Profit (Contra-Asset)	486	
Murabaha Profit (Income)		486
<i>(To record deferred profit amortisation in year 1)</i>		
Dec 31 Cash (Asset)	2,500	
Receivables (Asset)		2,500
<i>(To record the first instalment payment of the Murabaha)</i>		

Similarly, every year these entries will be posted resulting in a deferred profit and receivable balance of zero at the end of five years.

3.2.5.2 *Waivers, Discounts, and Write-Offs*

The IFI may decide to waive part of a receivable (e.g., as an incentive to the customer for making an early payment). In this case, the reduction in the receivable will be recorded in the period in which the settlement occurs. FAS 28 requires that any waiver or write-off of this kind be first offset against any unamortised deferred profit balance. If part of the balance still remains, then this should be offset against the current year deferred profit amortisation credited in the income statement. Thereafter, any remaining balance should be recorded as an expense in the income statement for the period.

3.2.5.3 *Subsequent Discounts on Inventory*

In the case where the IFI has made the sale to the customer and then receives a discount on the cost of the inventory, the discount will reduce the cost of sales and the related accounts payable liability. In case of a cash *Murabaha*, the discount will be recognised in the income statement in the period in which it has been received. However, for a multi-period *Murabaha*, the discount will increase the deferred profit balance and be amortised to the income statement over the credit period.

If the benefit of the discount is passed onto the customer, then this will be presented as a reduction in the gross revenue (contra-revenue).

Box 3.10 Concept Check

Identify which of the following five statements are true or false. If a statement is false, discuss why this statement is false.

- 1) Profit for a multi-period sales contract should be recognised immediately if payment is due within the same period.
- 2) The difference between sales revenue and the historical cost of the inventory is the total profit on a sales transaction.
- 3) To record the deferment of multi-period profit, we debit an asset account and credit an income account.
- 4) If a solvent debtor delays payment, the IFI will record penalty charges separately, but they will not contribute to the IFI's income.
- 5) When a debtor unduly delays payment, the IFI will credit the Charity Payable account to record the penalty charged.

Solution:

- 1) False. Profit for a multi-period sales contract should be allocated over the period on a time-proportionate basis even if payment is due within the same period.

- 2) True.
- 3) False. To record the deferment of multi-period profit, we debit an income account and credit a contra-asset account.
- 4) True.
- 5) True.

3.3 Accounting Treatment in Buyer's Books

3.3.1 Initial Recognition of Purchase of Inventory and Payable

The IFI can enter into a *Murabaha* contract with its vendor to purchase the asset to sell to its client instead of engaging in a spot sale. The asset should be recognised initially at face value, which is the gross invoice value (including the vendor's profit). The cost of the inventory will include all incidental, direct costs incurred in the acquisition of the asset. The IFI will record a related accounts payable in relation to the acquisition of this inventory.

3.3.2 Advance Payment Made by IFI

If the IFI is required to pay *Hamish Jiddiyyah* or *Urboun* under the *Murabaha* contract with the vendor, such payments are treated as an asset in the books of the IFI. Once the asset is acquired by the IFI, the *Hamish Jiddiyyah* is returned in full unless the contract states that it will be offset against the payables. *Urboun* is offset against the payable amount. If the IFI fails to purchase the asset, then the vendor forfeits the *Urboun*. The accounting entries are shown in the following illustration.

Box 3.11 Illustration 3.8 *Hamish Jiddiyyah* and *Urboun*

Bank Al-Jadid entered a *Murabaha* contract on Apr 6, 2023, and procured a batch of air-conditioners for the client from MGCR Corp. The bank pays *Hamish Jiddiyyah* of USD 8,000 to MGCR Corp on Apr 10.

Requirement: Pass the entry in Bank Al-Jadid's books when:

- a) The payment of *Hamish Jiddiyyah* is made.
- b) The air-conditioners are acquired by Apr 20 assuming:
 - i) The bank had initially paid *Hamish Jiddiyyah*.
 - ii) The bank had initially paid *Urboun*.
- c) The bank fails to purchase the air-conditioners by Apr 25.

Solution:

- a) On payment of *Hamish Jiddiyyah* by Bank Al-Jadid, the following entry will be passed:

		Dr.	Cr.
Apr 10	<i>Hamish Jiddiyyah</i> (Asset)	8,000	
	Cash/Bank		8,000
	<i>(To record the payment of Hamish Jiddiyyah and Urboun to the vendor)</i>		

- b) Upon acquisition of the asset, Bank Al-Jadid will pass the following entries.

- i) If *Hamish Jiddiyyah* was paid:

		Dr.	Cr.
Apr 20	Cash/Bank (Asset)	8,000	
	<i>Hamish Jiddiyyah</i> (Asset)		8,000
	<i>(To record the return of Hamish Jiddiyyah from the vendor)</i>		

- ii) If *Urboun* was paid

		Dr.	Cr.
Apr 20	Accounts Payable (Liability)	8,000	
	<i>Urboun</i> (Asset)		8,000
	<i>(To record adjustment of Urboun against payable)</i>		

- c) If Bank Al-Jadid fails to purchase the asset, the following entry will be passed to derecognise the *Urboun* from its books:

		Dr.	Cr.
Apr 25	Forfeited <i>Urboun</i> (Expense)	8,000	
	<i>Urboun</i> (Asset)		8,000
	<i>(To derecognise the Urboun asset after it was forfeited by the vendor)</i>		

3.3.3 Subsequent Measurement of Inventory and Accounts Payable

At the end of each period, inventory should be recorded at the lower of cost and net realisable value. If there has been a decline in the value of the inventory, then a write-down must be made to its carrying value, and an expense must be recorded in the income statement of the relevant period. However, if a creditworthy customer has made a binding promise to purchase the inventory at a value greater than or equal to the cost, then no write-down is required and the inventory will continue to be recorded at cost.

Accounts payable on account of *Murabaha* should be recorded at each period end at an amount equal to the gross value less any repayments or other adjustments (such as discounts or rebates).

Box 3.12 Practical Insight: Sustainability-Linked *Murabaha* Financing by Ahli United Bank, Bahrain

In July 2022, a sustainability-linked, dual-tranche *Murabaha* financing worth USD 1.1 billion was obtained by Ahli United Bank in Bahrain. This financing facility is notable as it represents the first instance of a sustainability-linked, dual-tranche *Murabaha* financing in the global financial industry. One tranche adhered to *Shariah* standards outlined by AAOIFI, while the other tranche followed the traditional commodity *Murabaha* facility structure commonly used in the market (Norton Rose Fulbright, 2022).

Box 3.13 Concept Check

Identify which of the following five statements are true or false. If a statement is false, discuss why this statement is false.

- 1) If the IFI is required to pay *Hamish Jiddiyyah* or *Urboun* under the *Murabaha* contract with the vendor, such payments are treated as an expense in the books of the IFI.
- 2) When IFI fails to purchase the asset, the vendor will forfeit the full amount of *Urboun*.
- 3) If there has been a decline in the value of the inventory, a provision is recorded as a liability.
- 4) At the end of the accounting period, accounts payable should be calculated as gross liability minus any repayments or discounts/rebates.
- 5) To record any discounts received from a vendor, the IFI should debit Accounts Payable and credit Inventory.

Solution:

- 1) False. If the IFI is required to pay *Hamish Jiddiyyah* or *Urboun* under the *Murabaha* contract with the vendor, such payments are treated as an asset in the books of the IFI.
- 2) True.
- 3) False. If there has been a decline in the value of the inventory, a provision is recorded as a contra-asset account.
- 4) True.
- 5) True.

3.4 Presentation and Disclosure

In addition to the presentation and disclosure requirements of FAS 1, the following disclosures are given in FAS 28 in relation to *Murabaha*.

3.4.1 Disclosures in Seller's Books

- The accounting policies in relation to *Murabaha* transactions;
- Details of inventories (including any longer-term inventories) – segregating those held under binding and non-binding promises or without promises;
- Information relating to secured and unsecured receivables against *Murabaha* transactions together with their maturities. Receivables will be shown under *Financing assets* in the statement of financial position;
- The sales revenue and cost of goods sold should be mentioned in the notes to the accounts in relation to *Murabaha* transactions. Profit is disclosed under *Income from financing* in the IFI's income statement;
- Unamortised deferred profit against *Murabaha* receivables, including movements during the period;
- Outstanding *Hamish Jiddiyyah* and *Urboun* amounts;
- Details of any profits waived or receivables written off during the period;
- Details of any charity payments recovered or recoverable against any defaults or breaches.

3.4.2 Disclosures in Buyer's Books

- The accounting policies adopted by the IFI in relation to the purchases against *Murabaha*;
- Details of accounts payables against *Murabaha* along with their maturity dates;
- Estimated value and nature of the securities provided against the *Murabaha* accounts payables;
- Any amounts waived by the seller during the period.

3.5 IFRS Perspective

A *Murabaha* transaction has the following main accounting implications – the acquisition of an asset by the IFI, its subsequent sale to the customer, the recognition of the profit, and the recovery of the receivable by the IFI.

Accounting for the acquisition of the asset is the same under both IFRS and AAOIFI. The asset is treated as inventory which means initial recognition takes place at historical cost whilst subsequent valuations are at the lower of cost or net realisable value as required by **IAS 2. Inventories**. Cost includes the purchase price and other costs incurred in bringing the inventories to their present location and condition.

There may, however, be differences in the accounting treatment once the sale takes place. The substance-over-form debate determines how the sale and resultant profit are to be recorded. There are two possibilities. First, the transaction is recorded as a genuine sale and trading transaction, and second, it is recorded as only a financing transaction.⁶

3.5.1 Sale

If a *Murabaha* transaction is considered an actual trading arrangement, then the applicable standard for recording the sale is *IFRS 15 Revenue From Contracts With Customers*. The main ambiguity, in this case, is that IFRS 15, paragraph 6 states that “A customer is a party that has contracted with an entity to obtain goods or services that are an output of the **entity’s ordinary activities** in exchange for consideration”. So the question is whether the transaction of the sale of goods is a part of the ordinary activities of the bank.

Furthermore, where the timing of the payment does not coincide with the transfer of goods (as in the case of deferred payment sales), and credit is extended over a long period of time, the IFRS interpretation is that this is effectively the same as providing financing to the customer. Therefore, the sales contract is said to involve a **significant financing component** which is accounted for using **time value of money**. This enables the entity to compute the revenue from the transaction based on the **cash selling price**⁷ of the goods. Any consideration in excess of the cash selling price will be recorded as financing (interest) income. The **fair value** of the receivable is computed by discounting the consideration received using an imputed rate of interest. This is usually the interest rate that discounts the nominal amount of the consideration to the cash selling price of the goods.

In summary, therefore, if the deferred payment sale transaction is recorded under IFRS 15, then the bank will record sales revenue (cash selling price) and the cost of goods sold as separate line items in the income statement. The resultant profit is reflected in the income statement in the period of the transaction. The receivable is recorded at fair value (including any financing

element). The difference (i.e., consideration in excess of the transaction price) is treated as interest income and amortised to the income statement over the period of repayment using the effective method. As a practical expedient, IFRS does not require the discounting of receivables due within 12 months. These may be recorded at the transaction price.

This classification of *Murabaha* is more or less in line with the AAOIFI classification outlined in the chapter. However, AAOIFI uses the term *deferred profit* instead of *interest income*.

3.5.2 Financing Transaction

The alternative treatment for *Murabaha* is to treat the transaction as a financing transaction at the very outset. The justification for this approach is that since most *Murabaha* sales, in practical terms, are backed by a binding promise by the customer to purchase the asset, Islamic banks are just acting as intermediaries to finance the acquisition of the asset. Therefore, the substance of the transaction is that of financing, and the cashflows arising from the sale of the *Murabaha* asset should be recorded as a financial asset under **IFRS 9 Financial Instruments**.

In this case, in the period of sale, the sales revenue is recorded at an amount equal to the cost of goods sold. Therefore the net impact on gross profit is zero, and the entire profit on the transaction is recorded as financing income, amortised over the life of the instrument using the effective profit rate method based on the implicit rate in the transaction.⁸

Box 3.13 Practical Insight: IFRS Versus AAOIFI Accounting for *Murabaha*

A 2016 comparative analysis of IFRS and AAOIFI accounting for *Murabaha* notes that IFRS focuses on the economic consequences of financial instruments, while AAOIFI also considers the legal structure based on *Shariah* principles. IFRS-based reporting may not fully capture the unique structure of *Murabaha* contracts, impacting representational financial reporting. However, IFRS recognises *Murabaha* as financing, as do most Islamic banks in Malaysia. In terms of measurement, IFRS employs the time value of money concept, similar to conventional loan transactions, while AAOIFI uses a straight-line basis for profit allocation in *Murabaha* contracts (Ahmed et al., 2016).

Box 3.14 Concept Check

Identify which of the following five statements are true or false. If a statement is false, discuss why this statement is false.

- 1) An asset acquired in respect of a *Murabaha* contract is treated by the bank as inventory under IAS 2.
- 2) The sale of an asset under a *Murabaha* contract may be interpreted as a sale transaction or a financing transaction.
- 3) Proceeds from a sale transaction would be entirely recorded as sales revenue under IFRS 15.
- 4) A *Murabaha* transaction may be treated as a financing transaction under IFRS 9 without any impact on the gross profit of the IFI.
- 5) Any interest income is amortised to the income statement over the credit period using the market rate of interest.

Solution:

- 1) True.
- 2) True.
- 3) False. If it can be determined that the sales contract involves a significant financing component, then a portion of the proceeds is recorded as sales revenue and a portion is recorded as interest revenue.
- 4) True.
- 5) False. Interest income is amortised over the life of the instrument using the effective profit rate method based on the implicit rate in the transaction.

3.6 Chapter Summary

- A deferred payment sale is a type of sales transaction where the payment of the sale consideration is deferred over a fixed credit term – either in instalments or on a lump sum basis. (LO 1)
- A *Murabaha* is a sale of goods with an agreed-upon markup on cost. (LO 1, 2)
- IFIs usually acquire assets only after getting a binding promise from the customers that they will buy the ordered goods from IFI at the purchase price plus a profit markup. Such a promise is usually bilateral, where both parties agree to an obligation. If a bilateral promise is obtained from the customer, then the transaction is called *Murabaha* to purchase orderer (MPO), and the item purchased must meet specifications laid out by the customer.

- Inventory assets should be recognised when the legal title is transferred to the bank. At the time of acquisition, the inventory should be measured on a historical cost basis. In case of subsequent measurement, it will be at lower of cost or NRV. (LO 3)
- Once the legal ownership is given to the client, the sale will be completed, and the resultant receivable should be recorded at the sale value. However, at period end, receivables should be measured at cash equivalent value. (LO 3)
- Profit in a sales contract transaction should be recognised immediately if it is on cash or cash is due within the current accounting period. However, the profit for a multi-period contract should be proportionately allocated on an accrual basis. (LO 3)
- If a *Murabaha* transaction is considered a trading arrangement, then the applicable standard for recording the sale is IFRS 15 Revenue From Contracts with Customers. The alternative treatment for deferred payment sale is to treat the transaction as a financing transaction at the very outset in which case it will be recorded as a financial asset under IFRS 9 Financial Instruments. (LO 4)

3.7 Key Terms and Definitions

- **Control:** An institution controls an asset or business when it has all risks and rewards incidental to ownership of such asset or business, duly meeting both of the following conditions:
 - it is directly exposed to, or has rights to, variable returns (negative or positive, respectively) from its involvement with such assets or business; and
 - it can affect those returns through its power over the assets or business.
- **Deferred payment sale:** Any kind of sales transaction in which the payment of sales consideration is deferred over a fixed credit term, in instalments, or on a lump sum basis.
- **Direct costs:** Incurred by the bank to bring inventory to its present location and condition. Direct costs include any legal fees associated with acquiring the asset, any commissions paid, duties and taxes, insurance (*Takaful*), and transportation cost.
- **Fair value:** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
- **Hamish Jiddiyyah:** The amount deposited as a security against the fulfilment of a contract, promise, or completion of a transaction by one of the parties to the other.
- **Inventory:** In relation to the standard, an asset held for sale in the ordinary course of business or the process of production for such sale.

- **Murabaha:** The sale of goods with an agreed-upon profit markup on the cost. This could be on a spot basis or deferred payment basis.
- **Murabaha to purchase orderer:** Refers to a sale and purchase transaction where the purchaser makes an order and confirms the order with a promise (*Wa'ad*) to purchase the specified subject matter from the intended seller on agreed *Murabaha* terms.
- **Net realisable value (NRV):** The estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale, considering the factors specific to the institution.
- **Promise:** The promise is a constructive obligation assumed by one party (in *Murabaha*, the purchase orderer). The promise is understood to be binding in religious law on the individual who makes it unless a legitimate excuse under Islamic *Shariah* arises and prevents its fulfilment. Nevertheless, a promise is understood to be binding from the juristic perspective if it is pending on a cause, and the promisee has incurred costs because of the promise. A mutual promise is a promise against a promise.
- **Urboun:** The amount paid by the intending buyer in a sale transaction as a security-cum-advance payment against the sales price, along with a promise to purchase. In line with contractual terms, it may be forfeited in case of default on the promise to purchase by the buyer.

3.8 Review Questions

- 1 Falah Islamic Bank acquired an asset on Dec 30, 2022, for USD 1,000. A creditworthy client made a binding promise to purchase the asset on Jan 1, 2023, at 20% markup. However, on Dec 31, 2022, the asset was damaged in a fire, and its fair value was reduced to USD 900. The bank should record the asset at:
 - a) USD 1,000 because under a binding promise all risk is borne by the client
 - b) USD 1,200 because the asset will be sold at a 20% markup
 - c) USD 900 and record USD 100 as due from the client
 - d) USD 900 and charge USD 100 to profit and loss
- 2 Mr Hamad made a non-binding promise to an Islamic bank that he would buy a vehicle from the bank and paid USD 240 as *Hamish Jiddiyyah*. The bank purchased a car for USD 500 and offered it to Mr Hamad for USD 650. Mr Hamad decided not to buy the car at this price and so the bank sold the car for USD 600 to another customer. Which of the following will apply?
 - a) The bank should charge a loss of USD 50 to profit and loss.
 - b) The bank should deduct USD 50 from *Hamish Jiddiyyah*.

- c) The bank should record USD 150 as income and deduct USD 50 from *Hamish Jiddiyyah*.
 d) The bank should record USD 100 as income and return *Hamish Jiddiyyah* in full.
- 3 On Dec 31, 2022, a client made a non-binding promise to purchase a car from the bank as a part of a *Murabaha* arrangement. The bank purchased the car on Jan 1, 2023, at a cost of USD 1000 and sold the car to the client at a price of USD 1,500 on Jan 2, 2023. At the time of purchase, the bank will make the following accounting entries:
- a) Dr. Inventory 1,000; Cr. Cash 1,000.
 b) Dr. Receivables 1,500; Cr. Inventory 1,500.
 c) Dr. Receivables 1,000; Cr. Inventory 1,000.
 d) Purchase of asset is not recorded in financial statements of banks.
- 4 (Continued from Question 3) As per the *Murabaha* contract, the selling price of USD 1,500 is due from the client in five equal instalments of USD 300 at the end of each year. What entry should be passed by the bank at the time of the sale in respect of the profit element of the transaction:
- a) Dr. Receivables (Asset) 500; Cr. Profit (IS) 500
 b) Dr. Receivables (Asset) 100; Cr. Profit (IS) 100
 c) Dr. Profit (IS) 500; Cr. Deferred Profit (Contra-Asset) 500
 d) Dr. Deferred Profit (Contra-Asset) 500; Cr. Profit (IS) 500
- 5 Under FAS 28, if a client accelerates payment of one or more of the instalments before the due date, the bank may waive part of the profit that was agreed upon earlier. The deducted amount shall be credited to _____
- Receivables
 Profit–Income Statement
 Deferred profit on *Murabaha* sales
 None of the above
- 6 Barkat Islamic Bank purchased an item of machinery for sale on Jan 2, 2022, for USD 10,000. The equivalent cash price of the machinery through a spot sales contract was USD 11,000. The machinery is to be sold at a markup of 25% on cost. The sales contract between the bank and the client was executed on Jan 3, 2022, for a period of five years. The first instalment payment is due on Dec 31, 2022, which is also the accounting period end of the bank. The total profit on this transaction of USD 2,500 will be:
- a) Recognised entirely in the first year;
 b) Spread equally over the five-year instalment period;
 c) USD 1,000 will be recognised in the first year; USD 1,500 will be deferred and amortised over the contract term using the straight line method;

84 *Murabaha and Deferred Payment Sales*

- d) USD 1,000 will be recognised in the first year; USD 1,500 will be deferred and amortised over the contract term using the effective profit rate method.

7 JITB Islamic Bank purchased a motor vehicle which it intends to sell under a *Murabaha* contract. The cost of the car was USD 1,000,000. Other costs related to the acquisition were:

Transportation to the bank's premises	USD 30,000
Administrative overheads attributable to the car	USD 20,000
<i>Takaful</i> -in-transit	USD 15,000
Storage at bank premises	USD 5,000
Commission paid to the agent	USD 7,000

At what value will JITB Islamic Bank record the purchase of the vehicle?

- a) USD 1,052,000
b) USD 1,077,000
c) USD 1,072,000
d) USD 1,047,000
- 8 Rehmat Islamic Bank sells a generator under a *Murabaha* contract which it acquired for Rs 1,000,000. The terms of the contract require that instalment are due over a period of three years. The annual instalment payment is Rs 400,000. At the time of sale, the cash equivalent price of the generator was 1,050,000. What amount will the bank recognise as deferred profit at the time of the sale?
- a) Rs 200,000
b) Rs 50,000
c) Rs 150,000
d) Rs 100,000
- 9 If an IFI expects that some of the proceeds under a *Murabaha* contract will not be recovered, what entry should be made in the accounts of the IFI?
- a) Cr. Receivable; Dr. Provision for Doubtful Debts
b) Cr. Provision for Doubtful Debts, Dr. Receivable
c) Dr. Cash, Cr. Receivable
d) Dr. Receivable, Cr. Cash
- 10 Barkat Bank acquires an asset from a vendor to be sold under a *Murabaha* contract to its client. At what point should the bank recognise the inventory in its books?
- a) When the legal title is transferred to the bank
b) When the *Murabaha* contract is signed
c) At the time the bank makes cash payment to its vendor
d) When the asset is delivered to the client under the *Murabaha* contract

Notes

- 1 In the rest of this chapter, the term *Murabaha* shall be read as “*Murabaha* and other deferred payment sales”.
- 2 A legal document used across the banking industry.
- 3 Constructive possession of an asset refers to a situation where an individual has legal/actual control over the asset without having physical control over it.
- 4 The effective rate is determined using the annuity tables. Present value of annuity = annuity payments \times annuity factor $3,200 = 960 \times$ annuity factor; annuity factor = 3.333; interest rate = 7.71%.
- 5 The effective rate is determined using the annuity tables. Present value of annuity = annuity payments \times annuity factor $11,000 = 2,500 \times$ annuity factor; annuity factor = 4.4; interest rate = 4.42%.
- 6 These two divergent viewpoints have been earlier deliberated at length by the IASB Consultative Group on *Shariah*-compliant Instruments and Transactions. The following discussion summarises the two main possibilities which might emerge.
- 7 The “cash selling price” for the goods or services is the price that the customer would pay in cash for the goods or services when (or as) they transfer to the customer.
- 8 Under the effective interest method, recognition of income is done in such a manner as to produce income equal to a **constant percentage** of the carrying value of the receivable. Note that differences in the timing of revenue recognition will arise only in the case of multi-period *Murabaha*.

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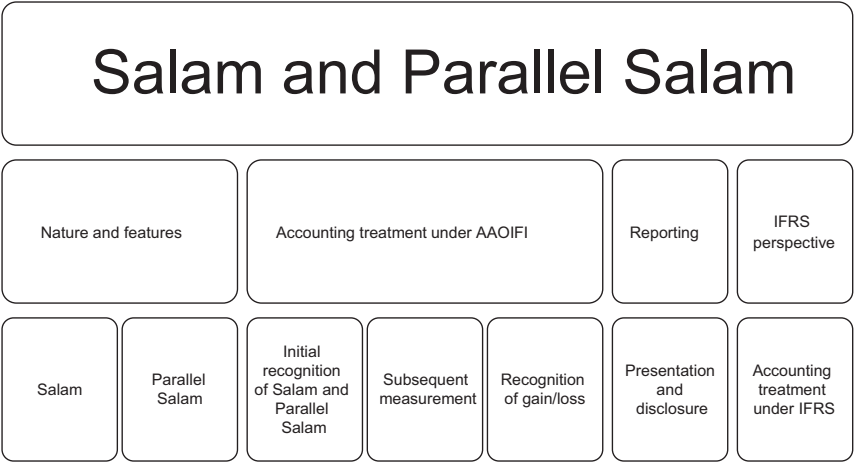
4 Salam and Parallel Salam

Learning Objectives

After going through this chapter, you should be able to:

- 1 Describe the nature of *Salam* and *Parallel Salam*.
- 2 Understand the process and challenges in *Salam* and *Parallel Salam contracts*.
- 3 Describe the accounting entries, presentation, and disclosure requirements for *Salam* and *Parallel Salam* under **FAS 7 Salam and Parallel Salam**.
- 4 Understand the main differences in the accounting treatment of *Salam* and *Parallel Salam* under IFRS and AAOIFI.

Chapter Preview



Cover Story

Pakistani smallholder farmers face limited financing options, hindering their ability to build assets over time. The traditional reliance on informal middlemen often traps farmers in perpetual debt. However, since 2009, the Wasil Foundation, a Pakistani NGO, has offered an alternative financing solution called *Salam*. This innovative approach empowers farmers and provides them with a pathway towards sustainable livelihoods. *Salam* financing operates through advance purchase agreements, enabling farmers to access cash for agricultural inputs.

Salam financing, provided by the Wasil Foundation, addresses the specific needs of the smaller farmers in several ways. Wasil provides cash financing to farmers, who later repay the amount in crops at the agreed-upon price at harvest. This approach eliminates the need for farmers to use their land as collateral or adhere to strict monthly loan repayments.

Salam financing offers benefits to small farmers, paving the way for asset building and poverty reduction. Farmers have the freedom to choose high-quality seeds and fertilisers from their preferred retailers. This leads to increased yields of at least 15% to 30%, enabling farmers to enhance their productivity and profitability. The price for the crops at harvest time is set at the time of financing. Negotiation between the farmer and Wasil (based on the previous year's price and weather forecasts) ensures a fair price for both parties.

Wasil estimates that within approximately three years to five financing cycles, farmers utilising *Salam* financing can elevate themselves above the poverty line. This demonstrates the potential for *Salam* to contribute significantly to poverty alleviation efforts in rural Pakistan. *Salam* financing provides farmers with a more active role in decision-making regarding their farming practices. By choosing their inputs and negotiating prices, farmers gain autonomy and a sense of ownership over their agricultural activities. Despite operating on a relatively small scale, Wasil's *Salam* offering has proven to be financially sustainable, generating an average gross margin of 30%. This profitability enables the programme's expansion and replication to benefit more farmers (Wasil Foundation, 2022).

4.1 Introduction to *Salam*

It is October, and Ali is trying to arrange capital for his winter crops cycle. Ali is the owner of a commercial farm in the southern district of Punjab, Pakistan. This year, because of a scorching summer, many farmers in the southern parts of Punjab have suffered crop failures. There is a continuous drop in farmers' profitability, and like most other farmers, Ali is facing severe liquidity issues. After assessing his current cash position and prices of the inputs, Ali has estimated that he needs at least PKR 1,000,000 of external financing for the entire winter crop cycle of around six months. The

current price of wheat is PKR 45 per kg, and Ali expects to produce 25,000 kg of wheat. So, if everything goes right, Ali should get a crop worth PKR 1,125,000 in six months' time.

The second option is to sign a sales contract for deferred delivery with an Islamic financial institution. Under this contract, Takreem Islamic Bank has offered to buy all the wheat produce at a price of PKR 40 per kg, PKR 5 less than the market price. The bank will pay PKR 1,000,000 immediately and will receive delivery of the crops in six months' time. This financing option is known as *Salam* transaction. The term *Salam* refers to a *sale of a prescribed commodity for deferred delivery in exchange for immediate payment of the price* (Figure 4.1).

From a *Shariah* perspective, *Salam* is allowable because it provides a form of financing for those who require it. For example, farmers and merchants need working capital for their enterprises and day-to-day expenses. The requirements of businesses ranging from small and medium-sized businesses to larger conglomerates engaged in agricultural and industrial production and trade can be potentially met by a *Salam* contract. By purchasing the goods for less than market value, the buyer also stands to benefit. *Salam* has provided an investment opportunity in the form of financing the working capital for trade. It also helps those who need liquidity, as long as they are able to fulfil the orders they receive on time. Although *Salam* is commonly used by farmers and agricultural businesses, it has applications in many other industries too.

There are two subject matters of a *Salam* transaction: *Salam* capital and *Salam* commodity. To be *Shariah*-compliant, there are important conditions attached to both. For example, the *Salam* capital must be known to both parties and paid immediately at the start of the contract. It may be in cash or non-cash form. The non-cash form includes fungible goods (e.g., wheat or other cereals), material form (e.g., livestock), or the general usufruct of a certain asset (e.g., living in a house or use of an item of equipment for a certain period). The *Salam* commodity should be something of a homogenous nature (not specific or distinct, such as "this car") which may be weighed, measured,

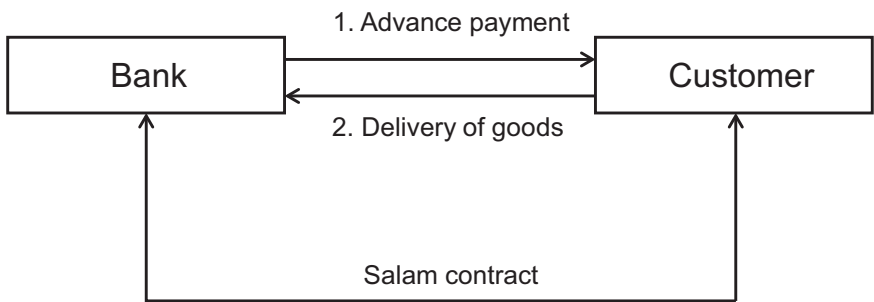


Figure 4.1 Mechanism of a *Salam* Contract

Source: Diagram by the authors.

or counted. The specifications of the commodity should be clearly drawn up and mentioned in the contract to avoid any ambiguity.

Salam transactions can also be accompanied by another contract where the bank, after taking the (constructive) possession of the *Salam* goods, employs the customer as its agent to sell the commodity in the market at the time of harvest and pass on the proceeds to the bank, thus obviating the need for a double movement of commodity, first from the field to the bank's warehouse and second from there to the market. The saving in the logistic costs or a part of it can be paid to the farmer as a fee. This second transaction is referred to as **Parallel Salam**.

Let's explain a few technical terms used in a *Salam* transaction. The buyer or the financier is called the *Al-Muslam* while the seller or borrower is called *Al-Muslam Ileihi*. The nature, specification, and quantity of a commodity, that is, 25,000 kg of, say *Ujala*, 2016 variety of wheat, is called *Al-Muslam Fibi*. The consideration (cash or non-cash) given by the bank to the farmer at the time of the *Salam* contract is called ***Salam capital***. When the *Salam* capital is recorded in the books of the IFI, it is termed ***Salam financing***.

From the aforementioned example, it is clear that the more the price of wheat rises above PKR 45 per kg, the more Takreem Bank will gain, and Ali will lose, leading to an exploitation of the latter. A significant movement of price in the reverse direction can lead to Takreem Bank sustaining abnormal losses. To safeguard the *Salam* capital from the wilful default of the seller in *Salam*, the buyer may ask the seller to provide some security.

Box 4.1 Practical Insight: Habib Bank Limited's *Salam* Financing

Habib Bank Limited (HBL) in Pakistan provides *Salam* financing to its clients. The facility provided caters to the working capital needs of the agricultural sector and manufacturers/exporters of homogeneous commodities. It is marketed as a financing option for customers to cover overhead and utility costs, particularly suitable for agricultural financing purposes. HBL sets specific criteria that customers must meet, including compliance with the bank's relevant regulatory policies. Additionally, customers are required to offer collateral acceptable according to the bank's requirements (Habib Bank Limited, 2023).

4.2 Introduction to Parallel *Salam*

Parallel *Salam* is when the Islamic bank enters another *Salam* contract with a third party to sell the goods that it has acquired through the first *Salam* contract. The two *Salam* contracts operate in parallel. In the first *Salam* contract,

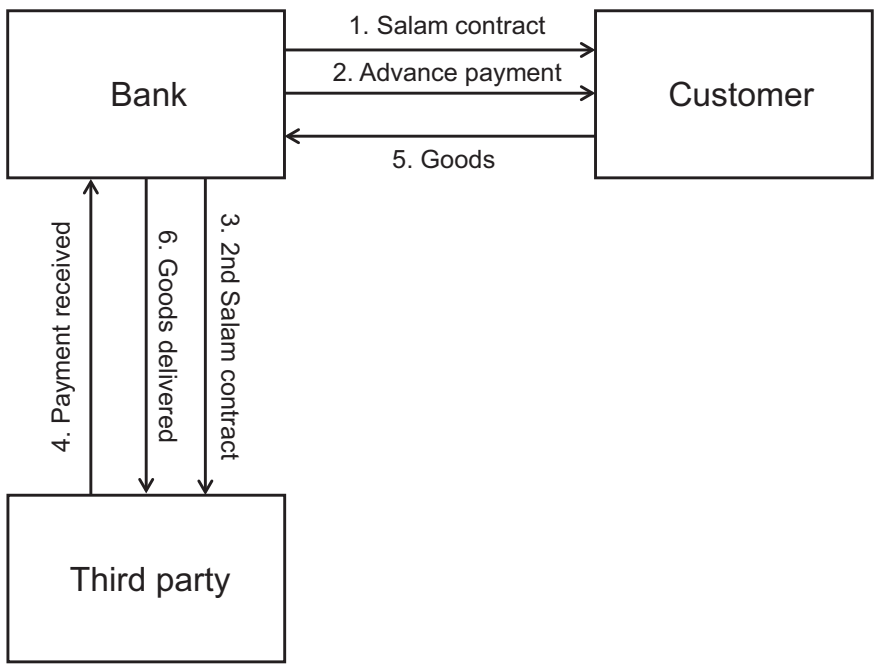


Figure 4.2 Mechanism of Parallel Salam Contract

Source: Diagram by the authors.

Table 4.1 Steps in Creating Salam and Parallel Salam Contracts

<i>Salam</i>	<i>Parallel Salam</i>
STEP 1: The IFI provides advance funds to the client/farmer under a <i>Salam</i> contract.	STEP 2: The IFI enters a Parallel <i>Salam</i> contract with a third party and receives funds in advance.
STEP 3: The IFI receives the goods from the client later under the <i>Salam</i> contract.	STEP 4: The IFI delivers the goods received from the <i>Salam</i> contract to the third party under the Parallel <i>Salam</i> contract.

the Islamic bank acts as the buyer whilst, in the second parallel *Salam* contract, the Islamic bank act as the seller. It is permissible for the Islamic bank to form a parallel *Salam* contract with a third party or the seller of the first *Salam* contract. However, it is not permissible for the parties involved in *Salam* and Parallel *Salam* contracts to link the obligations under the two *Salam* contracts together. The obligations and the rights under the two contracts must stand independent of one another. Any loss or damage under the first *Salam* contract does not affect the performance of the obligations under the parallel *Salam* contract (Figure 4.2).

Table 4.1 shows the main steps involved in both types of *Salam* contracts and how they function in parallel.

Box 4.2 Practical Insight: Risks in Parallel Salam

A Parallel *Salam* contract is used to decrease the price risk associated with the *Salam* goods. However, it is essential to note that this mechanism is not without its own risks. For example, although the Islamic bank hedges its price risk using Parallel *Salam*, it assumes another market risk since both *Salam* contracts are independent of the other and must be fulfilled irrespective of the status of the other contract. If the commodities purchased in the first *Salam* are not delivered on time by the seller to the Islamic bank, the Islamic bank may have to buy the goods from the market to meet its delivery obligation in the Parallel *Salam* contract (and in doing so, may have to incur a loss) (Alamad, 2019).

Box 4.3 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) A *Salam* contract is the sale of a specific (unique) item for deferred delivery in exchange for immediate payment of the price.
- 2) The seller can pay the price in a *Salam* contract only in the form of cash.
- 3) It is not permissible for the parties involved in *Salam* and Parallel *Salam* contracts to link the obligations under the two *Salam* contracts together.
- 4) The price of the commodity, which is known as *Salam* capital, is paid to the seller sometime after the signing of the contract.
- 5) The amount of capital should be known to both parties and should be clearly stated in the contract.

Solution:

- 1) False. A *Salam* contract refers to the sale of a prescribed commodity (which should be of a homogenous nature, not specific or distinct) for deferred delivery in exchange for immediate payment of the price.
- 2) False. The payment may be in both cash and non-cash form.
- 3) True.
- 4) False. The price of the commodity, which is known as *Salam* capital, is paid to the seller immediately.
- 5) True.

4.3 AAOIFI Accounting Treatment

The accounting treatment for *Salam* and *Parallel Salam* contracts is prescribed by AAOIFI's Financial Accounting Standard 7, and the presentation and disclosure requirements are prescribed in Financial Accounting Standard 1 (Revised 2021).

4.3.1 Accounting for Salam Financing

4.3.1.1 Initial Recognition and Measurement

A *Salam* transaction comprises two elements:

- Advance payment to the seller for the commodity purchase
- Future delivery of the commodity to the IFI

The Islamic bank should recognise the *Salam* transaction as soon as the bank has made the payment to the seller and the funds are available for the seller to use. It is also permissible to transfer non-cash assets as part of the payment. In such scenarios, the bank should recognise the *Salam* transaction when the asset is available to the seller.

Box 4.4 Illustration 4.1 Initial Recognition of *Salam* Financing

Itehad Islamic Bank signed a *Salam* contract with a farmer on Jan 1, 2022, wherein the farmer will sell 1,000 tons of wheat to the bank on May 30, 2022, for USD 300 per ton. The bank, after due processing, transfers the funds into the account of the farmer on the same day.

Requirement: Show how *Salam* financing will be recorded.

Solution:

Since Itehad Islamic Bank transferred funds to the account of the client on Jan 1, 2022, the bank will recognise the *Salam* financing on Jan 1, 2022. The *Salam* capital provided to the farmer by the IFI through the payment of cash is recorded at its face value.

Recording of *Salam* Capital (Cash Payment) by IFI:

	Dr.	Cr.
Jan 1 Salam Financing (Asset)	300,000	
Cash/Bank (Asset)		300,000
(To record the payment of cash as <i>Salam</i> financing)		

If, however, the capital is provided in the form of a non-cash asset (e.g., tractor, ploughing machine etc.) or benefits (right to use agricultural machinery for a specified time), it should be measured at the **fair value**. FAS 7 defines fair value as the value of assets that is mutually agreed upon between the Islamic bank and the client.

Box 4.5 Illustration 4.2 Non-Cash Salam Financing

Let us continue with the example of Itehad Islamic Bank, wherein the bank will purchase 1,000 tons of wheat at an agreed price of USD 300 per ton. The delivery date agreed upon between the parties was May 30, 2022. The bank agreed to transfer USD 100,000 in cash and provide agricultural machinery worth USD 200,000. After processing the contract and procuring the machinery, Itehad Islamic Bank transferred the funds to the farmer on Jan 7, 2022, and delivered the machinery to the client on that day.

Requirement: Show how *Salam* financing will be recorded.

Solution:

Itehad Islamic Bank should recognise the payment and wheat receivable at a value equal to the cash funds transferred to the farmer and the fair value of the agricultural machinery delivered to the farmer.

Recording of Salam Capital (Non-Cash Consideration) by IFI:

	<i>Dr.</i>	<i>Cr.</i>
Jan 7 <i>Salam</i> Financing (Asset)	300,000	
Cash (Asset)		100,000
Agricultural Machinery (Asset)		200,000
<i>(To record the provision of Salam financing against 1,000 tons of wheat at USD 300 per ton)</i>		

4.3.1.2 Subsequent Measurement

At the end of the accounting period, the *Salam* financing will be reflected in the books of the IFI at its historical cost (the contract price). However, in certain circumstances, an adjusting entry may be required to reduce the carrying value of the asset to its cash equivalent value. **Cash equivalent value** is the amount of cash which can be obtained by selling an asset. This adjustment is made through the creation of a provision. For example, if it is probable that the client will be unable to deliver the goods as promised in the contract (known as client default risk) or if it is probable that the fair value of assets to be received will be lower than the book value of the receivable (known as price risk of *Al-Muslam Fibi*), then the IFI will create a provision at the balance sheet date.

Provision for Salam Financing is a contra-asset account. It will reduce the value of *Salam* financing (asset) in the statement of financial position to its cash equivalent value.

Box 4.6 Illustration 4.3 Provision for Salam Financing

On Nov 3, 2022, Hannan Islamic Bank formed a *Salam* contract with a client to receive rice worth USD 4,500 (5 tons at the rate of USD 900 per ton) next year on Mar 3, 2023. However, there was a flood in that area which resulted in a lower rice yield. Based on a survey conducted by the expert, the management is of the view that the farmer will be able to give only 3 tons of rice. There is no sufficient collateral to recover the remaining balance.

Requirement: Show how the provision for *Salam* financing will be recorded.

Solution:

On Dec 31, 2022, Hannan Islamic Bank should recognise a provision to reduce the value of the rice receivable to its cash equivalent value which is now USD 2,700 (3 tons at USD 900 per ton).

	Dr.	Cr.
Dec 31 Provision Against <i>Salam</i> Financing (Expense)	1,800	
Provision for <i>Salam</i> Financing (Contra-Asset)		1,800
<i>(To record a provision for Salam Financing at cash equivalent value)</i>		

4.3.2 Accounting for Salam Inventory

4.3.2.1 Initial Recognition and Measurement

The *Salam* inventory should be delivered to the IFI on the contract maturity date in accordance with the precise specification mentioned in the contract. However, there are a number of different scenarios which the IFI might face on the contract maturity date.

- i) Goods are delivered on the maturity date as per the contract.
- ii) Goods are delivered on the maturity date but **not** as per the contract.
- iii) Goods are not delivered on the maturity date.

The accounting entries performed by the IFI on the contract maturity date will differ for each of these scenarios (see Figure 4.3):

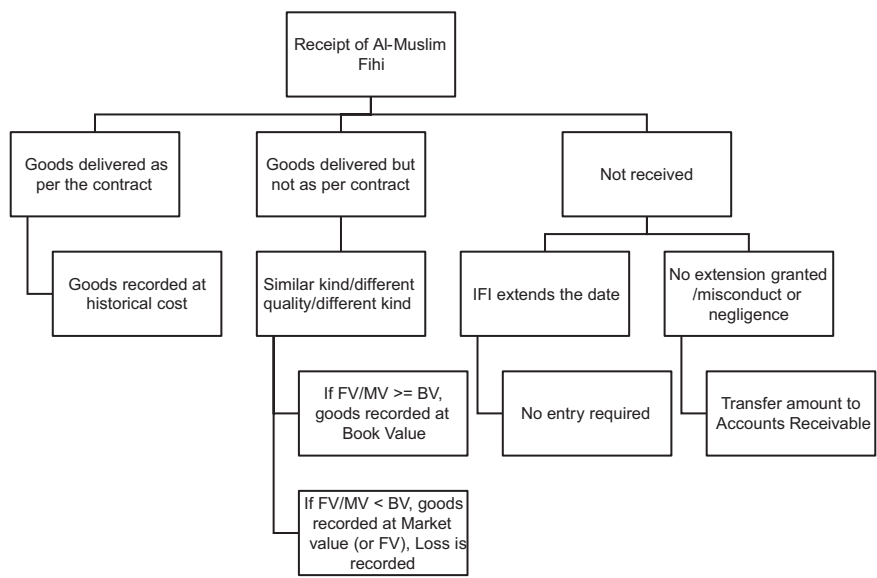


Figure 4.3 Summary of Accounting Treatment for *Salam* Inventory

Source: Diagram by the authors.

1 GOODS DELIVERED AS PER THE CONTRACT

Al-Muslim Fihi received on the contract date in accordance with the specifications of the contract will be recorded at their historical cost value (i.e., the amount originally paid by the IFI).

Box 4.7 Illustration 4.4 Goods Delivered as per the Contract

Hannan Islamic Bank formed a *Salam* contract with a client to receive a fixed quantity of barley on Jun 7, 2023. The bank transferred USD 300,000 for this commodity on Jan 5, 2023.

Requirement: Show how delivery of the barley will be recorded.

Solution:

The journal entry that Hannan Islamic Bank will record on Jun 7, 2023, when it receives delivery of the commodity is:

	Dr.	Cr.
Jun 7 <i>Salam</i> Inventory – Barley (Asset)	300,000	
<i>Salam</i> Financing (Asset)		300,000
<i>(To record the delivery of the Salam Inventory)</i>		

2 GOODS DELIVERED BUT NOT AS PER THE CONTRACT

If the client provides the IFI with similar goods on the maturity date but with a variation in quality, then these goods will be valued differently. There can be two separate cases:

- **Equal value:** If the market value (or fair value, if the market value is not available) of the received commodity is equal to the value specified in the contract, the received commodity will be measured and recorded at the book value. Book value is the current estimated value of the *Salam* financing in the buyer's books after adjusting for subsequent measurements, for example, impairments. If no adjustments have been made, then the book value is the same as the historical cost. The journal entry is the same as shown in Illustration 4.4.
- **Difference in the value:**
 - If the market value (or fair value, if the market value is not available) of the received commodity is lower than the book value of the commodity promised in the contract, then the goods will be measured and recorded at the market value (or fair value) available at that time, and the difference between the market value and the book value shall be recognised as a loss.
 - In case the market value (or fair value) is higher, no such gain is recognised, and the *Salam* inventory is recorded at historical cost.

Box 4.8 Illustration 4.5 Goods Delivered but not as per the Contract

Al Khair Islamic Bank formed a *Salam* contract with a client to receive a fixed quantity of barley on Jun 7, 2023. The bank transferred USD 300,000 for this commodity on Jan 5, 2023. On Jun 7, 2023, the barley delivered was worth USD 270,000 (less than given in the original contract).

Requirement: Show how delivery of the barley will be recorded.

Solution:

Recording of *Salam* inventory at lower than book value (not in accordance with the contractual promise):

	<i>Dr.</i>	<i>Cr.</i>
Jun 7 <i>Salam</i> Inventory – Barley (Asset)	270,000	
Loss on <i>Salam</i> Financing (Expense)	30,000	
<i>Salam</i> Financing (Asset)		300,000
<i>(To record the delivery of the Salam Inventory at less than book value)</i>		

3 NO DELIVERY OF GOODS ON THE DUE DATE

If the client is unable to deliver the promised goods on the contract maturity date, the bank can extend the date to facilitate him, in which case no entry is required. In case the bank does not extend the date, then the bank will record a receivable due from the client equal to the book value of the *Salam* financing. It is imperative to note that in a case where no extension is provided, the bank must transfer *Salam* Financing to *Salam* Receivable as the nature of the asset has changed. The contract is terminated, which means the bank no longer makes a recovery from the client through the commodity receipt and instead must book a receivable with an appropriate provision for doubtful debts if deemed prudent by the management.

Box 4.9 Illustration 4.6 No Delivery of Goods on Due Date

Bilad Islamic Bank formed a *Salam* contract with a client to receive a fixed quantity of goods on May 5, 2023. The bank transferred USD 300,000 for this commodity on Jan 5, 2023. On May 5, the client was unable to deliver the goods.

Requirement: Show how this event will be recorded in the bank’s books.

Solution:

Bilad Islamic Bank will record the following entry on this date:

		Dr.	Cr.
May 5	Accounts Receivable – <i>Salam</i> Seller (Asset)	300,000	
	<i>Salam</i> Financing (Asset)		300,000
	(To record a receivable due to non-delivery of <i>Salam</i> Inventory)		

4.3.2.2 Subsequent Measurement

At the year-end, *Salam* inventory should be measured at the lower of its cash equivalent value and the historical cost. If there is a reduction in the cash equivalent value below the historical cost, the difference must be reflected in the income statement as a loss.

Box 4.10 Illustration 4.7 Subsequent Measurement – Reduction in Cash Equivalent Value

Bilad Islamic Bank formed a *Salam* contract with a client to receive a fixed quantity of barley on Jul 7, 2023. The bank transferred USD 300,000 for this commodity on Jan 5, 2023. The bank received delivery of the commodity on Jul 7, 2023; however, the market value of the commodity received has fallen to USD 290,000. The fair value could not be decided upon.

Requirement: Show how this event will be recorded in the bank’s books.

Solution:

Bilad Islamic Bank will record the following entry on Jul 7, 2023:

	<i>Dr.</i>	<i>Cr.</i>
Jul 7 <i>Salam</i> Inventory – Barley (Asset)	290,000	
Loss on <i>Salam</i> Financing (Expense)	10,000	
<i>Salam</i> Financing (Asset)		300,000
<i>(To record the delivery of the Salam Inventory at less than book value)</i>		

On Dec 31, 2023, when Bilad Islamic Bank was preparing its financial statements, the cash equivalent value of the inventory was estimated at USD 260,000. The journal entry to record this is:

Recording a reduction in the cash equivalent value below the historical cost:

	<i>Dr.</i>	<i>Cr.</i>
Dec 31 Impairment/Loss on <i>Salam</i> (Expense)	30,000	
<i>Salam</i> Inventory – Barley (Asset)		30,000
<i>(To record the loss in value of the inventory)</i>		

4.3.3 Recovery of Receivables

Where the IFI has recorded accounts receivable in its books (in case of non-delivery of the goods), the receivables can be settled either through cash payment by the seller or through the liquidation of any pledged securities.

- **Cash payment:** In case of non-delivery of *Salam* inventory, if the client chooses to make a cash payment to settle the account instead of providing the IFI with the goods, the IFI will be able to recover its receivables.
- **Liquidating the pledged securities:** If the IFI has pledged securities against the *Salam* inventory, then in case of non-delivery, the IFI can liquidate the securities it received from the client and recover its receivables. If the sales proceeds are less than the outstanding amount, then the balance amount will continue to stand as a receivable. On the other hand, if the amount received from the sales proceeds is greater than the outstanding amount, the bank should return the excess amount to the client, and that amount should be credited to the customer by the bank.

Box 4.11 Illustration 4.8 Recovery of Receivables

Taqwa Islamic Bank signed a *Salam* contract with a customer on Jan 5, 2023. However, the customer defaulted on the contract. On Jul 14, 2023, Taqwa Islamic Bank decided to sell the pledged securities to recover the amount of *Salam* receivable of USD 2,000.

Requirement: Determine how the liquidation will be recorded in the books of Taqwa Islamic Bank in the following scenarios:

- The sales proceeds the bank received through the disposal of the securities were USD 2,300.
- The sales proceeds the bank received through the disposal of the securities were USD 1,800.

Solution:

- The bank recovered USD 2,000 and returned the remaining USD 300 to the client by recording a liability in this regard.

The following entry will be recorded:

	Dr.	Cr.
Jul 14	Cash/Bank (Asset)	2,300
	Accounts Payable (Liability)	300
	Accounts Receivable (Asset)	2,000
	<i>(To record an adjustment from proceeds from disposal of securities)</i>	

(b) The bank recovered USD 1,800 and recorded a receivable of USD 200 for the remaining amount due from the client.

The following entry will be recorded:

	Dr.	Cr.
Jul 14 Cash/Bank (Asset)	1,800	
Accounts Receivable (Asset)		200
<i>(To record an adjustment from proceeds from disposal of securities)</i>		

4.3.4 Accounting for Disposal of Salam Inventory

The disposal of *Salam* inventory can be executed in the following ways:

- 1 Sale in the open market
- 2 Sale in the open market with a pre-promise
- 3 Parallel *Salam*

In the first method, the bank can sell the received commodity in the open market at a spot rate. Selling goods directly in the open market exposes the IFI to several kinds of risks, such as price risk, which occurs in the case where the IFI sells the commodity at a lower price than its original value and suffers a loss. However, the second method to dispose of the *Salam* inventory helps in mitigating these risks. In this method, the bank enters a written contract (promise) with a client in advance to buy the commodity from the bank when received – this reduces the risk factor for the IFI. Lastly, the bank can enter a Parallel *Salam* to sell the inventory received as discussed earlier.

Box 4.12 Illustration 4.9 Disposal of Salam Inventory

On Jan 1, 2023, Jazira Islamic Bank entered a *Salam* contract with a client. According to the contract, 400 metric tons of rice had to be delivered to the IFI on Jun 15, 2023, at USD 1,200 per metric ton. The client was paid the money on Jan 1, and the bank received the goods on Jun 15, as promised.

Requirement: Show what entries will be recorded in the bank’s books.

Solution:

The following entries were recorded by the IFI:

		Dr.	Cr.
Jan 1	<i>Salam</i> Financing (Asset)	480,000	
	Cash/Bank (Asset)		480,000
	<i>(To record the transfer of Salam Financing)</i>		
Jun 15	<i>Salam</i> Inventory (Asset)	480,000	
	<i>Salam</i> Financing (Asset)		480,000
	<i>(To record the delivery of the Salam Inventory)</i>		

After receiving the goods, the bank sold all the goods in an open market without an agent on Jun 20, 2023. The market value of one metric ton of rice was USD 1,230. The following entry for the disposal of goods was recorded by the IFI:

		Dr.	Cr.
Jun 20	Cash/Accounts Receivable (Asset)	492,000	
	Sale of <i>Salam</i> Inventory (Income)		492,000
	Cost of Goods Sold (Expense)	480,000	
	<i>Salam</i> Inventory (Asset)		480,000
	<i>(To record the disposal of Salam goods)</i>		

4.3.5 Recognition and Measurement of Parallel Salam Financing

Parallel *Salam* is an independent *Salam* transaction wherein the bank agrees to sell the same agricultural produce it purchased under the first *Salam* contract. Hence, the accounting treatment of the parallel *Salam* is a mirror image of the *Salam* transaction.

4.3.5.1 Initial Recognition and Measurement

Islamic banks should recognise the parallel *Salam* transaction (a receipt of payment and a liability to deliver goods) when the bank has received the payment, and it is available to the bank for use. The bank may also receive some assets as part of the payment. In this case, the bank should recognise the *Salam* transaction when the asset is made available to it.

Box 4.13 Illustration 4.10 Initial Recognition of Parallel Salam Financing

Saud Islamic Bank signed a Parallel *Salam* contract with a client on Jan 1, 2023, wherein the bank sold 10 tons of wheat, to be received through a *Salam* contract on Jun 31, 2023, to the client for USD 200,000.

The bank received the funds from the client on Jan 1, 2023, and recognised the Parallel *Salam* on that same day.

Requirement: Show how this event will be recorded in the bank’s books.

Solution:

At initial recognition, the amount received in cash or the cash equivalent should be measured at face value. The capital received in the form of an asset (car, plot, etc.) or benefits (right to use a building for a specified time) should be measured at fair value. However, the value of capital in kind should be agreed upon between the Islamic bank and the client.

Entry for receiving financing under Parallel Salam:

	<i>Dr.</i>	<i>Cr.</i>
Jan 1 Cash/Bank or Asset (Asset)	200,000	
Parallel Salam (Liability)		200,000
<i>(To record the receipt of Salam Financing)</i>		

4.3.5.2 Delivery of the Commodity

The Islamic bank will deliver the specified quantity of the commodity to the client at a pre-agreed date. The quality and quantity of the commodity are precisely stated in the Parallel *Salam* contract between the Islamic bank and the client. On the date of delivery to the client, the Islamic bank will recognise a profit/loss equal to the difference between the amount paid by IFI for the goods (via *Salam*) and the amount received for the goods from the buyer (via Parallel *Salam*).

Box 4.14 Illustration 4.11 Delivery of Salam Commodity

On Jan 2, 2023, Salaf Islamic Bank signed a *Salam* contract with a farmer to buy 3 tons of wheat at USD 2,000 per ton to be delivered on

Jun 30, 2023. Salaf Islamic Bank transferred the required funds to the customer on Jan 2, 2023. The client delivered the contracted amount of wheat to Salaf Islamic Bank on Jun 30, 2023. The carrying amount of the commodity will equal the amount the bank had paid to the client, that is, USD 6,000.

Suppose Salaf Islamic Bank had formed a Parallel *Salam* contract with another client on Jan 20, 2023, to sell the wheat to the client at USD 2,200 per ton. The bank accepted the delivery and delivered the wheat for USD 2,200 per ton to its client in the Parallel *Salam* contract on Jul 3, 2023.

Requirement: Show how the Parallel *Salam* transaction will be recorded in the bank's books.

Solution:

The entries pertaining to the Parallel *Salam* transaction would be:

		Dr.	Cr.
Jan 20	Cash/Bank (Asset)	6,600	
	Parallel <i>Salam</i> (Liability)		6,600
	<i>(To record the receipt of Salam capital)</i>		
<hr/>			
		Dr.	Cr.
Jul 3	Parallel <i>Salam</i> (Liability)	6,600	
	<i>Salam</i> Inventory (Asset)		6,000
	Profit on Parallel <i>Salam</i> (Revenue)		600
	<i>(To record the delivery of inventory and profit on Parallel Salam)</i>		

Remember that the performance of a Parallel *Salam* does not depend on the performance of the original *Salam* contract. An Islamic bank can therefore use the commodity received from a *Salam* contract to fulfil its obligation or, in case of non-performance of such a *Salam* contract, the Islamic bank will acquire the commodity from the market to fulfil its obligation. The journal entry to record the delivery of the inventory under the Parallel *Salam* contract will be the same in either situation.

Box 4.15 Illustration 4.12 Non-Delivery of the Salam Commodity

Consider Illustration 4.11. Suppose that the farmer was unable to deliver the wheat on Jun 30 as per the *Salam* contract. Since Salaf Islamic Bank is required to fulfil the Parallel *Salam* contract regardless of the initial *Salam* contract, the bank must purchase the wheat from the open market and then deliver this to its client.

Assume that Salaf Islamic Bank purchases the wheat from the open market for USD 2,250 per ton on Jul 1 and delivers this to the client on Jul 3 to fulfil its obligation under the Parallel *Salam* contract.

Requirement: Show how this event will be recorded in the bank's books.

Solution:

The journal entries in this situation are:

	Dr.	Cr.
Jul 3 Salam Inventory (Asset)	6,750	
Cash/Bank (Asset)		6,750
(To record the purchase of the commodity from the open market)		
Jul 14 Parallel Salam (Liability)	6,600	
Loss on Parallel Salam (Expense)	150	
Salam Inventory (Asset)		6,750
(To record the delivery of inventory and loss on Parallel Salam)		

Box 4.16 Practical Insight: Adoption of Salam in Indonesia

While *Salam* financing provides benefits to its users, no Islamic bank in Indonesia currently utilises *Salam* financing, with *Murabaha* financing being more popular and accounting for 56% of usage. This raises an intriguing question about whether the traditional *Salam* contract still holds relevance in the contemporary economy of Islamic finance. *Salam* appears convenient for both parties involved, whether the buyer or the

seller, there are certain risks associated with its consequences. As the buyer, the bank faces significant potential threats in this type of transaction. Price risk emerges when the cost of commodities may decrease during the delivery period while delivery risk arises when the seller has the right to refuse the agreed-upon delivery. Operational risks and natural calamities also pose additional challenges. These factors impact the confidence of buyers when deciding to enter into *Salam* financing contracts (Isahak et al., 2023).

Box 4.17 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) *Salam* financing and *Salam* receivable are recognised by the buyer.
- 2) *Salam* receivables are always presented at their historical value in the financial statements of the Islamic bank.
- 3) The commodity is recorded in the same amount as the *Salam* capital when the seller delivers it to the buyer.
- 4) The *Salam* profit is recognised when the *Salam* commodity is sold in the market or is delivered to the buyer in a Parallel *Salam* contract.
- 5) If the Islamic bank sells the commodity in the market, then the difference between the proceeds of the sale and the amount paid to the client is recognised as the profit/loss by the Islamic bank.

Solution:

- 1) True.
- 2) False. *Salam* receivables are generally presented on their historical value. However, if the market value or the fair value of the assets received is lower than the book value of the assets, Islamic banks should measure the asset at market value or fair value.
- 3) True.
- 4) True.
- 5) True.

4.4 Presentation and Disclosure

FAS 7 requires that the presentation and disclosure requirements of FAS 1 should be followed by the IFI in relation to *Salam*/Parallel *Salam* transactions. An IFI shall present *Salam* financing under the heading of *Salam* financing in

the *asset* section of the statement of financial position (net of any provisions). Similarly, transactions related to *Parallel Salam* shall be presented under the title of *Parallel Salam* within *Liabilities* in the statement of financial position. The Islamic bank should state the accounting policies followed in relation to *Salam* contracts and related gains or losses.

The following is a sample of how *Salam* financing and *Parallel Salam* will be presented in the financial statements.

<i>Ihsan Islamic Bank</i>		
<i>Statement of Financial Position as at 31 December 2022</i>		
	2022	2021
	USD	USD
Assets		
Cash and Cash Equivalents	xx	xx
Receivables	xx	xx
<i>Musharakah</i>	xx	xx
Investments	xx	xx
<i>Ijarah Muntahia Bittamleek</i>	xx	xx
<i>Salam</i> Financing	xx	xx
Investment in Real Estate	xx	xx
Building and Fixtures	xx	xx
Goodwill	xx	xx
Other Assets	xx	xx
Liabilities	xx	xx
Bills Payable	xx	xx
Borrowings	xx	xx
Deposits and Other Accounts	xx	xx
<i>Parallel Salam</i>	xx	xx
Accrued Expenses and Other Payables	xx	xx
Due to Related Parties	xx	xx
Subordinated Debts	xx	xx
Deferred Tax Liabilities	xx	xx
Other Liabilities	xx	xx

However, it is not always necessary that *Salam* Financing and *Parallel Salam* are presented on the face of the statement of financial position. If the amounts involved are immaterial compared to the total assets and liabilities, respectively, these are disclosed under the notes to the financial statements.

4.5 IFRS Perspective

The accounting treatment of *Salam* and *Parallel Salam* under IFRS is likely to be governed by IAS 2 *Inventories* and IFRS 15 *Revenue from contracts with customers*.

4.5.1 Salam

Salam capital paid by the IFI under a *Salam* contract is an advance payment for goods and will be disclosed as a current asset in the Statement of Financial Position. Where the consideration has been paid in cash, the asset will be recorded as *Salam* receivable at the face value amount on the date of payment. However, in the case of non-cash consideration (e.g., tractor, ploughing machine etc. or right to use agricultural machinery for a specified time), the asset is valued at the fair value of the consideration paid. This is like the treatment in FAS 7; however, a difference is most likely to arise in the valuation of the asset since the IFRS definition of fair value differs from that given in FAS 7. IFRS defines fair value as

the amount at which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arms-length transaction; the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants.

Under FAS 7, fair value is the “amount agreed between both parties”, and this does not usually entail discounting.

The measurement of the *Salam* receivable at the end of each accounting period will be at fair value under IFRS. As with AAOIFI principles, in certain circumstances, a provision may be required for impairment. Impairment in the fair value of *Salam* receivable will be recognised as an expense in the income statement.

The commodity delivered to the IFI under the *Salam* contract will be classified as inventory. IAS 2 prescribes the accounting treatment for inventory held by an entity. Once the IFI receives delivery of the commodity, it records the inventory asset at its historical cost (which will normally equal the amount paid and recorded as *Salam* receivable). IAS 2 further prescribes that inventory should be recorded at the lower of cost and net realisable value (NRV). NRV is the estimated selling price of the inventory, less any costs incurred to sell it. Therefore, any reduction in the NRV of the inventory will be recorded in the income statement in the period in which this has occurred. This treatment is also followed under Islamic accounting standards.

4.5.2 Parallel Salam

The capital received by the IFI from the client under a Parallel *Salam* contract represents the obligation of the IFI to transfer goods to the client at a future date. This is classified as a **contract liability** under IFRS 15 since the amount is received before the performance obligation has been satisfied and is disclosed as a current liability in the Statement of Financial Position. Once

the performance obligation is satisfied, the IFI records the revenue from the sale of the inventory in the income statement. Cost of goods sold is recorded in the period, and resultantly, the profit earned from the transaction is recognised on a time-apportioned basis (accruals basis).

Box 4.18 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) Under IFRS, the *Salam* receivable is recognised by the buyer when the contract is signed between the buyer and the seller.
- 2) Under IFRS, the *Salam* receivable is initially recognised at the face value of cash and/or the fair value of the asset delivered to the seller.
- 3) Under IFRS, the *Salam* commodity received is measured at the lower of cost and NRV.
- 4) The definition of fair value is the same under FAS 7 and IFRS.
- 5) Under IFRS, at the end of each period, the difference between the carrying value and fair value of the *Salam* receivable is recognised as an expense in the income statement.

Solution:

- 1) False. An Islamic bank should recognise the *Salam* transaction (payment and goods receivable) when the bank has made the payment to the seller (*Al-Muslam Ileihi*) and funds are available for the seller to use.
- 2) True.
- 3) True.
- 4) False. Under FAS 7, fair value is the amount agreed upon between both parties. Under IFRS, fair value is the amount at which an asset could be exchanged, or a liability settled, between knowledgeable, willing parties in an arms-length transaction.
- 5) True.

4.6 Chapter Summary

- A *Salam* contract takes place between two parties for the purchase of a commodity (*Al-Muslam Fih*) of an agreed specification (i.e., that may be weighed, measured, or counted) for deferred delivery in exchange for immediate payment (*Salam* capital). The amount of capital should be known to both parties and should be clearly stated in the contract. (LO1, 2)

- A Parallel *Salam* is a contract in which the Islamic bank enters another *Salam* contract with a third party to sell the goods that it has acquired through another independent *Salam* contract. Both the obligations and the rights under the two contracts must stand alone in all respects. The execution of the Parallel *Salam* contract obligations is not contingent on the outcome of the initial *Salam* contract. (LO1, 2)
- The Islamic bank should recognise the *Salam* transaction (payment and goods receivable) when the bank has made the payment to or has transferred the funds to the seller's account, and the funds are available for use by the seller. In the case of non-cash assets, the bank should recognise the *Salam* transaction when the asset is available to the seller. (LO 3)
- The *Salam* capital provided to the farmer by the IFI is recorded at face value (if paid in cash form) and at fair value (if paid in the form of non-cash assets). At the end of the accounting period, an adjustment to the *Salam* financing may be required in case of a client default risk or price risk of *Al-Muslam Fih*i. In such cases, a provision is created to adjust the value to its cash equivalent value. (LO 3)
- The Islamic bank should recognise the parallel *Salam* transaction (a receipt of payment and a liability to deliver goods) when the bank has received the payment, and the funds are available for use or, in the case of non-cash assets, when the asset is available for use. (LO 3)
- If the *Salam* inventory is delivered in accordance with the contract, the goods will be recorded at the historical cost (i.e., contract price). In case the inventory delivered is not identical to that specified in the contract, it will be recorded at the book value (provided the market value is higher). However, if the market value of the goods is lower than the book value, then the inventory will be recorded at the lower value, and a loss will be recorded in the income statement. If the goods are not delivered, and no extension in date is offered by the bank, then the amount is recorded as an accounts receivable. (LO 3)
- If the Islamic bank sells the commodity in the market, then the difference between the proceeds of the sale and the amount paid to the client is recognised as the profit/loss by the Islamic bank. (LO 3)
- If the Islamic bank transfers the commodity in a Parallel *Salam*, the difference between the amount paid to the seller in the *Salam* contract and the amount received from the buyer in the parallel *Salam* is recognised as the profit/loss by the Islamic bank. (LO 3)
- *Salam* financing is presented in the asset section of the statement of financial position, and Parallel *Salam* is presented within liabilities in the statement of financial position. (LO 3)
- Under IFRS, the accounting and disclosure requirements for a *Salam* and Parallel *Salam* transaction are similar to FAS 7. The Islamic bank recognises an asset in relation to the *Salam* capital paid to the client and records the commodity as its inventory under the provisions of IAS 2.

Capital received in relation to Parallel *Salam* is recorded as a liability, and revenue is recognised when the goods are transferred to the buyer. (LO 4)

4.7 Key Terms and Definitions

The definitions and meanings of these terms, where available, have been taken from AAOIFI's Conceptual Framework and respective accounting standards. Where it was not available in AAOIFI's framework, we used other accounting frameworks like IFRS and US GAAP.

- ***Al-Muslam Fihhi***: The commodity which is exchanged between the buyer and the seller in a *Salam* contract.
- ***Al-Muslam Ileihi***: The party which acts as the seller in a *Salam* contract.
- ***Al-Muslam***: The party which acts as a buyer in a *Salam* contract.
- **Book value**: The net amount shown for an asset or liability on the balance sheet; book value may also refer to the company's excess of total assets over total liabilities. Also called carrying value.
- **Cash equivalent value**: The number of monetary units that would be realised if an asset was sold for cash in the normal course of business as of the current date.
- **Fair value**: The amount which is agreed upon by both the buyer and the seller.
- **Historical cost**: In reference to assets, the amount paid to purchase an asset, including any costs of acquisition and/or preparation; with reference to liabilities, the amount of proceeds received in exchange for issuing the liability.
- **Market value**: The price at which an asset or security can currently be bought or sold in an open market.
- **Parallel Salam**: A *Salam* contract in which *Al-Muslam Ileihi* depends, for the execution of his obligation, on what is due to them – in their capacity as *Al-Muslam* – from a sale in a previous *Salam* contract, without making the execution of this *Salam* contract dependent on the execution of the first *Salam* contract (Financial Accounting Standard 7, Appendix E).
- **Provision for Salam financing**: A contra-asset account which reduces the value of the *Salam* financing in the statement of financial position to its cash equivalent value.
- ***Salam* capital**: The price paid by the seller to the buyer in a *Salam* contract.
- ***Salam***: The purchase of a commodity for deferred delivery in exchange for immediate payment according to specific conditions.

4.8 Review Questions

- 1 Which of the following statements is true about the subject matter under *Salam*?
 - a) The subject matter has to be specific with unique attributes that make them different from one another.

- b) The subject matter and *Salam* capital must be of the same nature and kind.
 - c) The subject matter must be in the form of gold or silver.
 - d) The quantity and quality of the subject matter has to be agreed upon between the seller and the buyer.
- 2 Which of the following is true?
- a) The buyer in a *Salam* contract may form a Parallel *Salam* contract acting as the seller.
 - b) Parallel *Salam* contract can't be formed with the seller of associated *Salam* contract.
 - c) Parallel *Salam* is dependent in terms of performance on the *Salam* contract.
 - d) Parallel *Salam* transfers the credit risk of the buyer to a third party.
- 3 Which of the following statements is true?
- a) Price in Parallel *Salam* contract should be greater than the price in *Salam* contract.
 - b) Price in *Salam* contract should be greater than the price in Parallel *Salam* contract.
 - c) Price in *Salam* contract has no relationship with the price in Parallel *Salam* contract.
 - d) Price in Parallel *Salam* contract is always based on the price in *Salam* contract.
- 4 When the *Salam* commodity is sold in the open market, then the *Salam* profit is equal to:
- a) The difference between the historical price of the *Salam* commodity and the price paid to the seller in the *Salam* contract
 - b) The difference between the market price of the *Salam* commodity and the price paid to the seller in the *Salam* contract
 - c) The difference between the market price of the *Salam* commodity and the cash equivalent price of the *Salam* commodity
 - d) None of the above
- 5 At the end of each period, under IFRS, the difference between the fair value of the *Salam* receivable and its historical value is:
- a) Recognised as a loss
 - b) Recognised as a bad debt expense
 - c) Recognised as a separate receivable
 - d) None of the above
- 6 Which of the following is not a method for disposing *Salam* inventory?
- a) Selling in the open market
 - b) Entering into a Parallel *Salam* contract

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- c) Entering into a traditional forward contract to sell the commodity
 - d) Selling in the open market with a pre-promise
- 7 Under AAOIFI, if an Islamic bank recovers receivables through pledged securities and the recovered amount exceeds the outstanding amount, the bank will:
- a) Debit cash, Credit accounts receivable, and Credit pledged securities
 - b) Debit cash and Credit *Salam*
 - c) Debit cash, Credit accounts receivable, and Credit accounts payable
 - d) Debit cash and accounts receivable and Credit *Salam*
- 8 Price risk of *Al-Muslam Fih*i refers to a scenario where:
- a) The client will be unable to deliver the commodity as promised in the contract.
 - b) The carrying value of the commodity exceeds the book value.
 - c) The market price of the commodity rises more than expected.
 - d) None of the above
- 9 Dhafer Islamic Bank (DIB) enters into a *Salam* contract with Hadi Corporation to receive a predetermined quantity of sugar on Aug 19, 2022. The advance payment for the sugar was Tunisian Dinars (TND) 565,000. When Hadi Corporation delivers the commodity to DIB, the entries DIB makes in its books will be:
- a) Dr. Salam Inventory – Sugar 565,000; Cr. *Salam* Financing (Liability) 565,000
 - b) Dr. *Salam* Financing (Asset) 565,000; Dr. Salam Inventory – Sugar 565,000
 - c) Dr. Salam Inventory – Sugar 565,000; Cr. *Salam* Financing (Asset) 565,000
 - d) Dr. Cash 565,000; Cr. *Salam* Financing (Asset) 565,000
- 10 On Jan 1, 2023, ABC Islamic Bank entered into a *Salam* contract with a farmer to buy 3 tons of wheat at USD 2,000 per ton to be delivered on Jun 30, 2023. The bank paid USD 6,000 at the date of entering the agreement and also formed a Parallel *Salam* contract with another client on Jan 10, 2023, to sell the wheat at USD 2,200 per ton. Payment under the Parallel *Salam* was received on Jan 15, 2023. ABC Islamic Bank received the commodity on June 30, 2023 and sold it to its client as per the Parallel *Salam* contract on Jul 3, 2023. What accounting entry will the bank pass at the time of selling the commodity under the Parallel *Salam* contract.
- a) Dr. Parallel Salam (Liability) 6,000; Cr. Salam Inventory (Asset) 6,000.
 - b) Dr. Parallel Salam (Liability) 6,600; Cr. Salam Inventory (Asset) 6,000, Profit on Parallel Salam (IS) 600.

- c) Dr. Salam Inventory (Asset) 6,000; Cr. Salam Financing (Asset) 6,000
- d) Dr. Parallel Salam (Liability) 6,600; Cr. Salam Inventory (Asset) 6,600

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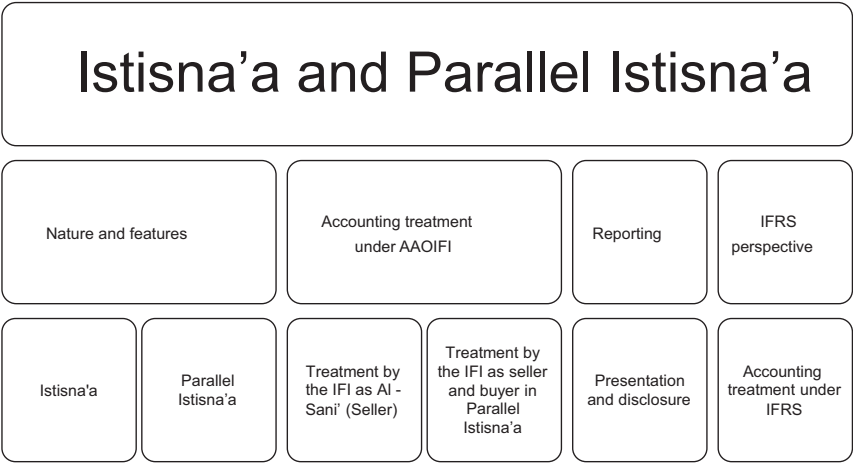
5 Istisna'a and Parallel Istisna'a

Learning Objectives

After going through this chapter, you should be able to:

- 1 Describe the nature of *Istisna'a* and Parallel *Istisna'a*.
- 2 Understand the steps involved in *Istisna'a* and Parallel *Istisna'a* contracts.
- 3 Describe the accounting entries, presentation, and disclosure requirements for *Istisna'a* and Parallel *Istisna'a* under FAS 10: *Istisna'a* and Parallel *Istisna'a*.
- 4 Understand the main differences in the accounting treatment of *Istisna'a* and Parallel *Istisna'a* under IFRS and AAOIFI.

Chapter Preview



Cover Story

Jordan, a country in the Middle East, has been actively pursuing economic development over the years. One of the key aspects of economic development is the growth and development of the industrial sector. In Jordan, the industrial sector represents 21% of the country's GDP and is made up of 17,000 industrial firms and 255,000 employees. 98.5% of these industrial firms are small and medium enterprises (SMEs) making them a significant contributor to the country's GDP. The Jordan Banks Association (JBA) reported that the total financing for the industry in Jordan reached JOD 3.5 billion in 2020, which is 11.7% of the gross banking facilities. The Central Bank of Jordan also represents around JOD 750 million for industrial SMEs during the same period. However, despite these efforts, SMEs still face several challenges when trying to obtain financing. The use of *Istisna'a* contracts can provide the necessary funding to support the growth and development of the industrial sector. Several Islamic banks in Jordan, including Islamic International Arab Bank, the Jordan Islamic Bank, and the Arab Jordan Investment Bank, have started offering *Istisna'a* financing solutions. These banks have developed *Istisna'a* financing solutions that cater to the needs of the industrial sector, including SMEs.

The *Istisna'a* financing solutions offered by these banks are designed to be flexible and tailored to the specific needs of the industrial sector. This means that businesses can access financing solutions that suit their requirements, whether they are looking for upfront payment, instalment payment, or payment upon completion of the project. Businesses can acquire the necessary goods and equipment without facing undue financial burdens, due to lower interest rates, longer repayment periods, and reduced collateral requirements. This makes it easier for SMEs to access the funding they need to grow and develop their businesses, thus contributing to the growth of the industrial sector in Jordan (Eid, 2022).

5.1 Introduction to *Istisna'a*

Zara has been living in rented accommodation for many years and is now looking to purchase her own home. Recently, she heard of an Islamic Finance product known as *Istisna'a* which could enable her to build a house with flexible payment options. An *Istisna'a* contract is a sale contract in which specified item(s) must be manufactured or constructed by the manufacturer or builder (contractor) with an obligation to deliver the item(s) to the customer before a specified future date. The items to be manufactured are referred to as the **subject matter** of the contract. Zara can therefore enter into an *Istisna'a* contract with an Islamic bank to build and hand over the house to Zara on an agreed-upon date in accordance with the specifications agreed. Zara will make payments in accordance with the payment plan agreed upon with the Islamic bank in the *Istisna'a* contract (Figure 5.1). The house in question is the subject matter of the contract.



Figure 5.1 Structure of an *Istisna'a* Contract as Practised by Islamic Banks

Source: Diagram by the authors.

Table 5.1 Major Differences Between *Salam* and *Istisna'a*

	<i>Salam</i>	<i>Istisna'a</i>
Nature	Advanced spot payment for deferred delivery of a commodity at a specified date.	Long-term construction contract (i.e., usually more than one year construction period) with flexible payment options for the customer.
Price	The full price in the <i>Salam</i> contract must be paid in advance.	Price in the <i>Istisna'a</i> contract may be paid in advance, in instalments, or on a future specified date.
Subject Matter	The subject matter of <i>Salam</i> must be fungible goods (e.g., a specific type of rice or cotton) that are commonly available, under normal circumstances, at the place agreed for delivery.	The subject matter cannot be products that are not manufactured or constructed, i.e., natural things such as crops, fruits and vegetables are excluded from the purview of the <i>Istisna'a</i> contract.

An *Istisna'a* contract, binding on both parties, must specify the quantity and the quality of the asset to be delivered, the price of the asset, and the delivery date (AAOIFI *Shariah* Standard 11, par. 2/2/1). The contract requires a manufacturing process, that is, raw material must be transformed into a finished product by employing labour and machinery, and it may not be executed in respect of an existing and identified asset.

The legitimacy of *Istisna'a* is derived from Hadiths narrated by *Bukhari & Muslim* in which the Prophet (peace be upon him) requested that a podium (for speech) and a finger ring be manufactured (for him). [Sahih al-Bukhari 5:220, Sahih Muslim 3:1655, Sahih al-Bukhari 2:908]

Let's explain a few technical terms used in an *Istisna'a* transaction. The buyer (customer) is called the *Al-Mustasni'* while the seller (which could be an Islamic bank) is called *Al-Sani'*. The subject matter of the contract (the item to be constructed/manufactured with precise specifications) is called *Al-Masnoo'*.

Istisna'a contract is like *Salam* in the sense that both are sale contracts in which the subject matter is required to be delivered at a future date. However, the major differences are summarised in Table 5.1.

An *Istisna'a* contract allows for the manufacturing/construction of the subject matter whilst offering flexible payment options for the customer.

Payment terms will normally extend beyond the contract execution and delivery date which means that part of the profit will be deferred and recognised in the income statement over the duration of the payment terms. This aspect is explained further in the section on the accounting treatment of *Istisna'a*.

5.2 Introduction to Parallel *Istisna'a*

It is not hard to imagine that an Islamic bank does not have the expertise to “build” or “manufacture” houses, plants, and machinery on its own. It will have to get built by someone else, hence the need for a second parallel contract called parallel *Istisna'a*. In this contract, the bank is the buyer (*Al-Mustasni*) and the manufacturer or contractor is the seller (*Al-Sani*). Since the Islamic bank has to onward deliver the manufactured goods, the delivery date of the Parallel *Istisna'a* contract must be before the delivery date of the original *Istisna'a* contract. While the specification of the asset to be manufactured must be the same in both contracts, other terms and conditions of the two contracts can vary.¹

As illustrated in Figure 5.2,

- 1 The client signs a contract (first *Istisna'a*) with the bank, whereby the bank promises to provide the specific asset to the client at a specific price

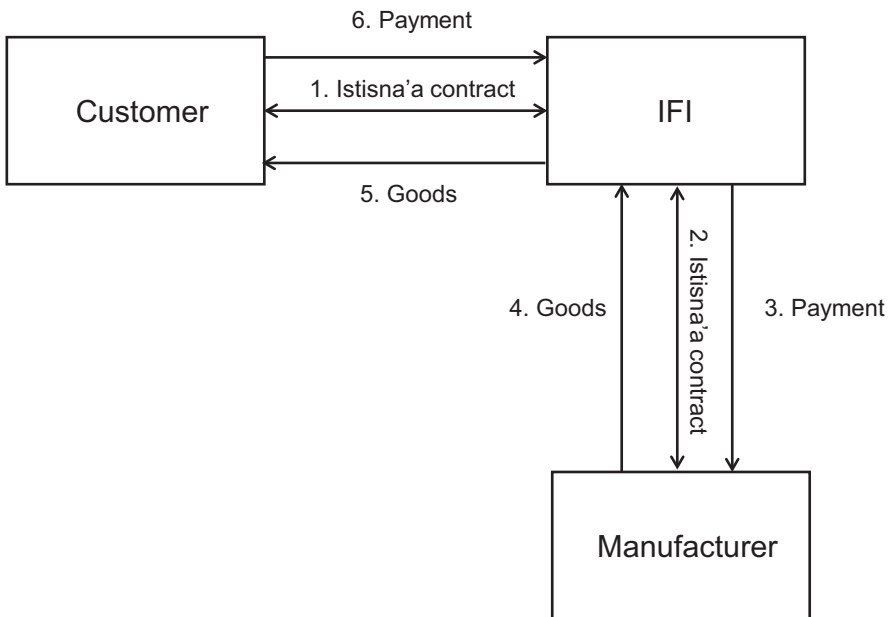


Figure 5.2 Structure of a Parallel *Istisna'a* Contract

Source: Diagram by the authors.

- and date. Payment by the client can be made in advance, in instalments, or post-delivery.
- 2 The bank signs a Parallel *Istisna'a* contract with the manufacturer specifying the asset qualities, its price, and delivery.
 - 3 The bank pays the *Istisna'a* price to the manufacturer in accordance with the terms in the Parallel *Istisna'a* contract.
 - 4 The asset is delivered to the bank under Parallel *Istisna'a*.
 - 5 The bank then delivers it to the client in the first *Istisna'a*.
 - 6 Payments are made by the client to the bank as per the first *Istisna'a* contract.

Box 5.1 Practical Insight: Why is *Istisna'a* Less Popular Than Other Islamic Modes of Financing in Malaysia?

In a recent study conducted in Malaysia, it was found that *Istisna'a*, despite its unique features, is perceived by IFIs and businesses as relatively riskier than other Islamic products. The biggest risk identified was the counter-party risk. Since the asset is being manufactured by a third party, a compromise on the quality or the delivery time of the asset can cause the customer of an Islamic bank to cancel the contract, leaving the Islamic bank with a customised asset with no buyer (Hasmawati et al., 2019).

Box 5.2 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) *Istisna'a* is a sales contract between *Al-Mustasni'* and *Al-Sani'* for the provision of services.
- 2) An *Istisna'a* contract cannot be made in respect of an identified and existing capital asset.
- 3) A difference between a *Salam* and *Istisna'a* contract is that with *Salam*, the full amount may be paid in advance, in instalments, or at a future specified date, whereas under an *Istisna'a* contract, the price of the contract must be paid in advance.
- 4) The obligations under an *Istisna'a* contract and a Parallel *Istisna'a* contract are completely independent.
- 5) In a Parallel *Istisna'a*, the Islamic bank is the buyer (*Al-Mustasni'*) and the subcontractor is the seller (*Al-Sani'*).

Solution:

- 1) False. It is a deferred sales contract to manufacture/construct goods/assets.
- 2) True.
- 3) False. A *Salam* contract requires that the price of the contract must be paid in advance, whereas under an *Istisna'a* contract, the full amount may be paid in advance, in instalments, or at a future specified date.
- 4) True.
- 5) True.

5.3 AAOIFI Accounting Treatment

The accounting treatment for *Istisna'a* and Parallel *Istisna'a* contracts is prescribed by AAOIFI's Financial Accounting Standard 10 (FAS 10), and the presentation and disclosure requirements are prescribed in Financial Accounting Standard 1 (Revised 2021).

As explained, an *Istisna'a* contract with an Islamic bank is likely to be accompanied by a corresponding Parallel *Istisna'a* contract. In the first contract, the bank is the seller (*Al-Sani'*) of the goods (*Al-Masnoo'*) to the ultimate buyer (*Al-Mustasni'*). In the second contract, the Islamic bank becomes the buyer (*Al-Mustasni'*) of *Al-Masnoo'* from another seller (*Al-Sani'*).

Accordingly, the accounting treatment prescribed by FAS 10 for the IFI is divided into two parts. First by considering the IFI to be the seller in an *Istisna'a* contract and second when it is a buyer in a Parallel *Istisna'a* contract.

5.3.1 Treatment by the IFI as *Al-Sani'* (Seller)

5.3.1.1 Accounting for *Istisna'a* Costs

Istisna'a costs comprise all the direct production costs incurred in the manufacture of *Al-Masnoo'* and any related indirect costs allocated on an objective basis. Pre-contract costs are also included in the cost of manufacturing the goods. Costs paid to subcontractors in a Parallel *Istisna'a* contract are also included, including the direct and indirect production costs as well as the pre-contract costs. Non-production costs such as selling, general and administrative expenses, or research and development costs are not included in the *Istisna'a* contract costs.

The direct and (allocated) indirect costs of production (construction) are charged to the *Istisna'a* Work in Process (WIP) asset account.² Pre-contract costs are recorded initially in a deferred (pre-contract) asset account; but once the *Istisna'a* contract materialises, then these costs are also transferred to the *Istisna'a* WIP account; otherwise, they are written off in the income statement.

Box 5.3 Illustration 5.1 Istisna’a Costs and Pre-Contract Costs

Fitr Islamic Bank entered into an *Istisna’a* construction contract on Mar 31, 2022, wherein the bank must deliver a furnished office apartment to its client within one year. By the close of its financial year, that is, Dec 31, 2022, the bank has incurred costs of SAR 300,000 and SAR 1,200,000 for labour payment and material purchases, respectively. SAR 50,000 were paid on Mar 1, 2022, as commission expenses to the agent who helped in securing the contract. At the time of payment, the contract was not yet finalised, but it was expected that it will materialise.

The client surveyor visited the site at the end of the year and was satisfied with the progress of the project.

Requirement: Show the journal entries to record the labour, material, and commission expenses.

Solution:

The journal entries to record the labour, material, and commission expenses are:

Recording of labour and material costs (assume these are payable):

	<i>Dr.</i>	<i>Cr.</i>
Dec 31	<i>Istisna’a</i> WIP – Labour (Asset)	300,000
	<i>Istisna’a</i> WIP – Material (Asset)	1,200,000
	Accounts Payable (Liability)	1,500,000
	<i>(To record the cost in Istisna’a WIP account)</i>	

Recording of commission expenses:

The bank should recognise the commission cost as pre-contract costs (deferred cost) on Mar 1 as long as the management is hopeful that they will secure the contract. Once the contract is signed, these costs will be transferred to the *Istisna’a* WIP account. The journal entries are:

	<i>Dr.</i>	<i>Cr.</i>
Mar 1	Deferred Commission Cost (Asset)	50,000
	Cash (Asset)/Accounts Payable (Liability)	50,000
	<i>(To record deferred pre-contract costs prior to finalisation of the contract)</i>	

Once the contract is finalised, on Mar 31, the balance in the deferred commission cost account is also transferred to the WIP account as shown:

Transferring of commission expenses to *Istisna'a* WIP:

	Dr.	Cr.
Mar 31		
<i>Istisna'a</i> WIP – Other Expenses (Asset)	50,000	
Deferred Commission Cost (Asset)		50,000
<i>(To record the pre-contract costs in Istisna'a WIP account)</i>		

However, if the contract does not materialise, the pre-contract costs should be charged to the profit and loss account as soon as it is known that the contract will not be finalised. The journal entry is as follows:

	Dr.	Cr.
Date		
Profit and Loss (Expense)	50,000	
Deferred (Pre-Contract) Cost (Asset)		50,000
<i>(To write off deferred pre-contract costs)</i>		

5.3.1.2 Accounting for Progressive Billing to the Customer

Periodically, and in accordance with the agreed payment terms, the Islamic bank will send invoices to *Al-Mustasni'* for payment. In doing so, the Islamic bank will debit *Istisna'a* Accounts Receivable and credit *Istisna'a* billing. The *Istisna'a* billing account is a contra-asset account, since the bank may not have earned the billed amount. This account is offset against the *Istisna'a* WIP account in the Islamic bank's statement of financial position. Therefore, the total *Istisna'a* WIP asset is reported net of amounts already billed to the client. Since *Istisna'a* is a financing mode, where the cost incurred on the construction of an asset and profit thereon is recovered from the client over a relatively long period of time, the balance of the WIP account will most likely exceed the amount invoiced to the client. The WIP net balance will therefore most likely be shown on the asset side of the balance sheet. Accounts receivable balance, until the amounts are recovered from the client, is also shown as a current asset on the asset side of the balance sheet.

5.3.1.3 Accounting for *Istisna'a* Revenue and Profits at the End of the Financial Period

Istisna'a revenue is the total price agreed upon between the Islamic bank as *Al-Sani'* and the client as *Al-Mustasni'*, including the Islamic bank's profit

Box 5.4 Illustration 5.2 Progressive Billings Sent to the Customer

Continuing from Illustration 5.1, Fitr Islamic Bank will bill the customer after six months of the commencement of the contract and then upon completion and delivery of the asset (at the end of the contract). The first bill was sent to the customer on Sep 30 for SAR 1,000,000.

Requirement: Show how the bank will record the billing in their books.

Solution:

The journal entry to record the *Istisna'a* billing is given:

	Dr.	Cr.
Sep 30	<i>Istisna'a</i> Accounts Receivable (Asset)	1,000,000
	<i>Istisna'a</i> Billing (Contra-Asset)	1,000,000
	<i>(To record Istisna'a receivable)</i>	

margin on the contract. *Istisna'a* profit is the difference between *Istisna'a* revenue and *Istisna'a* cost (i.e., the cost incurred to manufacture *Al-Masnoo'*). The revenue and related profit under an *Istisna'a* contract are recorded in each financial period under either the percentage of completion method or the completed contracts method.

The percentage of completion method recognises revenue (and resulting profit) commensurate with the work performed during a particular financial period. The completed *contracts* method recognises revenue once the manufacturing process has been completed. Both methods are explained through Illustration 5.3.

Box 5.5 Illustration 5.3 Recognition of Revenue, Expenses, and Profit

Behbud Islamic Bank has entered into an *Istisna'a* contract with a client to manufacture an office building for its customer. The total contract revenue is AED 500,000, and the expected cost of the project is AED 400,000. The contract is expected to be completed in two years. AED 300,000 expenditure is incurred in year 1 and AED 100,000 in year 2.

Requirement: Show how the revenue and profit will be recognised under:

- a) Percentage of completion method
- b) Completed contracts method

Solution:

The recognition of revenue and profit over the contract period under both methods is shown:

- (a) Percentage of completion method: This method spreads the recognition of revenue and profit in accordance with the percentage of completion of the contract.

	Year 1	Year 2
Cumulative costs incurred (AED)	300,000	400,000
Percentage of completion	75% (300,000/400,000)	100% (400,000/400,000)
Revenue recognised each year (AED)	(75% of 500,000) 375,000	(25% of 500,000) 125,000
Profit recognised (AED)	(375,000 – 300,000) 75,000	(125,000 – 100,000) 25,000

- (b) Completed contracts method: This method is used where it is difficult to estimate the percentage completion or the estimated costs to complete the contract.

	Year 1	Year 2
Costs incurred (cumulative) AED	300,000	400,000
Percentage of completion	75%	100%
Revenue recognised each year	0	500,000
Profit recognised	0	100,000

Note that the *total* revenue and profit recognised are the same under both methods.

When recording revenues and related costs and profits under either method, the bank will debit a *Cost of Istisna'a* Revenue account and credit an *Istisna'a* Revenue account. The difference is the profit, and this is debited to the *Istisna'a* WIP account. Therefore, the *Istisna'a* WIP account balance at any time is the total cost incurred to date plus (minus) the profit (loss) recognised to date. In case, in the subsequent periods, the assessment of future profits turns into expected future losses, the added profits are reversed and subtracted from the *Istisna'a* WIP account. Details of subsequent measurements of the *Istisna'a* WIP account will be discussed later in the chapter.

Box 5.6 Illustration 5.4 Recognition of Revenue, Expenses, and Profit

Refer to Illustration 5.3.

Requirement: What would be the journal entry at the end of year 1 to record the revenue, expense, and profit (assuming the percentage of completion method)?

Solution:

	Dr.	Cr.
Dec 31 Cost of Istisna’a Revenue (Expense)	300,000	
Istisna’a WIP – Profit (Asset)	75,000	
Istisna’a Revenue (Revenue)		375,000
<i>(To record Istisna’a revenue, its cost and resulting profit for year 1)</i>		

5.3.1.4 Accounting for Deferred Profit

An *Istisna’a* contract allows payment flexibility for the buyer. Both spot payment and instalment options may be chosen. However, given the financing nature of the instrument, the IFI, in most cases, will receive payment from the client based on a repayment plan which will run beyond the date of completion and delivery of the asset. If the payment is received from the client within the construction period of the asset, the accounting treatment will be straightforward and has already been explained. In case the repayment from the client is to be received beyond the completion date of the asset, a **deferred profit** account will have to be created (this is a contra-asset to *Istisna’a* accounts receivable).

Yearly profits out of deferred profit account should ideally be recognised using the **proportionate allocation** method, where the profit is allocated over the credit period agreed in the *Istisna’a* contract, and each period is allocated its portion of profit on an accrual basis (regardless of receipt of cash).³

Illustration 5.5 provides a comprehensive illustration of the proportional allocation method for recording deferred profit.

Box 5.7 Illustration 5.5 Comprehensive Example

Al-Jabbaar Islamic Bank commenced an *Istisna’a contract* on Jul 1, 2022, to construct a football stadium within a period of two years. The *Istisna’a* revenue (contract price) is AED 100 million, and the estimated profit is AED 40 million. Collection from the customer will take place over a period of ten years (at AED 10 million per year). It is agreed in the contract

that the bank will bill AED 30 million at the end of year 1 and the remaining AED 70 million at the end of year 2. At the end of the first and second years (Jun 30, 2023, and 2024), the bank incurred a total cost of AED 30 million each year. The expert concluded in his report that 40% of the work is completed in year 1 and the remaining 60% in year 2.

Requirement: Calculate the revenues, costs, and profits to be recorded by the Al-Jabbaar Islamic Bank and specify the accounting treatment of deferred profit under:

- a) the percentage of completion method
- b) the completed contracts method

Give the relevant journal entries under each method.

Solution:

a) Percentage of completion method

The revenue and costs to be recognised for years 1 and 2 will equal 40% and 60% of the total contract price and total estimated cost of the project, respectively. The total profit on the contract is AED 40 million (AED 100 million – AED 60 million). This deferred profit will be recognised over the credit period agreed upon (ten years) in the contract. Any profits arising out of revenues and costs recognised in years 1 and 2 will therefore be moved immediately to the deferred profit account. A systematic method will be used to move profits out of the deferred profit account into the yearly profits account over the credit period. The figures reported in the income statement and statement of financial position as of June 30 would be as follows:

Income statement

	Year 1	Year 2
Revenue (40%/60% × AED 100 million)	40 million	60 million
Cost of revenue (40%/60% × AED 60 million)	24 million	36 million
Profit (40%/60% × AED 40 million) – WIP	16 million	24 million
Profit taken to <i>deferred profit</i> account	16 million	24 million
Profit recognised in the income statement*	4 million	4 million

* In years 1 and 2, the bank will collect AED 20 million from the customer which represents 20% of the total contract price. Accordingly, 20% of the profit (AED 4 million) will be recognised within the first two years of the contract whilst the remaining AED 32 million will be recognised every year (AED 4 million per year) over the duration of the eight-year financing period. For the sake of simplicity, the profit amount to be recognised in each financing period has been kept constant. An alternative method of systematic allocation of profit may also be acceptable.

Statement of financial position

	Year 1	Year 2
<i>Istisna'a</i> WIP Account	AED 16 million* * WIP computation (year 1) <i>Istisna'a</i> Cost = 30 million Add: Profit = 16 million Less: <i>Istisna'a</i> billing = 30 million = AED 16 million	0 * WIP computation (year 2) Opening balance = 16 million <i>Istisna'a</i> Cost = 30 million Add: Profit = 24 million Less: <i>Istisna'a</i> billing = 70 million = 0
<i>Istisna'a</i> Receivable From Client	AED 20 million	AED 80 million
Deferred Profit (Contra-Asset)	12 million	32 million

Journal entries

		Year 1		Year 2	
		Dr.	Cr.	Dr.	Cr.
Jun 30	<i>Istisna'a</i> WIP (Asset)	30,000,000		30,000,000	
	Cash (Asset)		30,000,000		30,000,000
	(To record payment of <i>Istisna'a</i> costs)				
Jun 30	<i>Istisna'a</i> Accounts Receivable (Asset)	30,000,000		70,000,000	
	<i>Istisna'a</i> Billing (Contra-Asset)		30,000,000		70,000,000
	(To record <i>Istisna'a</i> receivable)				
Jun 30	Cash/Bank (Asset)**	10,000,000		10,000,000	
	<i>Istisna'a</i> Accounts Receivable (Asset)		10,000,000		10,000,000
	(To record collection of <i>Istisna'a</i> receivable)				

		Year 1		Year 2	
		Dr.	Cr.	Dr.	Cr.
Jun 30	Cost of <i>Istisna'a</i> Revenue (Expense)	24,000,000		36,000,000	
	<i>Istisna'a</i> WIP – Profit (Asset)	16,000,000		24,000,000	
	<i>Istisna'a</i> Revenue (Revenue)		40,000,000		60,000,000
	<i>(To record Istisna'a revenue, cost and resulting profit)</i>				
Jun 30	<i>Istisna'a</i> Profit (IS) Deferred Profit (Contra-Asset)	16,000,000	16,000,000	24,000,000	24,000,000
	<i>(To record deferred profit at the end of the year)</i>				
Jun 30	Deferred Profit (Contra-Asset)**	4,000,000		4,000,000	
	<i>Istisna'a</i> Profit (IS)		4,000,000		4,000,000
	<i>(To record amortisation of deferred profit)</i>				

** These entries will take place at the end of each year until year 10 gradually resulting in the deferred profit being recognised in the income statement until the payment terms are complete.

b) Completed contracts method

Under this method, no revenue, cost, or profit is recognised until the completion of the contract. Hence, at the end of the first year, the *Istisna'a* WIP account will carry only the accumulated costs less the billed amounts (which nets off to zero in the given example).

Journal entries

		Year 1		Year 2	
		Dr.	Cr.	Dr.	Cr.
Jun 30	<i>Istisna'a</i> WIP (Asset)	30,000,000		30,000,000	
	Cash (Asset)		30,000,000		30,000,000
	<i>(To record payment of Istisna'a costs)</i>				

		Year 1		Year 2	
		Dr.	Cr.	Dr.	Cr.
Jun 30	<i>Istisna’a</i> Accounts Receivable (Asset) <i>Istisna’a</i> Billing (Contra- Asset) (To record <i>Istisna’a</i> receivable)	30,000,000		70,000,000	
			30,000,000		70,000,000
Jun 30	Cash/Bank (Asset)*** <i>Istisna’a</i> Accounts Receivable (Asset) (To record collection of <i>Istisna’a</i> receivable)	10,000,000		10,000,000	
			10,000,000		10,000,000
Jun 30	Cost of <i>Istisna’a</i> Revenue (Expense) <i>Istisna’a</i> WIP – Profit (Asset) <i>Istisna’a</i> Revenue (Revenue) (To record <i>Istisna’a</i> revenue, cost and resulting profit at the end of two years)			60,000,000	
				40,000,000	
					100,000,000
Jun 30	<i>Istisna’a</i> Profit (IS) Deferred Profit (Liability) (To record deferred profit at the end of the year 2)			40,000,000	
					40,000,000

		Year 1		Year 2	
		Dr.	Cr.	Dr.	Cr.
Jun 30	Deferred Profit (Liability)**			8,000,000	
	<i>Istisna'a Profit (Revenue)</i>				8,000,000
	<i>(To record amortisation of deferred profit)</i>				
Years 3–10					
Jun 30	Deferred Profit (Liability)**	4,000,000			
	<i>Istisna'a Profit (IS)</i>		4,000,000		
	<i>(To record amortisation of deferred profit in years 3–10)</i>				
*** These entries will take place at the end of each year until year 10 gradually resulting in the deferred profit being recognised in the income statement until the payment terms are complete.					

Box 5.8 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) Contract costs include all direct and indirect costs in relation to the manufacturing/construction of the asset.
- 2) All contract costs are to be debited to an *Istisna'a* WIP account.
- 3) *Istisna'a* billing account is an income statement account.
- 4) Where the percentage of completion method cannot be used, the projections method is used to estimate revenues, expenses, and profits for a particular period.
- 5) *Istisna'a* revenue is the total *Istisna'a* price agreed between the bank (*Al-Sani'*) and the client (*Al-Mustasni'*).

Solution:

- 1) False. Contract costs include direct costs, *allocated* indirect costs, and any pre-contract costs.
- 2) True.
- 3) False. *Istisna’a* billing account is a statement of financial position account (contra-asset).
- 4) False. The completed contract method is used if the percentage of completion method cannot be used.
- 5) True.

5.3.1.5 Early Settlement

Where payment is deferred until after the contract period, the *Al-Mustasni* may decide to make the payment prior to the due date. In this case, the Islamic bank may waive part of the deferred profit in relation to this early payment. The Islamic bank should reduce both the *Istisna’a* receivable and *Istisna’a* deferred profit with the amount of profit waived off. The relevant accounting entries are explained in Illustration 5.6.

Box 5.9 Illustration 5.6 Early Settlement of Balance Due

Peace Community Islamic Bank has an outstanding *Istisna’a* receivable of PKR 35,000 which is due on Dec 31, 2022. The deferred profit against this *Istisna’a* receivable is PKR 10,000. The client approached the bank on Jun 30, 2022 and requested a waiver of PKR 5,000 if the remaining balance amount was paid immediately. This was agreed to by the bank.

Requirement: Show how the bank will record the settlement of the receivable in their books.

Solution:

The accounting entry to record the settlement of the *Istisna’a* receivable of PKR 35,000 will be:

		Dr.	Cr.
Jun 30	Cash (Asset)	30,000	
	Deferred Profit (Income)	5,000	
	<i>Istisna’a</i> Accounts Receivable (Asset)		35,000
	<i>(To record settlement of Istisna’a receivable)</i>		
Jun 30	Deferred Profit (Asset)	5,000	
	<i>Istisna’a</i> Profit (Income)		5,000
	<i>(To record recognition of deferred profit)</i>		

5.3.1.6 Subsequent Recognition and Measurement

Istisna'a WIP should be valued at an amount not exceeding its **cash equivalent value** (the difference between the contract price and the expected cost to complete the contract). If the amount in *Istisna'a* WIP is higher than its cash equivalent value, the difference should be recognised as a loss and charged to the profit and loss account of the bank.

Box 5.10 Illustration 5.7 Year-End Measurement of *Istisna'a* WIPs

Al-Rehmat Islamic Bank has entered into a three-year *Istisna'a* contract which has a total contract price of USD 300,000. By the end of the second year, the total costs incurred on the contract are USD 250,000, and the expected further costs to complete the contract are USD 75,000. The cash equivalent cost of the contract is USD 225,000 (USD 300,000 – USD 75,000).

If the bank has recognised profits on the contract of USD 10,000 in year 1, the book value of the *Istisna'a* WIP at the end of year 2 will be USD 260,000.

Requirement: What is the loss that should be booked in this case? Show the journal entry for booking the loss.

Solution:

The total loss which must be booked in this case at the end of the second year is USD 35,000 (USD 260,000 – USD 225,000). The journal entry to book this loss on Dec 31 is:

	Dr.	Cr.
Dec 31 Loss on <i>Istisna'a</i> Contract (Expense)	35,000	
<i>Istiisna'a</i> WIP (Asset)		35,000
<i>(To record the loss on the Istisna'a contract)</i>		

If the subcontractor in a Parallel *Istisna'a* fails to furnish the goods on time or fails to deliver at all, the Islamic bank may have to incur additional costs to fulfil its obligations to the *Al-Mustasni'*. Any such additional costs should also be recognised as losses in the valuation of *Istisna'a* costs and reported as such in the income statement.

5.3.1.7 Change Orders and Additional Claims

If there are some changes requested in the *Istisna'a* asset by *Al-Mustasni'*, these must be authorised and approved by *Al-Sani'* (the Islamic bank or the

subcontractor in the case of *Parallel Istisna'a*), and any additional revenue and cost pertaining to the change shall be recognised in the financial statements of the Islamic bank (or the subcontractor in case of *Parallel Istisna'a*).

Any additional claims made by *Al-Mustasni'* which result in additional costs will result in a related amount of revenue (equal to the additional cost) being recognised by the Islamic bank.

5.3.1.8 Maintenance and Warranty Costs

Under an *Istisna'a* contract, the costs for maintenance of *Al-Masnoo'* and any warranty provisions should be recognised on an accrual basis and matched with recognised revenue. Actual costs would be charged against the maintenance and warranty allowance account. The journal entries are:

To record the provision:

		Dr.	Cr.
Date	Maintenance and Warranty Expense (Expense)	xx	
	Maintenance and Warranty Allowance (Liability)		xx
	<i>(To record provision of costs)</i>		

To record actual costs incurred against the provision:

		Dr.	Cr.
Date	Maintenance and Warranty Allowance (Liability)	xx	
	Cash/Accounts Payable (Asset/Liability)		xx
	<i>(To record maintenance and warranty costs)</i>		

Box 5.11 Practical Insight: Liability for *Istisna'a* Goods in Islamic Banks in Pakistan

A study on the application of *Istisna'a* by Pakistani banks highlighted various issues with the current use of *Istisna'a* contracts causing doubts about the *Shariah* permissibility of the product. One of the issues raised was that in *Parallel Istisna'a*, the IFIs were overly demanding. They would purchase goods from the subcontractor without assuming any responsibility for misspecification or quality defects for as long as six months or more. This is tantamount to *Gharar* (uncertainty) in the contract. Further, it was observed that the IFIs would demand the subcontractor to provide storage space and maintain the security of the products at his or her expense even after delivery, which is contrary to *Shariah* law. *Shariah* compliance requires that Islamic banks must assume the risk associated with ownership and avoid exploitative and uncertain contracts (Shah and Nizazai, 2019).

Box 5.12 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) Deferred profit is defined as the amount of *Istisna'a* revenue which is due from *Al-Mustasni'* after the completion of *Al-Masnoo'* (the difference between *Istisna'a* revenue and the amount received during or before the completion of the project).
- 2) The Islamic bank should allocate the deferred profit over a single period agreed in the *Istisna'a* contract, and each period should carry its portion of the profit on an accrual basis.
- 3) In case the client makes an early payment, the Islamic bank can waive part of the profit or can reimburse part of the profit at its discretion.
- 4) *Istisna'a* WIP should be valued at an amount not exceeding its cash equivalent value.
- 5) Under an *Istisna'a* contract, the costs for maintenance of *Al-Masnoo'* and any warranty costs are recognised as expenses when incurred.

Solution:

- 1) True.
- 2) False. The Islamic bank should allocate the deferred profit over the credit period agreed in the *Istisna'a* contract, and each period should carry its portion of the profit on an accrual basis.
- 3) True.
- 4) True.
- 5) False. Under an *Istisna'a* contract, the costs for maintenance of *Al-Masnoo'* and any warranty provisions should be recognised on an accrual basis and matched with recognised revenue.

5.3.2 Treatment by the IFI as *Al-Mustasni'* (Buyer)

5.3.2.1 Accounting for Contract Costs and Progressive Bills

When the Islamic bank has entered a Parallel *Istisna'a contract*, an *Istisna'a* cost account is used in place of the *Istisna'a* WIP account. This is presented under assets in the Statement of Financial Position of the Islamic bank. The contract cost for the Islamic bank will be the total price fixed under the contract with the subcontractor (which will include direct costs, allocated indirect costs, and any pre-contract costs, as explained earlier). When the

subcontractor bills the Islamic bank (i.e., the Islamic bank is a buyer in *Istisna’a*), the bank makes the following entries:

	Dr.	Cr.
Date		
<i>Istisna’a</i> Cost (Asset)	xx	
<i>Istisna’a</i> Accounts Payable (Liability)		xx
<i>(To record subcontractor billings)</i>		

Note that when the Islamic bank is a buyer (*Al-Mustasni*) under a parallel *Istisna’a* contract, it is simultaneously a seller (*Al-Sani*) under the *Istisna’a* contract, which it has established with its client. As discussed earlier, when the bank bills its client, *Istisna’a* Accounts Receivable is debited and *Istisna’a* billings is credited. In this case, the *Istisna’a* billings account is presented in the statement of financial position as a contra-asset to the *Istisna’a* cost account.

5.3.2.2 Accounting for Istisna’a Revenue, Profits, and Deferred Profits

The Islamic bank is likely to be aware, with reasonable certainty, of its revenues and costs under a Parallel *Istisna’a*, and therefore, the bank will use the percentage of completion method to record revenues, expenses, and profits. The profit recognised will be added to the *Istisna’a* cost account and deferred profit will be accounted for in a similar manner to that discussed previously.

5.3.2.3 Receipt of Al-Masnoo’

FAS 10 discussed various scenarios which may arise in relation to the receipt of *Al-Masnoo’*.

1. AL-MASNOO’ IS IN ACCORDANCE WITH THE SPECIFICATIONS AND SCHEDULE OF THE CONTRACT

Once the asset is received by the bank, it should be recorded at historical cost (i.e., the book value) equal to the *Istisna’a* cost account. The relevant asset account (i.e., fixed asset, inventory etc.) is debited to record receipt of the asset whilst the *Istisna’a* cost account is credited in full.

Box 5.13 Illustration 5.8 Entries for Parallel Istisna’a

Al-Izzat Islamic Bank entered into an *Istisna’a* contract with a client to produce 500 chairs for PKR 30,000 in one year. The bank also signed a Parallel *Istisna’a* contract with a furniture manufacturer to produce 500 chairs for PKR 20,000 in one year. The chairs are delivered to the bank on Dec 31, 2022, by the manufacturer who also billed the bank for the amount due on the same date.

Requirement: Show how the bank will record the Parallel *Istisna'a* in their books.

Solution:

At the end of the year, the journal entries made by the bank to record the cost of the Parallel *Istisna'a* contract and the receipt of the asset are:

		Dr.	Cr.
Dec 31	<i>Istisna'a</i> Cost (Asset)	20,000	
	Cash/ <i>Istisna'a</i> Accounts Payable (Asset/Liability)		20,000
	(To record cost under Parallel <i>Istisna'a</i> contract)		
Dec 31	<i>Istisna'a</i> Asset (Asset)	20,000	
	<i>Istisna'a</i> Cost (Asset)		20,000
	(To record receipt of asset from the manufacturer)		

2. *AL-MASNOO'* IS DELIVERED LATER THAN SCHEDULED

If the *Al-Masnoo'* is delivered late, and this is due to the negligence of the *Al-Sani'*, then the Islamic bank is entitled to compensation for any damages incurred due to the delay. This compensation may be recovered through performance bonds. In case the amount of the performance bond is insufficient, then the Islamic bank will record a receivable from the *Al-Sani'* for the balance amount and if necessary, it will also recognise an Allowance for Doubtful Accounts.

3. *AL-MASNOO'* IS NOT IN ACCORDANCE WITH SPECIFICATIONS

In this scenario, the Islamic bank may accept or refuse delivery of *Al-Masnoo'*. If the bank refuses to receive delivery of *Al-Masnoo'*, then the bank will record an account receivable in relation to any progressive billings which are to be recovered from *Al-Sani'*. If necessary, an Allowance for Doubtful Accounts may also need to be recognised.

If the bank receives the *Al-Masnoo'* despite its non-conformance to specifications, then the asset shall be measured at the lower of its cash equivalent value or the historical cost (book value). Any loss arising as a result of this, which is not compensated by *Al-Sani'*, shall be recognised in the income statement of the Islamic bank in the current financial period.

4. *AL-MUSTASNI'* REFUSES TO ACCEPT THE *AL-MASNOO'*

If the client refuses to accept delivery of the asset, the Islamic bank will measure this at the lower of its cash equivalent value or the historical cost (book value). Any loss arising as a result of this shall be recognised in the income statement of the Islamic bank in the current financial period.

5.3.2.4 Maintenance and Warranty Costs

In the case of Parallel *Istisna'a*, maintenance and warranty costs are not accounted for on an accrual basis (as with *Istisna'a*). They are accounted for by the Islamic bank as an expense when incurred (on a cash basis). If the Islamic bank is able to recover such costs from the subcontractor, then a receivable will be debited equal to the total expense incurred for the amount to be recovered.

Box 5.14 Illustration 5.9 Maintenance and Warranty Costs Under Parallel *Istisna'a*

Alnoor Islamic Bank has signed an *Istisna'a* contract to deliver ten tons of special yarn to a fashion house. The bank made a Parallel *Istisna'a* contract to manufacture the desired quality of yarn with a spinning unit. When the bank received the yarn from the spinning factory and delivered it to the client, the client identified some quality issues and required some reprocessing which would require an additional cost of PKR 450,000. The management is of the opinion that it is not possible to recover this cost from the spinning unit.

Requirement: Show how the bank will record this event in their books.

Solution:

The bank should recognise the additional cost as an expense when incurred. The accounting entry of this loss will be:

	Dr.	Cr.
Jan 1 Maintenance and Warranty Cost (Expense)	450,000	
Cash/Accounts Payable (Asset/Liability)		450,000
(To record the expense from the additional reprocessing cost)		

5.3.2.5 Change Orders and Additional Claims

The same accounting treatment as mentioned under 5.3.1.7 for change orders and additional claims under *Istisna'a* is also applicable for Parallel

Istisna'a contracts. However, in this case, the costs of such changes or additional claims will be determined by the subcontractor (*Al-Sani*) and subject to the approval of the Islamic bank (*Al-Mustasni*).

Box 5.15 Illustration 5.10 Comprehensive Example: *Istisna'a* and Parallel *Istisna'a* Journal Entries

Bahaar Islamic Bank enters into two-year *Istisna'a* and Parallel *Istisna'a* contracts. The contract price is BHD 500,000 and BHD 400,000, respectively.

The basic data for the contract is:

	<u>Istisna'a contract</u>		<u>Parallel Istisna'a</u>	
Contract price (two-year contract)	500,000		400,000	
<i>Transactions</i>	<i>Year 1</i>	<i>Year 2</i>	<i>Year 1</i>	<i>Year 2</i>
1 Billings by (<i>Al-Sani</i>) subcontractor			300,000	100,000
2 Billings by Islamic bank to (<i>Al-Mustasni</i>) purchaser	280,000	220,000		
3 Payments to subcontractor			290,000	110,000
4 Collections from purchaser	230,000	270,000		

Requirement: Provide the journal entries recorded by the Islamic bank for transactions (1) to (4).

Solution:

	<u>Year 1</u>		<u>Year 2</u>	
	<i>Dr.</i>	<i>Cr.</i>	<i>Dr.</i>	<i>Cr.</i>
1 <i>Istisna'a</i> Costs	300,000		100,000	
<i>Istisna'a</i> Accounts Payable		300,000		100,000
2 <i>Istisna'a</i> Accounts Receivable	280,000		220,000	
<i>Istisna'a</i> Billings		280,000		220,000
3 <i>Istisna'a</i> Accounts Payable	290,000		110,000	
Cash		290,000		110,000
4 Cash	230,000		270,000	
<i>Istisna'a</i> Accounts Receivable		230,000		270,000

Box 5.16 Practical Insight: *Istisna'a* for Project Financing in Malaysia

Istisna'a is a commonly employed financing method for infrastructure projects. In Malaysia, *Istisna'a* was utilised as a financing facility for the construction of the Kuala Lumpur Light Rail Transit 2 project, which stands as a successful example of *Istisna'a* financing implementation in the country. Nevertheless, *Istisna'a* receives less attention from IFIs in Malaysia when compared to other financing modes. Data from the Central Bank of Malaysia reveals that in 2018, *Istisna'a* financing amounted to approximately MYR 2 billion, whereas *Murabaha* financing reached MYR 190 billion and *Bay' Bithaman Ajil* financing reached MYR 65 billion during the same period (Nasucha et al., 2019).

Box 5.17 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) The *Istisna'a* cost account is presented under liabilities in the statement of financial position of the Islamic bank.
- 2) Progress bills received by the Islamic bank will be debited to the *Istisna'a* cost account and credited to *Istisna'a* accounts payable.
- 3) When the Islamic bank has entered into a Parallel *Istisna'a* contract for the manufacturing of *Al-Masnoo'*, it may use the percentage of completion method or completed contracts method to recognise its revenues, expenses, and profits in relation to the *Istisna'a* contract.
- 4) If *Al-Masnoo'* is received by the Islamic bank in accordance with the specifications and schedule of the contract, it will be recorded at its historical cost.
- 5) The sale of *Al-Masnoo'* must be through spot payment terms.

Solution:

- 1) False. The *Istisna'a* cost account is presented under assets in the statement of financial position of the Islamic bank.
- 2) True.
- 3) False. Since the Islamic bank will be aware of its revenues and costs, it must use the percentage of completion method to record revenues, expenses, and profits.
- 4) True.
- 5) False. The Islamic bank may sell the asset on either spot terms or instalment terms.

5.4 Presentation and Disclosure

FAS 10 summarises in detail the disclosure requirements in relation to an *Istisna'a* contract. An Islamic bank must disclose the following in its financial statements:

- The revenues and profit of *Istisna'a* contracts recognised for the financial period;
- The accounting method used for measuring revenues and profits of *Istisna'a* contracts;
- Cumulative *Istisna'a* contract costs and the revenues and profits recognised to date;
- The amount of retention on contracts in progress until completion;
- *Istisna'a* receivables and payable accounts (these should not be offset).

The notes to the financial statements should give the following additional disclosures:

- Any unsettled claims and contingent fines related to penalty clauses due to a delay in the delivery of *Al-Masnoo'*;
- The method used for determining the percentage completion for contracts in progress;
- The value of Parallel *Istisna'a* in progress and its time period;
- The value of *Istisna'a* contracts signed but not yet commenced in the current financial period and their time duration.

5.5 IFRS Perspective

Istisna'a is a construction/manufacturing contract of an Islamic bank with a customer, usually long-term in nature. The accounting of this instrument falls under the scope of IFRS 15 *Revenue From Contracts With Customers*.

5.5.1 Istisna'a

Similar to the AAOIFI treatment, under IFRS, contract costs are recorded in an inventory account, known as Construction-in-Progress and billings are recorded in a contra-asset account, known as Billings on Construction-in-Progress. The recognition of the revenue takes place over the same period in which the company works towards satisfying its performance obligation under the contract. Two methods are used, **percentage of completion** and **cost recovery (zero profit)**. Percentage of completion estimates the work done to record revenues and gross profits whilst the cost recovery method delays the recording of any profit until all costs have been incurred under the contract.

Any increased costs relating to the *Istisna'a* contract must be recorded by the Islamic bank depending upon the overall profitability of the contract. Where the contract is still profitable, any cost increase will be charged in the current year's income statement (since it represents a change in estimate). However, where the entire contract goes into loss as a result of the cost increase, then the entire expected loss must be immediately recognised in the current period income statement.

In contrast to FAS 10, IFRS 15 contains no provision to defer profits in relation to any delayed payments beyond the period of the contract. Revenues and gross profits are recognised on the basis of the satisfaction of the performance obligations under the contract.

Under IFRS, when establishing the transaction price (the contract price), the parties must establish whether the contract involves a **significant financing component**. If, under a contract, the IFI has given extended credit terms to the customer, then effectively the IFI is providing financing, and this must be recorded separately from the sales revenue, as **interest income** over the period of financing. The financing element will usually be computed by discounting the consideration to be received in the future by an imputed interest rate.⁴ What is considered to be *significant* is a matter of judgement and will vary from contract to contract. In general, a large difference between the contract consideration and the amount that would be payable in cash at the time of fulfilment of the performance obligation suggests that an implicit financing component exists. Another indicator that a significant financing component exists could be the length of time between the fulfilment of the performance obligation and the payment of cash by the customer.

The receivable relating to the financing portion will be disclosed in the financial statements as a financial asset under IFRS 9 Financial Instruments. No such provisions exist under AAOIFI in relation to a potential financing component under an *Istisna'a* contract.

5.5.2 *Parallel Istisna'a*

In a *Parallel Istisna'a*, the bank enters into a contract with another party for the manufacturing/construction of the goods and so acts as the customer. The amounts billed by the subcontractor are recorded as assets (contract costs) in the statement of financial position of the Islamic bank. Once the asset is completed and delivered, it is recorded at book value by the bank.

An important consideration when the Islamic bank enters into a *Parallel Istisna'a* transaction is that under this arrangement, arguably, the bank passes on the risk for the construction of the asset to a third party. This can potentially change the substance of the entire *Istisna'a* transaction from a trading one to a financing one (with the bank merely acting as a financial intermediary between the buyer and the seller). In this scenario, the accounting treatment will potentially shift from IFRS 15 to primarily one under IFRS 9.

Box 5.18 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) Contract costs are recorded in an inventory account called Construction-in-Progress.
- 2) Profits of an *Istisna'a* contract will be recognised over the period in which the performance obligation is completed on the basis of the percentage of completion and cost recovery (zero profit).
- 3) Under IFRS 15, the recognition of profits is deferred if the instalments extend beyond the completion of the contract.
- 4) The presence of a significant financing component will require the entity to record the entire revenue from the contract as sales revenue.
- 5) The existence of a Parallel *Istisna'a* contract could potentially alter the substance of the transaction from a trading one to a financing one.

Solution:

- 1) True.
- 2) True.
- 3) False. IFRS 15 contains no provision to defer profits in relation to any delayed payments beyond the period of the contract. Revenues and gross profits are recognised on the basis of the satisfaction of the performance obligations under the contract.
- 4) False. The presence of a significant financing component will require the separate recording of sales revenue (trading) and interest income (financing). Similarly, the receivable relating to the financing portion will be recorded as a financial asset under IFRS 9.
- 5) True.

5.6 Chapter Summary

- *Istisna'a* is a deferred sales contract between the client, that is, *Al-Mustasni'* (the buyer) and *Al-Sani'* (the seller) wherein *Al-Sani'* – based on an order from *Al-Mustasni'* – undertakes to have manufactured or otherwise acquire *Al-Masnoo'* (the subject matter of the contract) according to the specifications and sell it to *Al-Mustasni'* for an agreed-upon price and method of settlement. (LO 1, 2)
- The Islamic bank will generally enter a Parallel *Istisna'a* contract for the manufacture/construction of the goods in the primary *Istisna'a* contract. In this case, the bank becomes the buyer, and the subcontractor is the seller. The subcontractor will manufacture/construct the asset according

to specifications and sell it to the Islamic bank for an agreed-upon price and method of settlement. The obligations under both contracts are completely independent. (LO 1, 2)

- In an *Istisna'a* contract, the direct costs, allocated indirect costs, and pre-contract costs are recorded in an *Istisna'a* WIP account. Progress bills are sent to the customer in accordance with the agreed schedule. These are recorded by debiting *Istisna'a* accounts receivable and crediting *Istisna'a* billing (a contra-asset account). (LO 3)
- *Istisna'a* revenue, costs, and profit are recorded on the basis of either the percentage of completion method or the completed contract method. The percentage of completion method recognises revenue and profit commensurate with the work performed during a particular financial period. Where it is not possible to make the necessary estimates, the completed contract method is used. (LO 3)
- The difference between the price paid by the customer during the contract period and the total contract price is referred to as deferred profit. Deferred profits can be recognised in two ways – proportionate allocation over future periods or the receiving of instalment method. (LO 3)
- In proportionate allocation, an Islamic bank should allocate the deferred profit proportionately over the credit period agreed in the *Istisna'a* contract (accruals basis). The alternative is to record profit each year on a cash basis, however, this is only to be used if allowed by the *Shariah* board. (LO 3)
- In a Parallel *Istisna'a* contract, the bank records the progress bills from the subcontractor (the contract costs) in an *Istisna'a* cost account. Revenues, expenses, and profits are recorded in accordance with the percentage of completion method. (LO 3)
- If *Al-Masnoo'* is delivered in accordance with specification and delivery schedule, it is recorded at its historical cost (being the balance in the *Istisna'a* cost account). If *Al-Masnoo'* is not in accordance with the specification, the Islamic bank may be entitled to compensation. The sale of *Al-Masnoo'* to the customer by the Islamic bank may be on spot or instalment terms (through a *Murabaha* contract). (LO 3)
- An Islamic bank is required to disclose the revenues and profits in relation to *Istisna'a* contracts, the method used for measuring revenues and profits, cumulative contract costs, the amount of retention on contracts in progress, and *Istisna'a* receivables and payable accounts. (LO 3)
- In general, the recognition of revenues and costs of an *Istisna'a* contract will come under the scope of IFRS 15 **Revenue from contracts with customers**. A key difference under IFRS is the existence of a Significant Financing Component in the price of the contract which will be accounted for as interest revenue separate from the revenue for the provision of the goods. IFRS also does not contain any deferred profit provision. A Parallel *Istisna'a* may alter the nature of the transaction from a trading one to a financing one in which case IFRS 9 Financial Instruments will be the applicable standard. (LO 4)

5.7 Key Terms and Definitions

- **Istisna'a:** A sale contract between *Al-Mustasni'* (the buyer) and *Al-Sani'* (the seller) where *Al-Sani'* – based on an order from *Al-Mustasni'* – undertakes to have manufactured or otherwise acquire *Al-Masnoo'* (the subject matter of the contract) according to the specifications and sell it to *Al-Mustasni'* for an agreed-upon price and method of settlement whether that be at the time of contracting, by instalments, or deferred to a specific future time. It is a condition of the *Istisna'a* contract that *Al-Sani'* should provide either the raw material or the labour.
- **Parallel Istisna'a:** If *Al-Mustasni'* (the purchaser) does not stipulate in the contract that *Al-Sani'* (the seller) should manufacture *Al-Masnoo'* by himself, then *Al-Sani'* may enter into a second *Istisna'a* contract in order to fulfil his contractual obligations in the first contract. The second contract is called Parallel *Istisna'a*.
- **Istisna'a work-in-progress account:** An asset account in which *Istisna'a* contract costs are accumulated. When the percentage of completion method is used, a portion of *Istisna'a* profit commensurate with the work completed during a financial period is also debited to this account.
- **Istisna'a cost account:** An asset account when a Parallel *Istisna'a* exists. It accumulates progress billing made by the subcontractor. A portion of the *Istisna'a* profit commensurate with the work completed during a financial period is also debited to this account.
- **Percentage of completion method:** An accounting method that recognises the revenues and profits of the *Istisna'a* contract as work progresses.
- **Completed contract method:** An accounting method that recognises *Istisna'a* costs and revenues only in the financial period in which the contract is completed.
- **Contract losses:** Losses expected to happen when the sum of the costs accumulated in the *Istisna'a* account or receivable *Istisna'a* billing account and the estimated additional costs for the completion of the contract exceeds the price fixed in the *Istisna'a* contract.
- **Change orders:** Approved modifications in the specifications, quantities, design, or other attributes defined in the original *Istisna'a* contract, the implementation of which affects the contract costs.
- **Additional claims:** Amounts more than the agreed *Istisna'a* contract price which are claimed by *Al-Sani'* for delays, errors in the specifications and designs, or other causes of unanticipated costs caused by *Al-Mustasni'*. Recognition of these claims by *Al-Sani'* requires the satisfaction of the following conditions:
 - a) The existence of a legal basis for the additional claim supported by objective and verifiable evidence.
 - b) Claims must be due and are not the result of the deficiencies, failure, or negligence of *Al-Sani'*.

- c) Costs associated with the additional claims are identifiable and reliably estimable.

5.8 Review Questions

- 1 *Istisna'a* is a sales contract between
 - a) *Al-Mustasni'* and *Al-Sani'*
 - b) *Al-Mustasni'* and *Al-Masnoo'*
 - c) *Al-Mustasni'* and client
 - d) *Al-Sani'* and the manufacturer
- 2 *Al-Mustasni'* in an *Istisna'a* contract is
 - a) Seller
 - b) Buyer
 - c) Manufacturer
 - d) Bank
- 3 In an *Istisna'a* contract, the manufacturer promises to deliver the specifically manufactured asset at an/a:
 - a) Unspecified date but pre-set price
 - b) Specific date and fair value price at the time of delivery of the product
 - c) Within one year at the fair value price at that time
 - d) Specific date at a pre-set price
- 4 In a Parallel *Istisna'a* contract, compared to primary *Istisna'a*, a third party is involved which is:
 - a) Buyer
 - b) Seller
 - c) Manufacturer
 - d) Bank
- 5 After signing an *Istisna'a* contract, how would the pre-contract cost be recorded in the books of the bank?
 - a) Debit deferred (pre-contract) cost, Credit *Istisna'a* WIP
 - b) Debit *Istisna'a* WIP, Credit deferred (pre-contract) cost
 - c) Debit deferred (pre-contract) cost, Credit cash/payable/bank
 - d) Debit cash/receivable, Credit deferred (pre-contract) cost
- 6 Cash equivalent value in an *Istisna'a* contract is
 - a) The expected cost to complete the contract
 - b) The difference between the expected *Istisna'a* profit and the expected cost to complete the contract
 - c) The difference between the contract price and the expected cost to complete the contract

- d) The difference between the contract price and the actual cost incurred during the year
- 7 The revenue and related profit under an *Istisna'a* contract are recorded in each financial period using:
- Percentage of completion method only
 - Cost to complete method only
 - Percentage of completion method or cost to complete method
 - Percentage of completion or completed contract method
- 8 An Islamic bank has an *Istisna'a* agreement to construct a football stadium within a period of four years. The *Istisna'a* revenue is USD 200 million, and the estimated profit in the contract is USD 80 million. It is agreed in the contract that the bank will bill the client based on the stage of completion determined by its expert. At the end of the first year, the bank incurred a total cost of USD 40 million. The expert concluded in his report that 30% of the work is completed.
- What would be the journal entry to record *Istisna'a* receivable?
- Debit *Istisna'a* receivable by USD 60,000,000 Credit *Istisna'a* billing by USD 60,000,000
 - Debit *Istisna'a* receivable by USD 80,000,000 Credit *Istisna'a* billing by USD 80,000,000
 - Debit *Istisna'a* WIP by USD 40,000,000 Credit *Istisna'a* receivable by USD 40,000,000
 - Debit *Istisna'a* WIP by USD 120,000,000 Credit cash by USD 120,000,000
- 9 Under the completed contract method, in case the percentage of completion is unknown, how should the bank recognise the revenue and cost in the income statement?
- Equally divide revenue and cost over the period of the contract
 - Full revenue and cost at end of year one of the contract
 - Full revenue in last year of the contract but divide costs equally over the contract life
 - Full revenue and cost in the last year of the contract when the contract is complete
- 10 An Islamic bank entered an *Istisna'a* contract with a client to produce 500 chairs for USD 30,000 in one year. The bank also signed a Parallel *Istisna'a* contract with a furniture manufacturer to produce 500 chairs for USD 20,000 in one year.
- What would be the journal entry to record the payment to the manufacturer?
- Debit *Istisna'a* receivable, Credit *Istisna'a* billing
 - Debit *Istisna'a* billing, Credit *Istisna'a* receivable

- c) Debit *Istisna'a* cost, Credit accounts payable
- d) Debit *Istisna'a* accounts payable, Credit cash

Notes

- 1 For further discussion, refer to AAOIFI *Shariah* Standard 11.
- 2 Where the Islamic bank has entered into a parallel *Istisna'a*, this account is called the *Istisna'a* costs account (see Section 5.3.1.3).
- 3 An allowed alternative is the recognition of deferred profits on the *receiving of the instalment* method, where profit is recognised only when the cash is received. However, the use of this method is subject to the decisions of IFT's *Shariah* Supervisory Board or upon requirement by the supervisory authorities.
- 4 No discounting is generally required if payment is to be received within one year.

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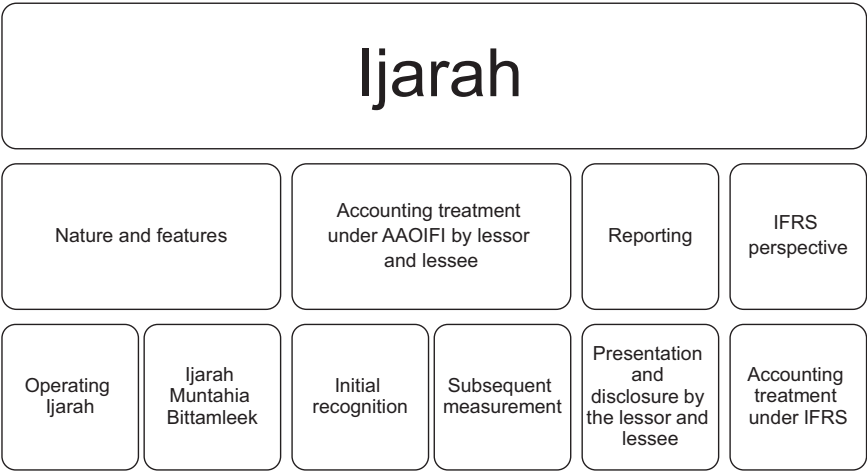
6 Ijarah

Learning Objectives

After going through this chapter, you should be able to:

- 1 Describe the nature of *Ijarah*.
- 2 Understand the process and types of *Ijarah* and the different methods of transferring ownership of *Ijarah* assets.
- 3 Describe the accounting entries, presentation and disclosure requirements for *Ijarah* under FAS 32.
- 4 Identify the key differences between IFRS and FAS accounting for *Ijarah*.

Chapter Preview



Cover Story

Gulf Air, the flag carrier of Bahrain, was founded in 1950 as one of the earliest commercial airlines in the Middle East. It operates regular flights from

its main base at Bahrain International Airport, serving destinations across Europe, the Middle East, Africa, the Indian subcontinent, and the Far East.

In 2009, Gulf Air entered into a USD 70 million *Ijarah* facility agreement with Bahrain Islamic Bank (BIsB). *Ijarah* is an Islamic structure which resembles conventional leasing arrangements; however, it remains within the remit of *Shariah*-compliance. The four-year medium-term facility was intended to partially finance the acquisition of eight A320 aircraft, scheduled for delivery in the fourth quarter of 2009 and the first quarter of 2010.

As the national carrier, Gulf Air plays a vital role in Bahrain's economy. The arrangement was intended to support Gulf Air's objective of strengthening its presence as a key player in the regional and global aviation industry and aligning with Bahrain's "Vision 2030" strategy. Gulf Air was committed to collaborating with local companies since becoming 100% Bahraini owned in 2007. The company's aim was to develop an efficient and sustainable business while serving the people and economy of Bahrain. The loan facility served as a testament to the trust and confidence BIsB had in Gulf Air's future.

The partnership with BIsB, as Bahrain's first Islamic bank, is seen as a strategic move for Gulf Air. The loan facility aligns with the company's goal of strengthening its position in the aviation industry and contributes to the realisation of Bahrain's long-term development strategy. The collaboration also reflects Gulf Air's commitment to working with local entities, showcasing its dedication to building a sustainable national airline that serves Bahrain's economy and people (Times Aerospace, 2009).

6.1 Introduction

In Islamic *Fiqh*, *Ijarah* means to give something for rent. An *Ijarah* contract transfers the **usufruct** (right to use) of an asset for a certain period in exchange for an agreed consideration. The risks and rewards that come along with the ownership of the asset must not be borne by the party that is using the asset. Additionally, the party using the asset has no right to alter the asset without the permission of the owner of the asset.

In an *Ijarah* contract, two parties are involved: the lessee and the lessor. Lessee is the party who acquires the right to use the *Ijarah* asset for a predetermined time. A lessee can be an individual, a firm, or sometimes even a bank. Normally, firms do *Ijarah* agreements to finance assets like plant machinery, property, and vehicles. On the other hand, the lessor is the party who transfers the right to use the *Ijarah* asset for the term of the *Ijarah* contract and in return, receives the agreed rental payment from the lessee. Islamic banks generally act as the lessors. They buy the *Ijarah* assets, rent them out to the clients, and earn rent from the *Ijarah* payments made by the client over the term of *Ijarah*.

6.1.1 Types of Ijarah

There are two types of *Ijarah* agreements. One is called operating *Ijarah*, while the other is called *Ijarah Muntahia Bittamleek*.

6.1.1.1 Operating Ijarah

Operating *Ijarah* contracts just charge rentals against the usufruct of a particular asset, and the ownership is not transferred to the lessee. The lessor owns the asset and is hence bound to bear all risks incidental to its ownership. So it is just what we have studied so far about *Ijarah* – the normal renting contract.

6.1.1.2 Ijarah Muntahia Bittamleek

Ijarah Muntahia Bittamleek (*Ijarah* MBT) is an *Ijarah* contract that ends up with the transfer of ownership of leased assets to the lessee. According to the rulings of *Shariah*, it is not allowed to conclude a sale (transfer of ownership) and an *Ijarah* (transfer of usufruct) transaction simultaneously. Doing so renders the contract null and void. This restriction differentiates an *Ijarah* from a conventional financial lease, which is a hire purchase agreement resulting in the combination of the two contracts.

To meet customers' needs in a *Shariah*-compliant way while competing with conventional banking products, Islamic banks use an arrangement referred to as *Ijarah Muntahia Bittamleek* whereby, instead of combining the two contracts simultaneously, the transfer of ownership to the lessee takes place at the end of the lease term (conclusion of *Ijarah* contract) through a (gift or sale) contract which is independent of the *Ijarah* contract.

The transfer of ownership to the lessee may happen at the end of the *Ijarah* term in the following ways:

- 1 **An ordinary or conditional gift** in which the Islamic bank transfers the asset to the lessee at the end of the lease term without any additional consideration. It is the most widely used approach by Islamic banks nowadays. In the case of an ordinary gift, the Islamic bank promises to gift the *Ijarah* asset, whereas in a conditional gift, the bank agrees to gift the asset to the lessee as soon as the last payment is made by the lessee.
2. **A sale transaction** in which the *Ijarah* asset is sold to the client at the end of the lease term. The sale may occur at book value of the asset or the token a token consideration is some nominal value that may be determined at the beginning of the arrangement, whereby the lessor undertakes to sell the asset to the lessee at a certain price when all *Ijarah* payments have been made.

Let's dig deeper to understand the complete *Ijarah* process. First, the client shows interest in *Ijarah* financing and signs a promise to lease with an Islamic bank to obtain *Ijarah* financing. The promise to lease is binding on the client. It is shown in step 1 of the following diagram.

After signing the promise, the bank purchases an asset for *Ijarah* from a third-party vendor and pays the cash to the vendor, as shown by steps 2 and

3 in Figure 6.1. It is important to note that the bank owns the asset and has complete control over the asset before renting it out to the customer. An institution is said to have **control** of an asset or a business if it bears all the risks and rewards incidental to the ownership of an asset or a business.

If the bank makes an *Ijarah* agreement without ownership or control over an asset, the transaction will become non-*Shariah* compliant.

At the beginning of the contract, both parties need to mutually agree on the *Ijarah* term, the *Ijarah* rental payments and the residual value. Once agreed upon, they cannot be altered. The *Ijarah* term refers to the period which is normally the number of years for which the asset is being leased out. The *Ijarah* payments must be decided pre-hand for the whole *Ijarah* term and fixed payments in most cases. Alternatively, variable-rate *Ijarah* is also permissible, whereby the rental for the first period is fixed and agreed upon in advance while the lease rentals for the remaining period are tied to an agreed benchmark rate that will prevail in the future. **Residual value** of *Ijarah* assets is the amount that is expected to be obtained for these assets at the end of their useful life after subtracting the expected costs of disposal. An estimate of the residual value of the *Ijarah* asset is taken at the commencement of *Ijarah*. Once the contract is made, the lessee can start using the asset. In return, the lessee pays monthly *Ijarah* payments to the lessor, as shown in step 3 of the figure.

Step 4 in the figure is an optional step that is only applicable to *Ijarah* MBT. The ownership is transferred through an independent contract of sale, gift, or gradual ownership. However, it is important to note that step 4 cannot be a part of a normal *Ijarah* transaction since it will make the *Ijarah* agreement non-*Shariah* compliant.

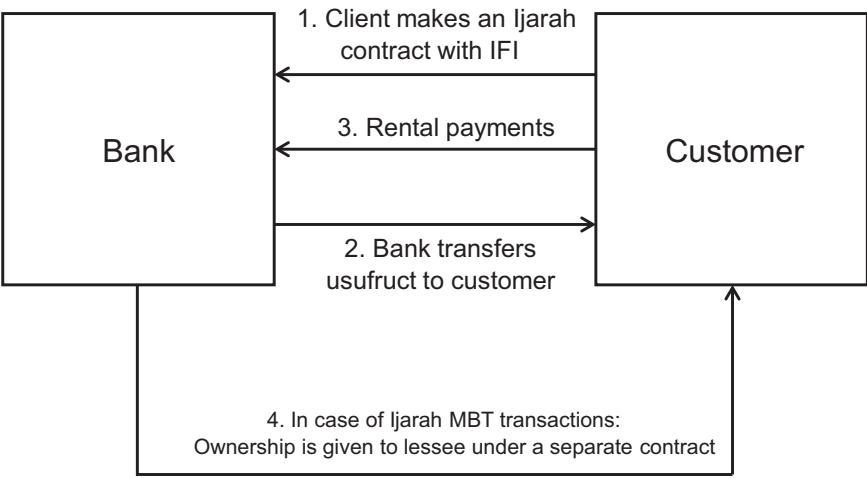


Figure 6.1 Mechanics of an *Ijarah* Contract

Source: Diagram by the authors.

Box 6.1 Practical Insight: Who Pays After the Death of the Lessee?

The Islamic Financial Services Act of 2013 (IFSA) modernised Malaysia's laws governing the oversight and monitoring of financial institutions to ensure that these laws remain relevant, maintain financial stability, promote comprehensive development in the financial sector and economy, and provide adequate security. IFSA 2013 allows banks to issue *Shariah* standards based on *Shariah* contracts' specific characteristics. According to IFSA, the *Ijarah* contract is not automatically terminated if one of the contracting parties dies. Legitimate heirs have the option of continuing or terminating the contract. An IFI may consider several factors when determining the appropriate remedial mechanism in the event of a customer's death, including claiming a sum of money from *Takaful* (if any), protecting the outstanding obligations of deceased customers, or including a special provision in the legal document for the financing that allows the heirs to continue financing. Aside from that, if the estate's rightful heirs choose to end the lease, the IFI may recover and own the *Ijarah* asset and then end the leasing agreement (Nor et al., 2021).

Box 6.2 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) At the end of every *Ijarah* agreement, the ownership of the underlying asset is transferred to the lessee.
- 2) The lessor can make an *Ijarah* agreement even without controlling and bearing the ownership of the *Ijarah* asset.
- 3) The *Ijarah* term and *Ijarah* payments must be decided before the commencement of *Ijarah* according to the rulings of *Shariah*.
- 4) The *Ijarah* term refers to the number of years for the *Ijarah* contract.
- 5) In the case of *Ijarah Muntahia Bittamleek*, the *Ijarah* asset can be gifted to the lessee without receiving any consideration.

Solution:

- 1) False. The ownership is not transferred in every *Ijarah* contract. Ownership is transferred only in the case of *Ijarah Muntahia Bittamleek* through a separate contract.
- 2) False. To make *Ijarah* transaction *Shariah*-compliant, the lessor must have ownership and control over the asset.
- 3) True.
- 4) True.
- 5) True.

6.2 AAOIFI Accounting Treatment by the Lessee

Previously, FAS 8: *Ijarah and Ijarah Muntahia Bittamleek* prescribed the accounting treatment of both *Ijarah* transactions. Recently, AAOIFI Accounting Board (AAB) issued a revised standard FAS 32: *Ijarah*, which supersedes FAS 8 in the accounting treatment of *Ijarah* and *Ijarah Muntahia Bittamleek (Ijarah MBT)*. The objective of this standard is to provide the basis for classification, recognition, measurement, presentation, and disclosure of *Ijarah* transactions for both parties – the lessee and the lessor. This section covers the accounting treatment by the lessee as prescribed by the FAS 32.

6.2.1 Initial Recognition

The **commencement date** of the *Ijarah* contract is the date on which the lessor makes the asset available to the lessee for use as intended. At the commencement date, the lessee will recognise a **right-of-use asset** and a net *Ijarah* liability (being the net of the **gross *Ijarah* liability** and the **deferred *Ijarah* cost**).

6.2.1.1 Advance Rentals Paid

Any rentals paid by the lessee prior to the commencement date of the contract are recorded by the lessee as an asset under the account “Advance *Ijarah* Rentals Paid”.

These advance rentals will later be adjusted against the gross and net *Ijarah* liability (explained in Section 6.4.1.3) post-commencement of the contract. The accounting entry for recording the advance rentals is given here:

		Dr.	Cr.
Date	Advance <i>Ijarah</i> Rental (Asset)	xx	
	Cash (Asset)		xx
	<i>(To record the payment of advance rentals)</i>		

Box 6.3 Illustration 6.1 Recognition of Advance *Ijarah* Rentals Paid

Banco Islamiyah entered into an *Ijarah* agreement with Tadawul Company for lab equipment on Apr 12, 2023. Tadawul Company made an advance payment of SAR 5,200 for the first *Ijarah* rental on May 1, 2023.

Requirement: Propose the accounting entry for recording the transaction.

Solution:

		Dr.	Cr.
May 1	Advance <i>Ijarah</i> Rentals (Asset)	5,200	
	Cash (Asset)		5,200
	<i>(To record the payment of advance rentals)</i>		

6.2.1.2 Right-of-Use Asset

The initial recognition of the right-of-use asset is at cost. Cost is defined as:

- The “prime cost” of the right-of-use asset paid by the lessor to the supplier of the asset
- Any initial direct costs incurred by the lessee
- Dismantling or decommissioning costs

Prime cost for *Ijarah* MBT is defined as:

- The purchase price of the asset (if it has been specifically acquired by the lessor for the *Ijarah* transaction) or the fair value if this is not the case; less
- Any expected terminal value of the asset at the end of the *Ijarah* term. The terminal value will be the promised transfer value at the end of the lease term or the expected fair value of the asset at that time. It might also be taken at nil if the asset is to be gifted.

In case of insufficient information, the prime cost may be estimated on the basis of the fair value of the total liability paid/payable (i.e., the lease rentals).

Box 6.4 Illustration 6.2 Initial Recognition of Right-of-Use Asset

Sadiq Islamic Bank of Malaysia entered an *Ijarah* contract with Thuwab Construction Company (TCC) on May 1, 2023. The bank sourced construction equipment from a vendor and transferred the usufruct of this asset to TCC on May 5, 2023. The purchase price of the equipment was MYR 560,000. The lessor also paid a 1% commission on the purchase. Initial direct costs incurred to bring the equipment to the lessee's premises were MYR 50,000. At the end of the *Ijarah* term, dismantling costs of MYR 11,000 will be incurred and the terminal value will be MYR 20,000.

Requirement: Calculate the prime cost of the asset and the value of the right-of-use asset to be recorded by TCC.

Solution:

Prime cost = 560,000 + 5,600 + 20,000 = MYR 585,600

TCC will record the following amount in its books for the construction equipment.

Right-of-use asset = Prime cost + Initial direct costs incurred by lessee
+ Dismantling costs
= 585,600 + 50,000 + 11,000
= MYR 646,600

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6.2.1.3 Ijarah Liability

At the initiation date, a lessee should recognise a net *Ijarah* liability, which comprises **gross *Ijarah* liability** net of **deferred *Ijarah* cost**. The gross *Ijarah* liability shall include the following payments made for the right to use the underlying asset during the *Ijarah* term:

- i) Fixed *Ijarah* rentals (less any incentives receivable).
- ii) Variable *Ijarah* rentals. These include rentals that are linked to an index or a rate, for example, consumer price index, regulatory benchmark rates etc., and include supplementary rentals payable in case of any additional services provided by the lessor; and
- iii) Any additional rentals for terminating the *Ijarah* agreement (if permitted by the contract).

Deferred *Ijarah* cost is the difference between the prime cost of the right-of-use asset and the gross *Ijarah* liability. This is shown as a contra-liability account in the statement of financial position.

The entry to record the right-of-use asset, gross *Ijarah* liability, and deferred *Ijarah* cost is given here:

		Dr.	Cr.
Date	Right-of-Use Asset (Asset)	xx	
	Deferred <i>Ijarah</i> Cost (Asset)	xx	
	Gross <i>Ijarah</i> Liability (Liability)		xx
	<i>(To record the right-of-use asset and gross Ijarah liability)</i>		

Box 6.5 Illustration 6.3 Recognition of Gross *Ijarah* Liability (Fixed Rentals)

Al Youm Islamic Bank entered into an *Ijarah* agreement with Hamdan Aviation Corp for aeroplane maintenance equipment on Jun 6, 2023. The prime cost of the equipment was AED 50,000. No costs were borne by the lessee to bring the asset to their premises or in a usable state. The total *Ijarah* rentals to be paid over the five-year term of the *Ijarah* was AED 60,000.

Requirement: State the value of the deferred *Ijarah* cost and pass the accounting entry for recording the *Ijarah* liability in Hamdan Aviation Corp’s books.

Solution:

The deferred *Ijarah* cost is AED 10,000.
 Deferred *Ijarah* cost = Gross *Ijarah* liability – Prime cost
 = 60,000–50,000
 = AED 10,000

		Dr.	Cr.
Jun 6	Right-of-Use Asset (Asset)	50,000	
	Deferred <i>Ijarah</i> Cost (Asset)	10,000	
	Gross <i>Ijarah</i> Liability (Liability)		60,000
	<i>(To record the right-of-use asset and gross Ijarah liability)</i>		

In addition to fixed *Ijarah* rentals, the total *Ijarah* rentals included in the measurement of the *Ijarah* liability may also include variable *Ijarah* rentals, if any, including any supplementary rentals and payments of additional rentals for terminating the *Ijarah*. Supplementary rentals may be based on the number of units produced using the equipment or machinery leased through *Ijarah*.

Box 6.6 Illustration 6.4 Calculation of Gross *Ijarah* Liability (Variable Rentals)

Shawqi Islamic Bank leases industrial equipment to Zein El Abidine Semiconductors Co. The *Ijarah* term for the equipment is four years with a fixed rental payment of CAD 4,000 per year for the production of up to 400,000 units per year. For every 100 units above this, there will be a variable rental payment of CAD 1 per 100 units. Zein El Abidine’s production schedule using the leased equipment over the *Ijarah* term is shown here.

Year	Units produced
1	450,000
2	366,000
3	420,000
4	410,000

Requirement: Calculate the *Ijarah* liability that Zein El Abidine Semiconductors should record in its books.

Solution:

Zein El Abidine Semiconductors will record the following amount in its books for the *Ijarah* liability.

Fixed *Ijarah* rentals = $4,000 \times 4 = 16,000$

Variable *Ijarah* rentals:

Year 1 = $(450,000 - 400,000)/100 \times 1 = \text{CAD } 500$

Year 2 = The actual production is less than 400,000 units. So no variable rent will apply.

Year 3 = $(420,000 - 400,000)/100 \times 1 = \text{CAD } 200$

Year 4 = $(410,000 - 400,000)/100 \times 1 = \text{CAD } 100$

Total variable rentals = $500 + 200 + 100 = \text{CAD } 800$

Ijarah liability = Fixed rentals + Variable rentals
 $= 16,000 + 800$
 $= \text{CAD } 16,800$

Let's look at a consolidated illustration for initial recognition of both the *Ijarah* asset and liability in the books of the lessee.

Box 6.7 Illustration 6.5 Right-of-Use and Gross *Ijarah* Liability

Tabarak Islamic Financing Corporation (TIFC) leases a small aircraft to Bey Flying Corp. (BFC) on Jun 23, 2023. TIFC sources the aircraft from an aircraft manufacturer for USD 300,000. The term of the *Ijarah* is ten years, and BFC is liable to make rental payments of USD 33,000 every year. To transport the aircraft to the premises of BFC, it pays direct costs of USD 1,000. After ten years, BFC is expected to incur dismantling costs of USD 4,000.

Requirement: State the journal entry to record the right-of-use of the aeroplane and the *Ijarah* liability.

Solution:

Right-of-use = $300,000 + 4,000 + 1,000 = 305,000$

Gross *Ijarah* liability = Rental payment per period \times *Ijarah* term
 $= 33,000 \times 10 = \text{USD } 330,000$

Deferred *Ijarah* cost = Gross *Ijarah* Liability – Prime Cost
 $= 330,000 - 305,000 = \text{USD } 25,000$

		Dr.	Cr.
Jun 23	Right-of-use Asset (Asset)	305,000	
	Deferred <i>Ijarah</i> Cost (Asset)	25,000	
	Gross <i>Ijarah</i> Liability (Liability)		330,000
	<i>(To record the right-of-use asset and gross Ijarah liability for the aircraft)</i>		

N.B. The cost elements of *Ijarah* asset are shown separately for the understanding of the readers.

Box 6.8 Concept Check

Identify which of the following three statements are true or false. If a statement is false, indicate why this statement is false.

- 1) The standard FAS 32 supersedes the standard FAS 8 for the accounting of *Ijarah* and *Ijarah Muntahia Bittamleek*.
- 2) FAS 32 describes the accounting treatment for *Ijarah* transactions for lessors only.
- 3) FAS 32 must be applied to those *Sukuk* agreements that involve underlying *Ijarah* assets.
- 4) For initial recognition of the asset, prime cost, initial direct cost, decommissioning, and dismantling costs are considered as the cost of the asset.
- 5) Deferred *Ijarah* cost is the difference between the right-of-use asset and the gross *Ijarah* liability.

Solution:

- 1) True.
- 2) False. FAS 32 on *Ijarah* provides the basis for classification, recognition, measurement, presentation, and disclosure of *Ijarah* transactions for both the lessor and the lessee.
- 3) False. FAS 32 cannot be applied to the *Sukuk* agreement in which the underlying asset is based on the *Ijarah* transaction. In such a case, FAS 34, "Financial Reporting for Sukuk-holders", should be followed.
- 4) True.
- 5) True.

6.2.2 Subsequent Measurement

6.2.2.1 Right-of-Use Asset – Amortisation and Impairment

After the *Ijarah* contract has commenced, the lessee measures the right-of-use asset at cost, less any accumulated amortisation and any accrued impairment losses. Any effect of *Ijarah* adjustment or appraisal of the asset’s value must also be accounted for. Amortisation is calculated for the duration of the entire *Ijarah* term in a systematic manner that reflects the pattern of usage of the right-of-use asset’s benefits. The cost of a right-of-use asset less any residual value, if any, is the amortisable amount.

The residual value of a right-of-use asset is equal to:

- Zero in case of operating *Ijarah* or *Ijarah* MBT through sale at fair value after the end of the *Ijarah* term; or
- the estimated residual value of the *Ijarah* asset at the end of the *Ijarah* term – in case of an *Ijarah* MBT through gradual transfer; or
- the estimated residual value at the end of the *Ijarah* term less promised purchase price in the case of *Ijarah* MBT through sale or gift, if it is highly likely that the option of transfer of ownership to the lessee will be exercised through purchase or gift.

The entries for amortisation in the lessee’s books will be as follows:

		Dr.	Cr.
Date	Amortisation of <i>Ijarah</i> Asset (Expense)	xx	
	Accumulated Amortisation of <i>Ijarah</i> Asset (Contra-Asset)		xx
	(To record amortisation of the <i>Ijarah</i> asset)		

Box 6.9 Illustration 6.6 Amortisation of *Ijarah* Asset

Turab Financiers leases a tractor to Nadine & Co. Both the useful life and *Ijarah* term are the same at five years. The cost of the tractor, including initial direct costs to bring it to a usable state, is AED 25,000. The residual value after five years is expected to be AED 5,000. Nadine & Co. uses the straight-line method to amortise its assets.

Requirement: What accounting entries will Nadine & Co. record to amortise the tractor at the end of the first year of using the tractor on Dec 31, 2023?

Solution:

The amortisation for the first year will be:

$$(25,000 - 5,000)/5 = \text{AED } 4,000$$

Nadine will pass the following entries.

		Dr.	Cr.
Dec 31	Amortisation – <i>Ijarah</i> Asset (Expense)	4,000	
	Accumulated Amortisation – <i>Ijarah</i> Asset (Contra-Asset)		4,000
	<i>(To record amortisation of the Ijarah tractor)</i>		

The lessor should apply FAS 30: Impairment, Credit Losses, and Onerous Commitments to evaluate if the right-of-use asset is impaired and account for any prospective impairment loss. The lessee should also determine whether any commitments, for example, promises to purchase the underlying asset through sale or gradual transfer are onerous and, if so, account for them as per FAS 30. **Onerous commitments** are those in which the costs of meeting the obligations of the commitment exceed the economic benefits to be received under it.

6.2.2.2 Accounting for Ijarah Liability

After the commencement date, at each period end, the lessee must measure the net *Ijarah* liability by:

- i) Reducing the carrying amount of the gross *Ijarah* liability for the *Ijarah* rentals paid; and
- ii) Increasing the net carrying amount to reflect the *Ijarah* liability's return through amortisation of the deferred *Ijarah* cost; and
- iii) Adjusting the carrying amount of the liability to reflect any changes, *Ijarah* contract modifications, or revised *Ijarah* rentals.

Deferred *Ijarah* cost is amortised over the *Ijarah* term on a time proportionate basis. FAS 32 recommends the use of the **effective rate of return method**, which results in the amortisation expense being a constant percentage of the opening right-of-use asset value.

In every period, the remaining value of the right-of-use asset is amortised by an amount equal to the rental paid less the deferred *Ijarah* cost for the period.

Box 6.10 Illustration 6.7 Subsequent Measurement of *Ijarah* Liability

Qurrat Islamic Bank leased radiographic and ultrasound equipment to FLB Welfare Hospital on Dec 31, 2022. The *Ijarah* term is five years. The rental payable per year is PKR 300,000. FLB Welfare Hospital uses an effective rate of return of 4.968% to amortise the deferred *Ijarah* cost after initial recognition. The right-of-use for the equipment is recorded at PKR 1,300,000 in the books of FLB Welfare Hospital.

Requirement: Create an amortisation schedule for the *Ijarah* liability in the books of FLB Welfare Hospital and pass the entries for the measurement of *Ijarah* liability at the end of year 1.

Solution:

At the start of the *Ijarah* contract, the following entry is recorded:

	Dr.	Cr.
Dec 31 Right-of-Use Asset (Asset)	1,300,000	
Deferred <i>Ijarah</i> Cost (Asset)	200,000	
Gross <i>Ijarah</i> Liability (Liability)		1,500,000
<i>(To record the right-of-use of ultrasound equipment and Ijarah liability)</i>		

The amortisation schedule for the *Ijarah* liability is shown here. Note that values have been rounded to whole numbers for simplicity.

Year	(a) Net <i>Ijarah</i> liability	(b) Rental	(c) Amortisation of deferred <i>Ijarah</i> cost $4.968\% \times (a)$	Right-of-use amortisation expense $(d) = (b) - (c)$ Net reduction	(e) = (a) – (d) Closing net <i>Ijarah</i> liability
0					1,300,000
1	1,300,000	300,000	64,581	235,419	1,064,581
2	1,064,581	300,000	52,886	247,114	817,468
3	817,468	300,000	40,610	259,390	558,078
4	558,078	300,000	27,724	272,276	285,802
5	285,802	300,000	14,198	285,802	0
Total		1,500,000	200,000	1,300,000	

The balance of the gross *Ijarah* liability is reduced by the rental paid each year. The balance of the net *Ijarah* liability reduces in line with the amortisation of the deferred *Ijarah* cost. This is shown in the following table:

Year	(a) Gross Ijarah liability	(b) Cumulative deferred Ijarah cost	(c) = (a) – (b) Net Ijarah liability
0	1,500,000	200,000	1,300,000
1	1,200,000	135,419	1,064,581
2	900,000	82,532	817,468
3	600,000	41,922	558,078
4	300,000	14,198	285,802
5	0	0	0

FLB Welfare Hospital will pass the following entries at the end of year 1 for measuring the *Ijarah* liability.

		Dr.	Cr.
Dec 31	Amortisation of Right-of-Use of <i>Ijarah</i> Equipment (Expense)	235,419	
	Accumulated Amortisation (Contra-Asset)		235,419
	<i>(To record the amortisation of the right-of-use asset at the end of year 1)</i>		
Dec 31	Gross <i>Ijarah</i> Liability (Liability)	300,000	
	Cash (Asset)		300,000
	<i>(To record the payment of rental and reduction in gross Ijarah liability at the end of year 1)</i>		

6.2.3 Ownership Transfer

6.2.3.1 Transfer of Asset in Ijarah MBT

In the case of simple (operating) *Ijarah*, the accounting treatment would be the same as described earlier. As we have discussed earlier, in the case of *Ijarah Muntahia Bittamleek*, there is a parallel contract to transfer the ownership of the asset from the lessor to the lessee. Additionally, the ownership is represented by the control over the underlying asset, which may be transferred through gift or sale. The contract is presented by one party and accepted by the other party. Both parties should record the transfer in their books when the control is transferred at the time specified in the contract.

The lessee should recognise the asset when the consideration is paid and the legal title is transferred to the lessee. The asset should be measured at its fair value.

6.2.3.2 *Transfer of Asset With No Consideration (Gift)*

At the end of the lease term, when all instalments have been paid, the lessee will receive the asset from the lessor as a gift (with no consideration). The lessee pays nothing but records a gain on the acquisition based on the fair value of the asset.

Box 6.11 Illustration 6.8 Transfer of Asset With No Consideration (Gift)

Habb Islamic Bank has a car under *Ijarah Muntahia Bittamleek* from a vendor. Both parties agreed to transfer the ownership of the car at the end of the *Ijarah* term as a gift. However, when the bank received the gift on Apr 3, 2023, its fair value was USD 1,500.

Requirement: How will Habb Islamic Bank record this transfer in its books?

Solution:

	Dr.	Cr.
Apr 3 <i>Ijarah</i> Car (Asset)	1,500	
Gain on <i>Ijarah</i> Car (Income)		1,500
<i>(To record the receipt of car from lessor as a gift)</i>		

6.2.3.3 *Transfer of Asset With a Token Consideration*

At the end of the lease term, when all instalments have been paid, the lessor offers the asset to the lessee for purchase at a consideration agreed upon in the ownership contract. The accounting entries are shown in the following illustration:

Box 6.12 Illustration 6.9 Transfer of Asset With a Token Consideration

Al Noor Islamic Bank has a car under *Ijarah Muntahia Bittamleek* from a vendor. The bank agreed to purchase the car at the end of the *Ijarah* term at a price of USD 1,300 on Sep 30, 2023.

Requirement: How will Al Noor Islamic Bank record this transfer in its books?

Solution:

		Dr.	Cr.
Sep 30	<i>Ijarah</i> Car (Asset)	1,300	
	Cash (Asset)		1,300
	<i>(To record the purchase of car from vendor)</i>		

6.3 AAOIFI Accounting Treatment by the Lessor

This section will discuss the accounting treatment from the perspective of the lessor.

6.3.1 Initial Recognition

6.3.1.1 Advance Payment to the Vendor

Any advance paid by the lessor to the vendor to purchase the underlying *Ijarah* asset must be recorded as an advance payment as follows:

		Dr.	Cr.
Date	Advance Paid to Vendor (Asset)	xx	
	Cash (Asset)		xx
	<i>(To record the payment for the Ijarah asset by the bank)</i>		

6.3.1.2 Advance Rentals Received

Any rentals received in advance by the lessor are recorded as an **obligation** under **advance rentals**.

6.3.1.3 Recognition of Underlying Asset

An asset must be recognised in the books of the lessor only when the lessor assumes all the risks and rewards incidental to the ownership of the asset, that the lessor has control over the asset.

Ijarah assets are measured at historical cost and include the purchase price of the asset (net of rebates and discounts) and all costs directly attributable to

bringing the underlying asset to its present location and condition; for example, all kinds of taxes (other than recoverable taxes) and transportation and handling costs including *Takaful* costs. Any costs incurred by the customer in the capacity of an agent and any fee paid to the agent will also be included.

Assets that are intended for *Ijarah* transactions are normally recorded under the accounts “*Ijarah Assets*” or “*Ijarah Muntahia Bittamleek Assets*”, depending on the type of intended *Ijarah* transaction. The accounting entry to record the asset at cost are:

		Dr.	Cr.
Date	<i>Ijarah Asset (Asset)</i>	xx	
	Cash (Asset)		xx
	<i>(To record the acquisition of Ijarah asset at cost)</i>		

Box 6.13 Illustration 6.10 Purchase of Asset

An Islamic bank purchased a car on Jan 1, 2023, for USD 10,000 to lease it out to its client. The bank paid a tax of USD 500 and a commission fee of 5%.

Requirement: Write the accounting entries to record the purchase of the car.

Solution:

Commission paid by the bank = 5% of 10,000 = USD 500
Total cost of car = purchase price + taxes paid + commission fee
= 10,000 + 500 + 500 = USD 11,000

		Dr.	Cr.
Jan 1	<i>Ijarah Car (Asset)</i>	11,000	
	Cash (Asset)		11,000
	<i>(To record the purchase of car by the bank)</i>		

6.3.1.4 Initial Direct Costs

Initial direct costs in the case of *Ijarah* include all the transaction costs that are not added to the cost of the asset. These costs should be capitalised and should be allocated over the lease term in a manner consistent with the allocation of *Ijarah* revenue. However, if such costs are immaterial, the lessor

should charge them to the profit and loss account of the period in which they occur. Initial direct costs which have been capitalised should be reported to the extent which should be amortised over the remaining period of the lease contract.

		Dr.	Cr.
Date	Initial Direct Costs (Asset)	xx	
	Cash (Asset)		xx
	<i>(To record the initial direct costs upon acquisition of Ijarah asset)</i>		

6.3.2 Subsequent Measurement

6.3.2.1 Accounting for Depreciation and Impairment

The lessor depreciates the *Ijarah* asset over its useful economic life. The depreciation amount is calculated for each year, and the expense is charged to the income statement.

Depreciable amount is defined as the total cost of an asset less the residual value of the *Ijarah* asset. FAS 32 defines the **residual value** as the (a) estimated fair value of the asset at the end of the *Ijarah* term when the asset is not sold or gifted to the lessee; (b) nil value or zero value when *Ijarah* MBT is done through the gift of *Ijarah* asset at the end of the *Ijarah* term; (c) sale value as promised at the start in case of selling through *Ijarah* MBT; or (d) lower of cost or net realisable value (LCNRV) when *Ijarah* MBT through a gradual transfer of ownership is made.

We have used the term useful economic life when talking about depreciation. **Useful economic life** in most cases is the *Ijarah* term or length of the contract period. However, in some circumstances where the *Ijarah* asset may be used by the lessor after the end of the operating *Ijarah* or the asset may be used for another (unrelated) *Ijarah* transaction, the useful economic life is the period equal to the economic lives of other similar assets of the lessor. For instance, a lessor buys a car for an *Ijarah* contract that is five years long. The useful life of other similar cars is ten years. The lessor knows that the car can be used for more than one *Ijarah* contract. So, in this case, the useful life would be ten years which is the useful life of a similar asset.

Coming to the method of depreciation, a lessor may choose any method to arrive at the depreciation amount. However, according to FAS 32, the method of depreciation must be “reflective of the expected pattern of economic benefits arising” from the asset. Normally, most companies use the straight-line method because of its simplicity. Additionally, the straight-line method truly depicts the pattern of flow of the economic benefits received by the company in most cases. Other methods like double declining balance

or Modified Accelerated Cost Recovery System (MACRS) may also be used depending on how the benefits are derived from the asset. Once the depreciable amount is calculated, the depreciation expense is debited to the income statement, and accumulated depreciation is credited to the balance sheet as:

		Dr.	Cr.
Date	Depreciation – <i>Ijarah</i> Asset (Expense)	xx	
	Accumulated Depreciation – <i>Ijarah</i> Asset (Contra-Asset)		xx
	(To record depreciation of the <i>Ijarah</i> asset)		

Box 6.14 Illustration 6.11 Accounting for Depreciation of *Ijarah* Asset

On Jan 1, 2023, an Islamic bank buys machinery to rent it out to Ali Chemicals Pvt Ltd under an *Ijarah* contract. The total cost of machinery, including all costs, is USD 30,000. The *Ijarah* contract term is five years. The Islamic bank predicts that the machinery cannot be used by the lessor nor for any other *Ijarah* contract.

Requirement: Calculate the depreciation expense and write accounting entries. The company uses the straight-line depreciation method.

Solution:

Since the *Ijarah* asset cannot be used after the *Ijarah* term for any other purpose, the *Ijarah* term is the useful life of the machine.

Depreciation expense = Total cost of machine/useful life of machine
Depreciation expense = 30,000/5 = USD 6,000
The accounting entry at the end of year 2022 would be:

		Dr.	Cr.
Dec 31	Depreciation – <i>Ijarah</i> Asset (Expense)	6,000	
	Accumulated Depreciation – <i>Ijarah</i> Asset (Asset)		6,000
	(To record depreciation of the machine)		

The underlying asset in the *Ijarah* must be subjected to impairment according to FAS 30 “Impairment, Credit Losses and Onerous Commitments” (discussed in Chapter 12 Impairment, Credit Losses, and Onerous Commitments).

Additionally, in *Ijarah MBT* through gradual transfer, the asset must be impaired using the principle of net realisable value (NRV).

6.3.3 Accounting for Ijarah Revenue

The revenue from the *Ijarah* contract is recognised by the lessor proportionately in each accounting period on an accrual basis. Recognition of the *Ijarah* revenue should be based on either

- a) The straight-line method
- b) Another systematic method, such as the effective rate method (if the pattern of benefit received by the lessor is better reflected through this method)

The *Ijarah* revenue is simply the agreed rental payments made by the lessee. If the rental payment is received at the proper time as promised by the lessee, the accounting entry is a debit to cash and credit to revenue. Even if the *Ijarah* payments are not made on time by the lessee, the lessor must record the *Ijarah* revenue in the corresponding financial period and record a receivable which is settled once the cash is received.

Gross *Ijarah* revenue minus *Ijarah* costs (depreciation and amortisation) equals **net Ijarah revenue**. The net carrying value of the underlying asset, including the unamortised initial direct cost, is the **net investment in Ijarah assets**.

6.3.3.1 Applying the Straight-Line Method

The straight-line method is the preferred method for recognising *Ijarah* revenue. Under this method, the *Ijarah* revenue receivable (for the period only) accrued is recognised by an equal amount in each period over the *Ijarah* term. This method is demonstrated in the following illustration.

Box 6.15 Illustration 6.12 Straight-Line Recognition of Ijarah Revenue

Fadl Bank leases equipment worth PKR 800,000 to a client. Fadl uses the straight-line method to represent the usage of the asset by the lessee over the *Ijarah* term. The *Ijarah* term is four years, and the total expected rentals to be paid over this term is PKR 1,000,000. The *Ijarah* starts on Jan 1, 2023, and ends on Dec 31, 2026. Assume that the client pays the rental as a balloon payment of 500,000 each at the end of years 2 and 4.

Requirement: State the entries that Fadl Bank will pass for recording *Ijarah* revenue and receivables.

Solution:

The *Ijarah* revenue to be recognised each year is:

$$\text{Rental} = 1,000,000/4$$

$$= \text{PKR } 250,000$$

Year	Opening Ijarah receivable (a)	Gross Ijarah revenue (b)	Cash received (c)	Closing Ijarah receivable (d) = (a) + (b) - (c)
1	0	250,000	0	250,000
2	250,000	250,000	500,000	0
3	250,000	250,000	0	250,000
4	250,000	250,000	500,000	0

The entry at the end of each year of the *Ijarah* term in the books of Fadl Bank will be:

	Dr.	Cr.
Dec 31	<i>Ijarah</i> Receivable (Asset)	250,000
	<i>Ijarah</i> Revenue (Income)	250,000
	<i>(To record the Ijarah receivable at the end of year 1)</i>	

The entry at the end of years 2 and 4 in the books of Fadl Bank will be:

	Dr.	Cr.
Dec 31	Cash (Asset)	500,000
	<i>Ijarah</i> Receivable (Asset)	500,000
	<i>(To record the Ijarah rental received in cash)</i>	

6.3.3.2 Applying the Effective Rate of Return Method

The effective rate of return method is regarded to be representative of the pattern in which the usage of the underlying asset is diminished in *Ijarah* MBT transactions. The allocation of the gross *Ijarah* revenue to the income statement over the *Ijarah* period is based on a constant rate of return of the opening net investment in *Ijarah* assets.

This approach is explained in the following illustration.

Box 6.16 Illustration 6.13 Effective Rate of Return Method

Rahme Islamic Bank (RIB) invests in machinery worth EGP 500,000 to lease to a client. RIB uses the effective rate of return method to represent the usage of the asset by the lessee over the *Ijarah* term. The *Ijarah* term is four years, and the effective rate of return used is 7.714%. The client is expected to pay fixed rentals of EGP 150,000.

Requirement: Demonstrate how RIB will allocate the gross *Ijarah* revenue over the *Ijarah* term. Assume Dec 31 to be the end of each period.

Solution:

The allocation of gross *Ijarah* revenue by RIB is shown here. Note that the figures have been rounded.

Year	Opening net investment in Ijarah asset (a)	Gross Ijarah revenue (b)	Ijarah cost (c) = 7.714% (e)	Net reduction in Ijarah receivable (d) = (b) - (c)	Closing net investment in Ijarah asset (e) = (a) - (d)
0					500,000
1	500,000	150,000	38,569	111,431	388,569
2	388,569	150,000	29,974	120,026	268,543
3	268,543	150,000	20,715	129,285	139,258
4	139,258	150,000	10,742	139,258	–

RIB will pass the following entry at the end of year 1 for measuring *Ijarah* revenue.

	Dr.	Cr.
Dec 31	Cash (Asset)	150,000
	<i>Ijarah</i> Rent Receivable (Asset)	150,000
	<i>(To record the reduction in Ijarah receivable at the end of year 1)</i>	

6.3.4 Accounting for Repair and Maintenance

The lessor (owner of the asset) bears all the repair and maintenance expenses of the *Ijarah* asset. The maintenance expense can be an operational expense that is incurred on a periodic basis or can be a significant repair expense which is rare as compared to operational expense. Although the lessee can pay on behalf of the lessor, the expense must be incurred by the lessor. The reason why the lessee pays is that it is not practically possible for the lessor to take the asset

from the lessee and have its maintenance done on a regular basis. So the lessee makes the payments for the lessor, and the lessor reimburses the lessee at the end of the agreement. The accounting entry for such a transaction is:

		Dr.	Cr.
Date	Repair and Maintenance (Expense)	xx	
	Expense Payable to Lessee (Liability)		xx
	<i>(To record the maintenance expense for Ijarah asset)</i>		

Box 6.18 Illustration 6.14 Accounting for Repair and Maintenance

On Feb 17, 2023, Tamam Bank made an *Ijarah* agreement with Herrera Company to rent out a car. The annual maintenance cost of the car is USD 2,000. Herrera agrees to pay for maintenance on behalf of Tamam Bank.

Requirement: Will there be any entry posted by Tamam Bank for recording maintenance expenses? If yes, specify the accounting entries.

Solution:

Although the lessee (Herrera) is paying for the maintenance, the expense is still incurred by the lessor (Tamam Bank). Therefore, the accounting entries for recording this transaction would be as follows:

		Dr.	Cr.
Feb 17	Repair and Maintenance (Expense)	2,000	
	Expense Payable to Lessee (Liability)		2,000
	<i>(To record the maintenance expense for Ijarah asset)</i>		

Box 6.19 Concept Check

- 1) In *Ijarah* MBT with gradual transfer of ownership, 100% of revenues should be recognised by the lessor immediately in their books.
- 2) The method of depreciation for the *Ijarah* asset should be reflective of the expected pattern of economic benefits arising from the asset
- 3) The gross *Ijarah* liability shall be initially recognised as the net amount of total *Ijarah* rentals payable for the *Ijarah* term, less any asset-related expenses expected to be incurred.
- 4) The straight-line method is the preferred method for recognising *Ijarah* revenue after initial recognition.

- 5) The lessee bears all the repair and maintenance expenses of the *Ijarah* asset.

Solution:

- 1) False. In *Ijarah* MBT with gradual transfer of ownership, revenues should be recognised by the lessor in the proportion of its equity in the ownership of the asset at a particular point in time.
- 2) True.
- 3) False. The gross *Ijarah* liability shall be initially recognised as the gross amount of total *Ijarah* rentals payable for the *Ijarah* term.
- 4) True.
- 5) False. The lessor (owner of the asset) bears all the repair and maintenance expenses of the *Ijarah* asset.

6.3.5 Ownership Transfer

6.3.5.1 Gift Transaction

If the ownership is transferred by a gift transaction, the lessor simply writes off the asset from its balance sheet without any consideration received. The accounting entries for such a transaction are:

		Dr.	Cr.
Date	Accumulated Depreciation – <i>Ijarah</i> Asset (Contra-Asset)	xx	
	<i>Ijarah</i> Asset (Asset)		xx
	<i>(To record the transfer of asset ownership as a gift)</i>		

6.3.5.2 Sales Transaction

The asset is derecognised from the books of the lessor, but consideration is received in this transaction. The loss or gain on the transaction is charged to the income statement. The loss or gain on the sales transaction is calculated by subtracting the carrying value of the *Ijarah* asset from the consideration receivable. As you may recall from beginner accounting books, **carrying value** is the book value of an asset net of accumulated depreciation. The accounting entries for a sales transaction are:

		Dr.	Cr.
Date	Accumulated Depreciation – <i>Ijarah</i> Asset (Contra-Asset)	xx	
	<i>Ijarah</i> Asset (Asset)		xx
	Consideration Receivable (Asset)	xx	
	Gain on Sale of <i>Ijarah</i> Asset (Income)		xx
	<i>(To record the disposal of Ijarah asset through sale)</i>		

Box 6.20 Illustration 6.15 Sale of Asset Through *Ijarah* MBT

Dhuhr Islamic Bank made an *Ijarah* MBT agreement to provide financing for a car to a customer. The cost of the car was USD 10,000. It was agreed between the two parties that the ownership would be transferred at the end of *Ijarah* when the client would pay USD 500. At the period end of *Ijarah*, accumulated depreciation of the car was USD 9,000.

Requirement: Record the entries for sale through *Ijarah* MBT on Dec 31, 2024.

Solution:

First, we will find the carrying value of the car by subtracting accumulated depreciation from the total cost of the car.

Carrying value = USD 10,000 – USD 9,000 = USD 1,000

Since the carrying value is greater than the consideration paid by the customer, the bank will incur a loss of USD 500 on the sale and therefore debit it in the income statement.

	Dr.	Cr.
Dec 31 Accumulated Depreciation – <i>Ijarah</i> Car (Contra-Asset)	9,000	
Consideration Receivable (Asset)	500	
Loss on Sale of <i>Ijarah</i> Car (Expense)	500	
<i>Ijarah</i> Car (Asset)		10,000
(To record the sale of <i>Ijarah</i> asset)		

6.3.6 Sale and *Ijarah*-Back Transactions

If a seller/lessee transfers an asset to the buyer/lessor, and the buyer/lessor unconditionally executes an *Ijarah* transaction on the same asset back to the same seller/lessee, we have what is called a sale and *Ijarah*-back transaction. In this case, both the seller/lessee and the buyer/lessor must account for the transfer contract and the *Ijarah*. The underlying asset is sold from the seller/lessee to the buyer/lessor when the control of the underlying asset is transferred to the buyer/lessor, together with the risks and rewards that come with ownership.

The accounting, presentation, and disclosure of sale and *Ijarah*-back transactions are out of the scope of this book.

Box 6.21 Practical Insight: Islamic Corporation for the Development of the Private Sector

The Islamic Corporation for the Development of the Private Sector (ICD), a part of the Islamic Development Bank, is actively involved in the Islamic leasing sector. It has significant ownership stakes, ranging from 20% to 100%, in 13 leasing companies across different countries, including Malaysia, Saudi Arabia, Tunisia, Turkey, and Egypt. In 2022, the ICD partnered with Uzbek Leasing International to enhance its product offerings by expanding the Ijarah financing model, aiming to attract more customers (Khan, 2023).

6.4 Presentation and Disclosure

6.4.1 Presentation and Disclosure by Lessor

6.4.1.1 Presentation

The lessor must present *Ijarah* assets as the “*Ijarah* Assets” heading. In their income statement, net *Ijarah* revenue should be presented as gross *Ijarah* revenue recognised during the period net of depreciation and *Ijarah* asset expenses such as *Takaful*, registration, legal, and repairs.

In the lessor’s balance sheet, advance *Ijarah* rentals must be recorded and shown as a liability. Initial direct expenses, including total initial direct costs and unamortised initial direct costs, are shown as an addition to the carrying value of the *Ijarah* assets.

The following is a sample of how *Ijarah* will be presented in the financial statements of the lessor.

<i>Jaffer Islamic Bank</i>		
<i>Statement of Financial Position as at 31 December 2023</i>		
	2022	2023
	USD	USD
Assets		
Cash and Cash Equivalents	xx	xx
Receivables	xx	xx
<i>Musharakah</i>	xx	xx
<i>Ijarah</i> Asset	xx	xx
<i>Ijarah Muntahia Bittamleek</i>	xx	xx
Investment in Real Estate	xx	xx
Building and Fixtures	xx	xx
Goodwill	xx	xx
Other Assets	xx	xx

(Continued)

(Continued)

<i>Jaffer Islamic Bank</i>		
<i>Statement of Financial Position as at 31 December 2023</i>		
	2022	2023
	USD	USD
Liabilities		
Bills Payable	xx	xx
Advance <i>Ijarah</i> Rentals	xx	xx
Deposits and Other Accounts	xx	xx
Accrued Expenses and Other Payables	xx	xx
Due to Related Parties	xx	xx
Subordinated Debts	xx	xx
Deferred Tax Liabilities	xx	xx

6.4.1.2 *Disclosure*

The minimum disclosure requirements for *Ijarah* transactions in the financial statements of the lessor are as follows:

- Accounting policies adopted for the accounting treatments of *Ijarah* and *Ijarah* MBT transactions, with an explanation of the types
- Amount of *Ijarah* assets by each major class of assets, net of depreciation and expenses
- Amortisation of initial direct costs
- Future cash inflows related to *Ijarah* transactions
- Future cash outflows, if material

Outstanding amounts of *Hamish Jiddiyyah*¹

- *Ijarah* rentals waived by the lessor
- Charity payments made and payable

6.4.2 *Presentation and Disclosure by Lessee*

6.4.2.1 *Presentation*

Right-of-use assets and net *Ijarah* liabilities are reported as “right-of-use assets” and liability, respectively, in the lessee’s balance sheet. *Ijarah* rentals paid in advance for *Ijarah* transactions that have yet to begin will be shown as receivable.

The lessee’s income statement must show the net *Ijarah* cost as a single operating expense appropriate to the nature of the right-of-use asset’s use, comprising, and disclosing separately, amortisation of right-of-use asset,

amortisation of deferred *Ijarah* cost, variable *Ijarah* rentals, and gain or loss on *Ijarah* modifications and other adjustments. The following is an example of how *Ijarah* will be presented in the balance sheet of the lessee.

<i>Taliah Construction Corporation</i>		
<i>Statement of Financial Position as at 31 December 2023</i>		
	2022	2023
	USD	USD
Assets		
Cash and Cash Equivalents	xx	xx
Right-of-Use Assets	xx	xx
Advance <i>Ijarah</i> Rentals	xx	xx
Building and Fixtures	xx	xx
Goodwill	xx	xx
Other Assets	xx	xx
Liabilities		
Bills Payable	xx	xx
Net <i>Ijarah</i> Liability	xx	xx
Accrued Expenses and Other Payables	xx	xx
Due to Related Parties	xx	xx
Deferred Tax Liabilities	xx	xx

6.4.2.2 Disclosure

If the *Ijarah* cost is related to the building or development of an asset, such disclosures must be made in the lessee's financial statements.

At a minimum, the lessee must disclose the following:

- Accounting policies used for and the different types of *Ijarah* transactions the lessee has engaged in;
- The amount of right-of-use assets by major asset type, net of additions, removals, and accumulated amortisation and impairment;
- The break-up of **combined assets** acquired under *Ijarah* MBT through gradual transfer;
- The gross and net *Ijarah* liability;
- Potential cash outflows not already accounted for as *Ijarah* liabilities;
- The nature of assets sold during the period under sale and *Ijarah*-back transactions;
- Unamortised deferred *Ijarah* costs against *Ijarah* liabilities;
- Outstanding amounts of *Hamish Jiddiyyah* at the end of the financial period;
- The excess expected cumulative amount of residual value of right-of-use assets in the case of *Ijarah* MBT;

- *Ijarah* rentals waived by the lessor;
- Charity payments made and payable as a penalty.

6.5 IFRS Perspective

Ijarah is accounted for under **IFRS 16 Leases**, similar to conventional finance and operating lease contracts.

Although the term *Ijarah* is often considered synonymous with leasing, there are some key differences with the conventional counterparts. For example, under a conventional finance lease, the risk and rewards of ownership of the asset primarily lie with the lessee; however, under an *Ijarah* contract, risks and rewards remain with the lessor. Another important difference is that under a finance lease contract, ownership will transfer to the lessee at the end of the contract term, whereas under *Ijarah*, ownership transfer is the subject of a separate contract. *Shariah* forbids combining two contracts into one. As a result, the sale of the asset is not included in the *Ijarah* contract. Furthermore, a future sale contract is prohibited by *Shariah*. Accordingly, the option of sale is in the form of a promise, binding on one party.

IFRS 16 was introduced in 2019 and brought about various changes within the conventional framework on how leases are to be accounted for from its predecessor, IAS 17. FAS 32 has also updated the earlier standard on *Ijarah*, FAS 8, and has many similarities with IFRS 16. Therefore, the accounting treatment under IFRS and AAOIFI is now more or less in line with one another.

6.5.1 Accounting by the Lessee

Previously, IAS 17 required the lessee to record an asset at the time of commencement of the lease and depreciate it as usual. However, IFRS 16 has introduced the treatment of recording a “right-of-use” asset, which is disclosed as an intangible asset, as well as a lease liability at commencement.

The right-of-use asset is initially recorded as the lease liability plus any initial direct costs incurred by the lessee less any incentives received. The lease liability is recorded at the present value of the lease payments to be made under the lease term. Post-commencement of the contract, the right-of-use asset is depreciated and recorded at cost less accumulated depreciation (and any impairments). The lease liability is reduced on the basis of the payments made. Lease payments are allocated to interest expense (in the income statement) and a reduction in the lease liability is recorded on the basis of the effective rate method. The initial and subsequent measurement of the right-of-use asset and lease liability is similar under IFRS 16 and FAS 32. However, FAS 32 does not disclose the amortisation of the deferred *Ijarah* cost as an interest expense since this is considered to be a rental cost.

6.5.2 Accounting by the Lessor

The lessor must classify the lease as an operating or a finance lease. A number of factors will determine which classification is to apply. In general, a finance lease is one where ownership of the asset is transferred to the lessee at the end of the lease term or the lessee has the option to buy the asset at a lower price than the fair value of the asset. These conditions are likely to apply to *Ijarah* MBT. Where these conditions do not apply, the lease is recorded as an operating lease.

At commencement, the lessor will be required to record the *Ijarah* MBT assets at cost. The rental income is recorded using the effective rate of return method.

Where there is no parallel sale contract, and the *Ijarah* meets the definition of an *operating lease*, the lessor records the operating lease rentals on a straight-line basis in the income statement or using any other systematic basis which is considered to better represent the diminishing benefit from use of the underlying asset.

6.6 Chapter Summary

- *Ijarah* is an agreement between two parties, the lessor and the lessee, where the lessor provides usufruct of an (*Ijarah*) asset to the lessee in exchange for monetary consideration. (LO 1)
- There are two types of *Ijarah*: operating *Ijarah* and *Ijarah Muntahia Bittamleek*. Operating *Ijarah* is a simple rental agreement without any transfer of ownership. In *Ijarah Muntahia Bittamleek*, the ownership is transferred to the lessee at the end of the *Ijarah* term through a separate ownership contract. (LO 2)
- The ownership contract in *Ijarah Muntahia Bittamleek* can be a gift, sale, or gradual ownership transfer agreement. (LO 2)
- Advantages of *Ijarah* include 100% financing of assets, reduced risk of obsolescence, flexibility to decide on contract terms and tax deductibility of *Ijarah* payments. (LO 2)
- FAS 32 applies to operating *Ijarah* and *Ijarah Muntahia Bittamleek* and does not address *Sukuks* in which underlying asset is based on *Ijarah*, *Ijarah* for natural resources, *Ijarah* concerning licensing agreements and service-based contracts. (LO 3)
- In a sale and *Ijarah*-back transaction, a seller/lessee transfers an asset to the buyer/lessor, and the buyer/lessor unconditionally executes an *Ijarah* transaction on the same asset back to the same seller/lessee. (LO 3)
- In a lessor's financial statements, *Ijarah* Assets must be shown on the balance sheet, net *Ijarah* revenue should be presented as gross *Ijarah* revenue recognised during the period net of depreciation and *Ijarah* asset expenses, advance *Ijarah* rentals must be shown as a liability, and initial

direct expenses are shown as an addition to the carrying value of the *Ijarah* assets. (LO 3)

- In a lessee's balance sheet, right-of-use assets are shown as *Ijarah* assets, net *Ijarah* liabilities are reported, and advance *Ijarah* rentals are shown as receivable. In the income statement, net *Ijarah* cost is shown as a single operating expense. (LO 3)
- When *Ijarah* and finance leases are compared, results show that *Ijarah* is similar to an operating lease and not a finance lease. (LO 4)

6.7 Key Terms and Definitions

The following key terms will facilitate a better understanding of the content of this chapter. We have used these terms repeatedly throughout the chapter.

- **Combined asset:** The underlying asset in the *Ijarah Muntahia Bittamleek* with gradual transfer of the ownership throughout the lease term. It is called a combined asset because the proportionate ownership of the lessee and right-of-use asset exists on it simultaneously.
- **Commencement date:** The date on which the *Ijarah* asset is made available to the lessee by the lessor. The asset should be in a condition in which it fulfils its intended purpose and use.
- **Control:** An institution is said to have control of an asset or a business if it bears all the risks and rewards in addition to the ownership of an asset or a business. To claim control, an organisation must meet the following two criteria:
 - The company has the right to all the positive or negative returns generated by the asset or the business;
 - The company has enough power over the assets to alter the returns generated by those assets.
- **Deferred *Ijarah* cost:** The difference between the gross *Ijarah* obligation and the prime cost of the right-of-use asset. It will be deferred at first using a deferred *Ijarah* cost account. Deferred *Ijarah* cost must be shown as a contra-liability (of respective liability).
- **Diminishing *Musharakah*:** An Islamic product that is used to provide financing to customers by creating a partnership between the customer and the IFI. The customer and the Islamic bank become co-owners of the asset. However, at the end of the contract/partnership, the ownership is transferred to the party (customer), who buys the share of the other party (Islamic bank) over the term of the contract through monthly rental payments.

In the case of *Ijarah*, diminishing *Musharakah Ijarah* represents *Ijarah MBT* with gradual transfer having the following properties:

- A partnership for a tangible *Ijarah* asset is created between the lessee and the lessor in a mutually agreed ratio. Moreover, the asset should not be involved in the common business of the lessee and the lessor.

- A contract is made in which the lessee agrees to make monthly instalments to buy the proportionate share of the lessor in the asset. In this way, a sale transaction takes place at each instalment wherein the lessee buys some additional share of the lessor in the asset. This process continues until the ownership is completely transferred to the lessee.
- An independent *Ijarah* agreement is made in which one partner (lessor) rents out his proportionate share in the asset to the other partner (lessee).
- **Effective rate of return method:** Used for reducing the *Ijarah* liability over the *Ijarah* term in the books of the lessee. Under this method, the gross *Ijarah* liability is allocated to the income statement over the term of *Ijarah* in such a manner that a uniform rate of return is produced in the form of deferred *Ijarah* cost.
- **Fair value of leased assets:** The amount for which an asset could be exchanged between well-informed, willing parties (seller and buyer) in an arm's length transaction.
- **Lessee:** In the *Ijarah* agreement, the party who acquires the right to use the *Ijarah* asset for a predetermined time and, in turn, pays the agreed rental payment to the lessor.
- **Lessor:** In the *Ijarah* agreement, lessee is the party who transfers the right to use the *Ijarah* asset for a predetermined time and in turn, receives the agreed rental payment from the lessee.
- **Net *Ijarah* revenue:** The amount of gross *Ijarah* revenue, net of *Ijarah* costs (depreciation and amortisation).
- **Net investment in *Ijarah* assets:** The net carrying value of the underlying asset, including the unamortised initial direct cost.
- **Onerous commitment:** Those commitments in which the costs of meeting the obligations of the commitment exceed the economic benefits to be received under it.
- **Residual value (for lessor):** The amount that is expected to be obtained for these assets at the end of their useful life after subtracting the expected costs of disposal. An estimate of the residual value of the *Ijarah* asset is taken at the commencement of *Ijarah*.
- **Useful (service) life:** Either the period over which these assets are expected to render services or the number of output units expected to be obtained from these assets.

6.8 Review Questions

- 1 In *Ijarah Muntahia Bittamleek*, transfer of ownership can happen in the following ways except:
 - a) An ordinary or conditional gift
 - b) A sale transaction
 - c) An auction

- d) Gradual transfer of ownership
- 2 All of the following are benefits of *Ijarah* transactions except:
- a) *Ijarah* allows companies to completely finance their long-term assets.
 - b) *Ijarah* can effectively reduce the risk of obsolescence.
 - c) The rental payments made by the lessee are 100% tax-deductible.
 - d) Simpler financial reporting requirements.
- 3 Which of the following topics on *Ijarah* is covered by FAS 32?
- a) Sale and *Ijarah*-back transactions
 - b) *Sukuk* agreement in which underlying asset is based on *Ijarah* transaction
 - c) *Ijarah* transactions concerning licensing agreements of certain items
 - d) Labour contracts, hiring of professional services, and other service-based contracts
- 4 In the books of the lessee, the right-of-use asset should initially be recorded at:
- a) Cost less expected depreciation
 - b) Fair value less costs to sell
 - c) Market price less estimated expenses of the asset over its useful life
 - d) Purchase price plus initial direct costs incurred by the lessee and dismantling or decommissioning costs
- 5 According to FAS 32, operating *Ijarah* is:
- a) Also termed as finance *Ijarah*
 - b) An *Ijarah* that is not accompanied with an option of transfer of ownership of the underlying asset to the lessee
 - c) Equivalent in terms of *Murabaha*
 - d) None of above
- 6 In the books of the lessor, revenue from the *Ijarah* contract is recognised:
- a) As the estimated revenue income at the beginning of each accounting period
 - b) Proportionately in each accounting period on an accrual basis
 - c) Proportionately in each accounting period on a cash basis
 - d) As and when received from the lessee
- 7 How are material initial direct costs (other than costs related to *Ijarah* assets) treated by the lessor?
- a) Expensed in the income statement in the period in which they are incurred
 - b) Added to the cost of the *Ijarah* asset

- c) Capitalised and allocated over the lease term in a manner consistent with the allocation of *Ijarah* revenue
 - d) Charged and recovered from the lessee
- 8 The accounting entries in the lessor's books for the transfer of *Ijarah* assets through a gift transaction in *Ijarah* MBT will be:
- a) Dr. *Ijarah* Asset; Cr. Accumulated Depreciation
 - b) Dr. Cash; Cr. *Ijarah* Asset
 - c) Dr. Accumulated Depreciation; Cr. *Ijarah* Asset
 - d) None of the above
- 9 Which of the following is not a minimum disclosure requirement for *Ijarah* transactions in the lessor's books?
- a) Estimated amounts of assets to be financed using *Ijarah* within the next 12 months
 - b) Amortisation of initial direct costs
 - c) Accounting policies adopted for *Ijarah* transactions
 - d) *Ijarah* rentals waived by the lessor, if any
- 10 Which of the following is a key difference between *Ijarah* and a finance lease?
- a) The Islamic bank does not own the asset in *Ijarah*, while the bank owns the asset in a finance lease.
 - b) The client bears all risks incidental to ownership in *Ijarah*, while the bank bears these risks in a finance lease.
 - c) The Islamic bank can increase rentals in *Ijarah*, while conventional banks cannot do so in a finance lease.
 - d) The Islamic bank cannot financially penalise the lessee, but conventional banks can charge a penalty or compound interest.

Note

- 1 *Hamish Jiddiyyah* is the amount deposited as a security against the fulfilment of a contract, promise, or completion of a transaction by one of the parties to the other. The concept is discussed in more detail in Chapter 3, *Murabaha*.

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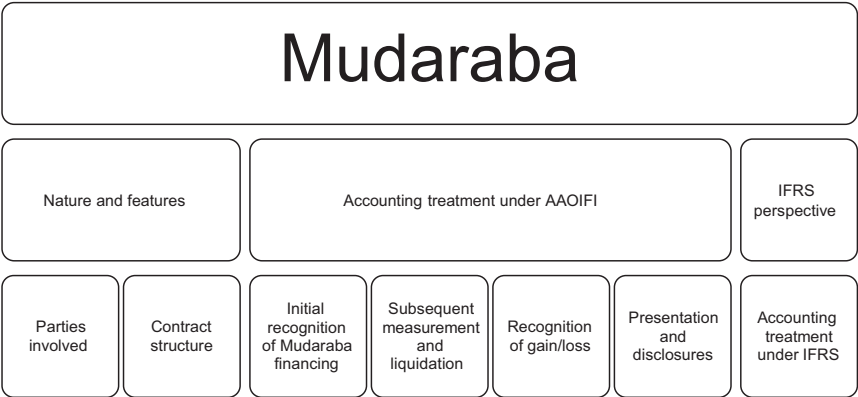
7 *Mudaraba*

Learning Objectives

After going through this chapter, you should be able to:

- 1 Describe the nature of *Mudaraba*.
- 2 Understand the process and challenges associated with *Mudaraba*.
- 3 Describe the accounting entries, presentation, and disclosure requirements for *Mudaraba* under FAS 3.
- 4 Identify the key differences between IFRS and FAS accounting for *Mudaraba*.

Chapter Preview



Cover Story

The State Bank of Pakistan (SBP) launched a *Mudaraba*-based Islamic Financing Facility for Renewable Energy (IFRE) in 2019, aimed at supporting power projects that utilise alternative and renewable energy

sources. This facility is available for Islamic Banking Institutions (IBIs) and Development Finance Institutions (DFIs) with authorised Islamic financing operations.

Under the IFRE, *Mudaraba* investments will be provided to selected Participating Islamic Financial Institutions (PIFIs), acting as *Rab al-Maal*, for financing eligible renewable energy projects and sponsors. The SBP's exposure under the scheme will cover all assets of the PIFI's general pool, corresponding to the SBP's investment, rather than being limited to the assets financed under the facility.

The financing under the IFRE is categorised into three categories. Category-I is for prospective sponsors setting up renewable energy power projects with a capacity ranging from over 1 MW to 50 MW for their own use or selling electricity to the national grid. The maximum financing period for Category-I is 12 years, including a grace period of two years.

Category-II is designed for prospective sponsors installing renewable energy source-based projects/solutions for electricity generation up to 1 MW. The maximum financing period for Category-II is ten years, including a grace period of three months.

Category-III is for vendors and suppliers certified under AEDB Certification Regulation 2018, allowing them to lease wind and solar systems or sell electricity to end-users. Financing under Category-III will have separate repayment schedules for each client.

7.1 Introduction to *Mudaraba*

According to *Shariah* Standard No. 13, *Mudaraba* is a partnership in profit whereby one party provides capital, and the other party manages the funds and the business. Any profit earned will be shared amongst both parties based on a pre-decided ratio. They are free to negotiate this ratio as the parties consider appropriate; however, any loss incurred will be borne solely by the provider of the capital. For the fund manager, the loss is in the form of time and effort that have been spent on the venture but for which no financial reward is earned.

To better understand how a *Mudaraba* works, consider this example: Zubair is thinking about taking a giant leap in his career. He has been working in the construction industry as an internal architectural expert for 12 years. Having worked for many of the major construction companies in the industry and being involved with numerous successful projects, he has earned an excellent professional reputation.

Now he is thinking about starting his own company and providing his services as an independent contractor. However, he lacks the investment

required to buy all the assets, hire the required staff and workers, and build a reasonable working capital for his business. Zubair has recently come to know about a product that Ferhad Islamic Bank is offering. The bank will provide all the initial investment for the business, and they agree upon a profit-sharing ratio of 35:65. For Zubair, this product is extremely attractive because not only is it *Shariah*-compliant, but only the bank will bear any potential business losses. The entrepreneur will not be liable for any business losses caused by the business's normal operations except for the loss incurred due to negligence or misconduct of the entrepreneur (*Mudarib*).

Zubair requires an initial investment of USD 3,000,000. The bank has agreed to a profit-sharing ratio of 35:65 for the client and the bank, respectively. The profit projections over the first five years and the related profit-sharing between both parties are summarised in Table 7.1.

The contract between Zubair and the bank is *Mudaraba*. Let us explain a few technical terms used in a *Mudaraba* transaction. It is a partnership between *work* and *capital*. The capital for the business is provided by one party (i.e., *Rab al-Maal*), and the business is managed by the other (*Mudarib*). Both parties share in the business's profit, whereas losses (if any) are borne only by the capital provider.

Figure 7.1 shows how two independent parties, that is, *Rab al-Maal* and *Mudarib*, combine their resources to form another entity, that is, *Mudaraba*. Figure 7.2 shows how this contract is structured.

Table 7.1 Profit-Sharing Between Zubair and the Bank

Year	Profit/(Loss) (USD)	Zubair's share in profits (USD)	Bank's share in profits (USD)	ROI for the bank
1	(300,000)	0	(300,000)	-10%
2	800,000	280,000	520,000	17.33%
3	900,000	315,000	585,000	19.5%
4	1,200,000	420,000	780,000	26%
5	1,300,000	455,000	845,000	28.15%

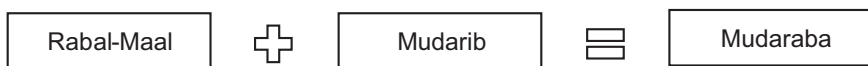


Figure 7.1 Parties Involved in Forming a *Mudaraba* Contract

Source: Diagram by the authors.

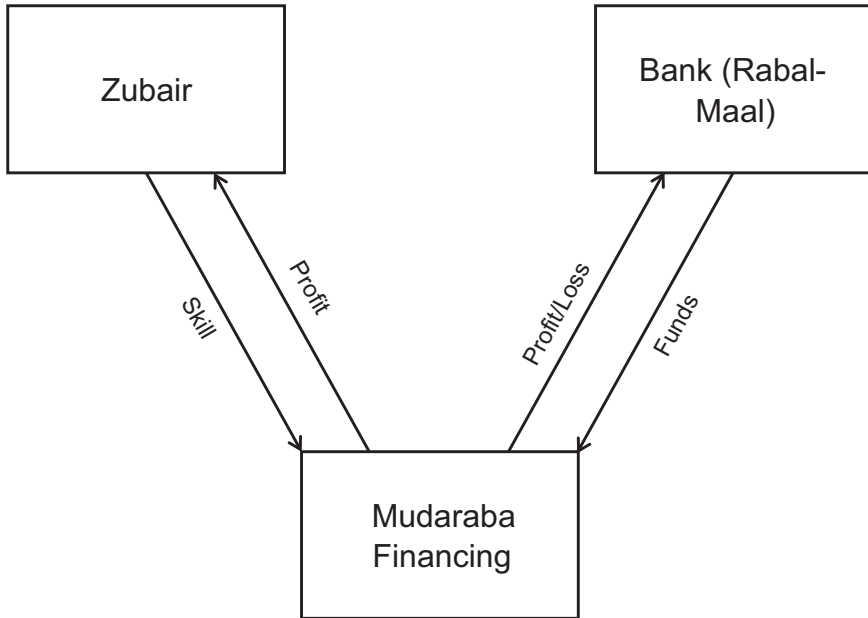


Figure 7.2 Structuring a *Mudaraba* Contract

Source: Diagram by the authors.

Box 7.1 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) A *Mudaraba* is a partnership between two parties where one party provides the investment for the business and other party manages the business for a fixed fee.
- 2) The capital provider in *Mudaraba* is known as *Rab al-Maal*.
- 3) *Mudarib* and *Rab al-Maal* can decide on any profit-sharing ratio of their choice for the division of profit amongst themselves.
- 4) The losses of the *Mudaraba* are allocated to the *Mudarib* and *Rab al-Maal* under the same ratio used to allocate profit between them.
- 5) *Rab al-Maal* can require the *Mudarib* to invest a minimum amount of funds in the *Mudaraba* venture.

Solution:

- 1) False. It can be seen as a partnership between work and capital. The capital for the business is provided by one party, and another party manages the business. Both parties share in the profit of the business; there is no fixed fee for either party.
- 2) True.
- 3) True.
- 4) False. Profit-sharing ratio and loss-sharing ratio are not the same in a *Mudaraba*. Losses that result from the “normal business” must be borne by the capital-providing party. Only losses created by the misconduct and negligence of the *Mudarib* can be allocated to the *Mudarib*.
- 5) False. Under the *Mudaraba* contract, *Rab al-Maal* cannot require the *Mudarib* to invest funds in the *Mudaraba* venture.

Box 7.2 Practical Insight: Mitigating *Mudaraba* Risks

Mudaraba is a high-risk finance model where the bank relies solely on the client’s management abilities and integrity, risking both the return and the capital itself. To mitigate risks, Islamic banks worldwide have introduced new variations of *Mudaraba* based on *Shariah* principles. These developments include limiting *Mudaraba* to public limited companies that offer transparency through audited financial statements and quarterly performance reports and introducing securities and collaterals in the *Mudaraba* contract, not against the capital or profit but to cover losses due to negligence, mismanagement, or delayed repayment. For instance, Bank Syariah Bukopin (BSB) in Indonesia requires collateral worth 125% of the financing amount (Bank Syariah Bukopin, 2023). Another development is advancing *Mudaraba* finance only to economic activities where the bank can clearly identify the monetary value of fund utilisation.

7.2 AAOIFI Accounting Treatment

The accounting treatment discussed in this section is as per the requirements of Financial Accounting Standard 3 (FAS 3). This standard applies to *Mudaraba* transactions, where the Islamic bank is the provider of capital (*Rab al-Maal*) and not *Mudarib*. It lays down the accounting treatment for the initial recognition of the *Mudaraba* contract as well as the revenues, expenses, gains, and losses attributable to it. The subsequent accounting treatment, as well as the liquidation of the *Mudaraba*, is also covered.

7.2.1 Recognition and Measurement of Mudaraba

7.2.1.1 Initial Recognition and Measurement

Capital refers to the money given by the provider of funds to the *Mudarib* for investment. The following criteria should be met in relation to *Mudaraba* financing:

- Capital should be known in terms of amount and type (i.e., currency).
- If capital is given in the form of trading assets such as inventory (which is permitted by some jurists), the **historical cost** or the value of the assets at the time of contracting will be determined and recorded as the *Mudaraba* financing.
- Other types of non-monetary assets, for example, planes, ships, etc., may be used as capital and these must be returned by the *Mudarib* at the end of the term.
- Capital cannot be in the form of debt. Rather, capital should be readily available in cash or kind.
- Capital should be paid to the *Mudarib* and made available for use. This might be a lump sum or in instalments.

An Islamic bank should recognise the *Mudaraba* financing when it is made available to the *Mudarib*. This means that when the funds have been paid to the *Mudarib*. If funds are made available through instalments, then each instalment shall be recognised at the time of its payment.

Sometimes, it is possible that the parties decide to form a *Mudaraba* contract if a particular event takes place such as securing a licence from the regulatory authority. In this case, *Mudaraba* financing will be recognised only when that event has taken place, and the capital has been made available to the client.

Box 7.3 Illustration 7.1 Initial Recognition of Mudaraba

Habib Islamic Bank agreed on Jan 1, 2023, to provide *Mudaraba* financing to the client. After the completion of the formal process and documentation, on Jan 25, 2023, the bank processed the transfer of funds to the client's account. The funds were successfully transferred to the client's account on Feb 1, 2023.

Requirement: When should the Islamic bank recognise the *Mudaraba* financing?

Solution:

In this case, the funds were effectively made available to the customer on Feb 1, 2023. So Habib Islamic Bank should recognise the *Mudaraba* financing on Feb 1, 2023.

The Islamic bank should measure the *Mudaraba* financing at the face value of cash paid. However, if all or part of the funds are in kind, for example, trading assets or non-monetary assets for use in the venture, such assets should usually be measured at their fair value (the value agreed between the Islamic bank and the client). In case there is a difference between the fair value and the book value, such a difference will be recognised as a profit or loss in the financial statements of the Islamic bank.

Box 7.4 Illustration 7.2 Recording Cash and Non-Cash *Mudaraba* Financing

Burj Islamic Bank provided USD 200,000 in cash and commercial property as *Mudaraba* financing for investment in a real estate project. Both parties agreed on the value of the apartment at USD 500,000. The funds and the apartment were effectively transferred to the client on Feb 3, 2023.

Requirement: How should Burj Islamic Bank recognise the *Mudaraba* financing in its books?

Solution:

The Islamic bank should recognise the *Mudaraba* financing at a value equal to the cash funds transferred to the client and the fair value of the property. The accounting entry will be:

	<i>Dr.</i>	<i>Cr.</i>
Feb 3 <i>Mudaraba</i> Financing (Asset)	700,000	
Cash (Asset)		200,000
Property (Asset)		500,000
<i>(To record the transfer of cash and property as Mudaraba financing)</i>		

Both parties may incur some expenses before the *Mudaraba* finalisation of the contract (e.g., feasibility studies). These expenses are charged to the profit and loss account of the respective entity unless both parties agree to include this within the *Mudaraba* financing. The entries are shown in Illustration 7.3.

Box 7.5 Illustration 7.3 Recording Pre-*Mudaraba* Expenses

Bilad Islamic Bank hired a real estate research expert to conduct a feasibility study and to evaluate the profitability of a new housing project proposed by a client. The real estate research expert was paid USD 50,000

by Bilad Islamic Bank. Both parties agreed that the bank could add this amount to the *Mudaraba* financing. Bank provided USD 1,000,000 under the *Mudaraba* financing contract to the client on Jan 5, 2023.

Requirement: How should Bilad Islamic record *Mudaraba* financing?

Solution:

The Islamic bank should recognise the *Mudaraba* financing as the total of funds delivered and the cost incurred in this respect. The accounting entry will be:

	Dr.	Cr.
Jan 5 <i>Mudaraba</i> Financing (Asset)	1,050,000	
Cash/Bank (Asset)		1,050,000
<i>(To record the Mudaraba financing including expenses incurred)</i>		

Box 7.6 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) *Mudaraba* financing is recognised when the bank signs a contract with a client to provide *Mudaraba* financing to the client (*Mudarib*).
- 2) Initially, *Mudaraba* financing is recognised at face value of the funds provided to the client.
- 3) If the *Mudaraba* financing is provided in kind, that is, some tangible asset other than cash, then it is recognised at the book value of the asset provided.
- 4) If the book value of the asset contributed by way of *Mudaraba* financing differs from the value at which the *Mudaraba* financing is recognised, the difference is capitalised by the bank.
- 5) In *Mudaraba*, both parties may incur some expenses in the pre-*Mudaraba* period that are related to the *Mudaraba*. These expenses should always be charged to the profit and loss account of the respective entity.

Solution:

- 1) False. An Islamic bank should recognise the *Mudaraba* financing when it is made available to the client (who is also the partner in the

Mudaraba contract). It means that when the funds have been paid or have been made available on account to the client.

- 2) True.
- 3) False. In the case of capital in kind, the *Murabaha* capital is recognised at fair value.
- 4) False. In a case where the asset has been recognised at fair value, the difference between fair value and the book value of the asset will be recognised in the profit and loss account for the period.
- 5) False. Generally, these expenses are charged to the profit and loss account by the bank and/or by the client. However, the bank and the client can decide to make the expenses a part of the *Mudaraba* financing.

7.2.1.2 Subsequent Measurement

The Islamic bank should continue recognising the *Mudaraba* financing at its initial recognition cost. However, the value of *Mudaraba* financing should be reduced if there is repayment of any part of the capital by the client.

Box 7.7 Illustration 7.4 Recording Repayment of *Mudaraba* Financing

On Jun 3, 2023, Jazeera Islamic Bank advanced USD 300,000 to a client under a *Mudaraba* arrangement for establishing a business. The duration of the *Mudaraba* contract is three years.

At the end of the period, as stipulated in the contract, the client paid back USD 100,000 of the principal.

Requirement: How should Jazeera Islamic Bank record the repayment of *Mudaraba* financing in its books?

Solution:

The bank should reduce the amount of its *Mudaraba* financing by USD 100,000. The accounting entry will be:

		Dr.	Cr.
Jun 3	Cash/Bank (Asset)	100,000	
	<i>Mudaraba</i> Financing (Asset)		100,000
	<i>(To record the repayment of Mudaraba financing by the client)</i>		

If a portion of the *Mudaraba* financing is lost prior to the inception of work because of damage or other causes not related to any misconduct or negligence on the part of the *Mudarib*, such loss should be deducted from the *Mudaraba* financing and shall be treated as a loss to the Islamic bank. However, if the loss occurs after the inception of work, it shall not affect the measurement of the *Mudaraba* financing.

Box 7.8 Illustration 7.5 Recognition of Loss of *Mudaraba* Financing Before Inception

Jizan Islamic Bank agreed on Jan 1, 2023, to provide *Mudaraba* financing to the client. After completion of the formal process and documentation, on Jan 25, 2023, the bank’s *Mudaraba* financing investment management team authorised the transfer of funds and assets to the client’s account. A commercial property was also part of the assets that Jizan Islamic Bank was going to provide as *Mudaraba* financing. The fair value of this commercial property was measured at USD 500,000. However, this property suffered considerable damage because of a fire before its transfer to the client. Jizan Islamic Bank transferred cash of USD 1,000,000 and this property to the client’s account on Feb 1, 2023. At the time of transfer of the property to the client, the fair value of the commercial property was USD 300,000.

Requirement: What will Jizan Islamic Bank record in its books in this case?

Solution:

In this case, on Feb 1, 2023, Jizan Islamic Bank will recognise a *Mudaraba* financing worth USD 1,300,000 and will recognise a loss of USD 200,000.

	<i>Dr.</i>	<i>Cr.</i>
Date <i>Mudaraba</i> Loss (Expense)	200,000	
<i>Mudaraba</i> Financing (Asset)		200,000
<i>(To record the loss on Mudaraba financing)</i>		

If the entire capital is lost before the inception of work without any misconduct or negligence on the part of the *Mudarib*, the *Mudaraba* should be terminated, the account thereof shall be settled, and the loss shall be treated as a loss to the Islamic bank.

Box 7.9 Illustration 7.6 Recognition of Loss of Entire *Mudaraba* Financing Before Inception

Alfalalah Islamic Bank agreed on Mar 5, 2023, to provide *Mudaraba* financing to the client. After completion of the formal process and documentation, on Apr 2, 2023, the bank's *Mudaraba* financing investment management team authorised the transfer of assets to the client. Alfalah Islamic Bank was going to contribute a mine-drilling machine and associated equipment worth USD 2,000,000 as *Mudaraba* financing. However, this machine was lost in a naval accident while it was being transported from South Africa to the United Arab Emirates when it was still under the possession and ownership of the bank. Hence, this machine was never transferred to the client by the Islamic bank.

Requirement: What will Alfalah Islamic Bank recognise in its books in this case?

Solution:

In this case, the *Mudaraba* contract between the client and Alfalah Islamic Bank will be terminated due to the loss of the drilling machine in the naval accident. The bank will recognise a loss of USD 2,000,000.

7.2.2 Recognition of *Mudaraba* Profit and Loss

The Islamic bank should recognise the profit/(loss) resulting from a *Mudaraba* investment in the year in which it was earned.

7.2.2.1 Single-Period *Mudaraba*

For a single-period *Mudaraba* (a *Mudaraba* that commences and ends during a single accounting period), the profit or loss shall be recognised at the time of liquidation of the *Mudaraba*.

Box 7.10 Illustration 7.7 Recording Single-Period *Mudaraba* Profit

Warba Islamic Bank signed a short-term *Mudaraba* contract with a client to import and sell a product. The funds were transferred from the bank to the client on Jan 3, 2023, and the transaction cycle was completed on Apr 30, 2023. The *Mudaraba* investment made by the bank was USD 700,000, and the net profit earned on the investment was USD 80,000. The profit-sharing ratio was 70:30 (bank:customer).

The principal amount of the *Mudaraba* and the bank’s share of the profit were transferred to the bank on Apr 30, 2023.

Requirement: What will Warba Islamic Bank record in its books at the end of this period?

Solution:

The Islamic bank should recognise the profit of USD 56,000 (USD 80,000 × 70%) on the liquidation of *Mudaraba* on Apr 30, 2023. The accounting entry will be:

		Dr.	Cr.
Apr 30	Cash/Bank (Asset)	56,000	
	<i>Mudaraba Profit (Income)</i>		56,000
	<i>(To record the profit earned on Mudaraba)</i>		

The payment of the principal amount should also be recorded in the books of the bank. The accounting entry will be:

		Dr.	Cr.
Apr 30	Cash/Bank (Asset)	700,000	
	<i>Mudaraba Financing (Asset)</i>		700,000
	<i>(To record the payment of principal amount to the bank)</i>		

7.2.2.2 Multi-Period Mudaraba

A multi-period *Mudaraba* continues for more than one accounting period. In the case of multi-period *Mudaraba*, an Islamic bank’s share of profit should be recognised only when it is distributed, that is, on a cash basis.

Box 7.11 Illustration 7.8 Recording Multi-Period Mudaraba Profit

Itemad Islamic Bank signed a multi-period *Mudaraba* contract with a client for importing and selling the goods in the local market. The contract was signed on Feb 8, 2023, and the bank provided financing of USD 4,000,000 to the client. During the first year of operations, the *Mudaraba* earned a profit of USD 500,000. The profit-sharing ratio between the bank and the client is 80% and 20%, respectively. The bank received its share of the profit from the client on Dec 28, 2023.

Requirement: What will Itemad Islamic Bank record in its books in this case?

Solution:

Itemad Islamic Bank should recognise the profit of USD 400,000 (USD 500,000 × 80%) when received by the bank. The accounting entry will be:

		<i>Dr.</i>	<i>Cr.</i>
Dec 28	Cash/Bank (Asset)	400,000	
	<i>Mudaraba Profit (Income)</i>		400,000
	<i>(To record the profit earned on Mudaraba)</i>		

In case of loss, the Islamic bank should recognise the loss to the extent that the management of *Mudaraba* has adjusted against the *Mudaraba* financing.

Box 7.12 Illustration 7.9 Recording Loss of *Mudaraba* Financing

Salaam Islamic Bank provided *Mudaraba* financing of USD 2,000,000 to a client for a textile manufacturing and marketing business. The funds were transferred from the bank to the client on Jan 13, 2023. At the end of first-year operations, the business incurred a loss of USD 30,000. The management strongly believes that in the second year of operations, the business would generate a good return for the bank.

Requirement: What will Salaam Islamic Bank record in its books in this case?

Solution:

In this case, Salaam Islamic Bank should recognise a loss of USD 30,000. The accounting entry will be:

		<i>Dr.</i>	<i>Cr.</i>
Dec 31	<i>Mudaraba Loss (Expense)</i>	30,000	
	<i>Mudaraba Financing (Asset)</i>		30,000
	<i>(To record the loss on Mudaraba)</i>		

7.2.3 *Accounting on Liquidation*

On liquidation of the *Mudaraba*, the Islamic bank will recover its capital invested in the *Mudaraba*. Any profit or loss (provided the loss is not caused by the misconduct or negligence of the *Mudarib*) should be recognised at the time of liquidation.

Box 7.13 Illustration 7.10 Recovery of *Mudaraba* Financing and Profit on Liquidation

Taqwa Islamic Bank invested in a five-year *Mudaraba* on Jan 1, 2023. The total *Mudaraba* investment capital provided by the bank was USD 300,000. On liquidation, only USD 250,000 could be recovered. The loss was due to normal business factors.

Requirement: What will Taqwa Islamic Bank record in its books in this case?

Solution:

Taqwa Islamic Bank should recognise a loss of USD 50,000 on liquidation that will be charged to the profit and loss account on Dec 31, 2028. The accounting entry will be:

	<i>Dr.</i>	<i>Cr.</i>
Dec 31 Cash/Bank (Asset)	250,000	
<i>Mudaraba</i> Loss (Expense)	50,000	
<i>Mudaraba</i> Financing (Asset)		300,000
<i>(To record the recovery of capital and loss on liquidation)</i>		

The *Rab al-Maal* can require a *Mudarib* to provide a guarantee against his/her explicit misconduct and negligence. This guarantee does not extend to losses in normal business operations that could not have been reasonably avoided by the *Mudarib*. Hence, if a *Mudarib* fails to pay the cash on liquidation, or losses are due to misconduct or negligence, the Islamic bank should record a receivable from the *Mudarib*.

Box 7.14 Illustration 7.11 Recovery of *Mudaraba* Financing and Loss on Liquidation

In the previous example, during the liquidation process, it was found that half of the losses to the original *Mudaraba* financing occurred due to the negligence of the *Mudarib*. The *Mudarib* has accepted the truth of this finding.

Requirement: What will Taqwa Islamic Bank record in its books in this case?

Solution:

Taqwa Islamic Bank should recognise a receivable of USD 25,000 on liquidation against the *Mudarib*. The accounting entry will be:

		Dr.	Cr.
Dec 31	Cash/Bank (Asset)	250,000	
	<i>Mudaraba</i> Loss (Expense)	25,000	
	Receivable From <i>Mudarib</i> (Asset)	25,000	
	<i>Mudaraba</i> Financing (Asset)		300,000
	<i>(To record the recovery of capital and loss on liquidation due to Mudarib's negligence)</i>		

Box 7.15 Practical Insight: Mudaraba Offerings at Ithmaar Bank in Bahrain

Bahrain’s Ithmaar Bank offers two types of *Mudaraba* – general and special. The General *Mudaraba* is a *Shariah*-compliant fixed deposit account, which allows individuals to earn profits by investing their money in accordance with Islamic principles. The *Mudaraba* Account provides a variety of investment periods, allowing customers to choose the duration that suits their needs. Additionally, Ithmaar Bank offers Special General *Mudaraba* accounts, which are similar to General *Mudaraba* accounts in terms of structure and benefits but with higher minimum initial deposits and expected profit rates to cater to investors seeking higher returns (Ithmaar Bank, 2023).

Box 7.16 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) In the case of a multi-period *Mudaraba*, an Islamic bank should recognise the *Mudaraba* financing at its book value.

- 2) If a portion of *Mudaraba* financing has been lost after the signing of the *Mudaraba* contract but before the transfer of *Mudaraba* financing to the client, then the client and the bank are collectively responsible for this loss.
- 3) In the case of multi-period *Mudaraba* financing, an Islamic bank's share of profit should be recognised when it is distributed.
- 4) In case of a loss, *Rab al-Maal* is responsible only for the loss that has been adjusted against the *Mudaraba* financing, and the rest of the loss is assigned to the *Mudarib*.
- 5) On liquidation of *Mudaraba*, the Islamic bank will recover its capital invested in the *Mudaraba*. The profit/loss, which is not due to the misconduct or negligence of *Mudarib*, should be recognised at the time of liquidation.

Solution:

- 1) False. In the case of a multi-period *Mudaraba*, the Islamic bank should continue to recognise the *Mudaraba* financing at its historical cost, adjusted for any losses.
- 2) False. If a portion of the *Mudaraba* financing is lost prior to the inception of work because of damage or other causes without any misconduct or negligence on the part of the *Mudarib*, such loss should be deducted from the *Mudaraba* financing and shall be treated as a loss to the Islam bank.
- 3) True.
- 4) False. *Rab al-Maal* is always responsible for all the losses that have not been created by the misconduct and negligence of the *Mudarib*. However, *Rab al-Maal* should recognise the loss to the extent the management of *Mudaraba* adjusts it to the *Mudaraba* financing.
- 5) True.

7.3 Presentation and Disclosure

The Islamic bank should disclose its *Mudaraba* financing transactions as a part of assets under the heading of "*Mudaraba* Financing". Non-monetary *Mudaraba* financing should be reported as "non-monetary *Mudaraba* assets". Any provision made for the decline in the value of the *Mudaraba* assets must be disclosed in the notes to the financial statements. The presentation and disclosure requirements of FAS 1 should be strictly followed by the IFI.

The following sample balance sheet shows how *Mudaraba* financing is presented typically in the books of an IFI.

Rayyan Islamic Bank		
Statement of Financial Position as at 31 December 2023		
	2022	2023
	USD	USD
Assets		
Receivables	xx	xx
Mudaraba Financing	xx	xx
Non-monetary Mudaraba Assets	xx	xx
Investments	xx	xx
<i>Ijarah Muntahia Bittamleek</i>	xx	xx
Salam Financing	xx	xx
Investment in Real Estate	xx	xx
Building and Fixtures	xx	xx
Goodwill	xx	xx
Other Assets	xx	xx
Liabilities	xx	xx
Bills Payable	xx	xx
Borrowings	xx	xx
Deposits and Other Accounts	Xx	xx
Parallel Salam	Xx	xx
Accrued Expenses and Other Payables	Xx	xx
Due to Related Parties	Xx	xx
Subordinated Debts	Xx	xx
Deferred Tax Liabilities	Xx	xx
Other Liabilities	Xx	xx

7.4 IFRS Perspective

This section is applicable to both Chapter 7 Mudaraba and Chapter 8 Musharakah. The term Shirkah is used to refer to both of these contracts in the following discussion.

There are multiple variants of how a *Shirkah* (Mudaraba or Musharakah) contract may be structured. For example, it may be similar to a joint venture type agreement or, alternatively, a share in a partnership. It could also be a *share of assets* arrangement. Accounting for a *Shirkah* investment under IFRS is complicated and depends upon the specific contract terms and the rights and obligations of the IFI. In practice, these are likely to be fairly diverse and can impact the accounting treatment significantly. For example, does the IFI have control over the venture, does it exercise significant influence on decision-making, or does it play the role purely of a fund provider without any involvement in decision-making? In each of these cases, the accounting treatment would change. An IFI may account for its *Shirkah* investments in

any of the following ways depending upon how exactly the transaction is structured:

- 1 As a financial asset
- 2 As an investment in a subsidiary or associate
- 3 As a joint arrangement

The different perspectives on accounting for *Shirkah* under IFRS are briefly summarised in the following sections.

7.4.1 Financial Asset

In practice, *Mudaraba* and *Musharakah* transactions are conducted through direct investment/financing in the business of the customer without any associated voting rights. Hence, under IFRS it can be argued that both transactions would have to be considered as a transfer of financial assets and measured as loans/receivables by the IFI. Financial assets are dealt with under **IFRS 9 Financial Instruments**. This includes equity instruments in relation to which the IFI does not exercise significant influence or control.

Whilst under AAOIFI, both *Mudaraba* and *Musharakah* financing are carried at historical cost, there are different possible classifications under IFRS which determine how the financing should be measured. Under IFRS 9, a financial asset is recognised when an entity becomes a party to the contractual provisions of the instrument (IFRS 9 para 3.11).

The financial asset will be classified on the basis of the following two conditions:

1 The business model test

This test is concerned with why the entity is holding the asset. The asset should be held primarily to collect contractual cash flows (as opposed to selling the asset).

2 Contractual cash flows characteristics test

This condition requires that the contractual terms specify the dates when the entity will be receiving cash flows from the asset, and these cash flows should comprise solely payments of principal and interest on the principal outstanding.

Based upon these two tests, a financial asset may be classified in three possible ways – at amortised cost, fair value through profit or loss (FVPL), or fair value through other comprehensive income (FVOIC). In general, in order to be measured at amortised cost, both of the above conditions must be met. Where the business model of the entity is to sell the asset, then FVPL will be applicable and for all other cases, FVOIC will apply.

In theory, a risk-sharing arrangement is by nature likely to have variable returns, which cannot be equated with “payments of principal and interest”. Hence, investments under such contracts would be measured at fair value in the initial and each subsequent period. However, practically, most transactions are structured such that the repayments are virtually fixed or determinable. In such cases, one can argue that, in substance, this amounts to the payment of principal and interest and should be measured at amortised cost.

7.4.2 *Investment in a Subsidiary or Associate*

If the investment by the IFI through the *Mudaraba* amounts to the IFI having “control over another entity”, then this may be classified as a subsidiary of the IFI. “Control” is usually (but not always) determined through having more than 50% ownership of shares in an entity. **IFRS 10 Consolidated Financial Statements** provides further clarity on the definition of control and requires that the results of the subsidiary be consolidated with the entity using the **acquisition method**. This method requires combining the assets, liabilities, equity, income, and expenses of the parent with its subsidiaries. However, certain adjustments are also required to avoid double counting. For example, the carrying value of the parent’s share in the subsidiary and the parent’s share of the subsidiary’s equity must be eliminated. Similarly, intra-group transactions must also be offset against one another.

An associate is defined by **IAS 28 Investments in Associates and Joint Ventures** as “an entity over which an investor has **significant influence**, and which is neither a subsidiary nor an interest in a joint venture”. Significant influence is defined as when a party has the **power to participate** in the financial and operating policy decisions of the investee. In general, this is where between 20% and 50% of the shares are held. However, the percentage ownership is not necessarily conclusive and other factors may also need to be considered to evidence significant influence. IAS 28 requires that associates be accounted for using the **equity method**. The equity method requires initial recognition of the investment to take place at cost in the statement of financial position. Subsequently, the investor increases or decreases the carrying value of its investment by its share of profit or loss in the associate. Correspondingly, the profit or loss is recognised in the income statement. When dividends are received from the associate, the amount received also reduces the carrying value of the investment in the statement of financial position.

7.4.3 *Joint Arrangement*

A *Mudaraba* might be classified as a joint arrangement between a bank and its customer. **IFRS 11 Joint Arrangements** defines the financial reporting principles for entities that have an interest in arrangements that are jointly controlled. **Joint control** effectively means that all parties are bound by a contractual arrangement, and decisions that significantly affect the returns

of the arrangement require the unanimous consent of all parties that collectively control the arrangement. No individual party can make decisions independently.

A joint arrangement may be classified as a **joint operation (JO)** or a **joint venture (JV)** depending upon the rights and obligations of the different parties to the arrangement. If the arrangement is classified as a joint operation, then the parties that have joint control of the arrangement have rights to the assets and obligations for the liabilities relating to the arrangement (IFRS 11, para 15). A joint venture, on the other hand, is a joint arrangement whereby the parties that have joint control of the arrangement have rights to the net assets of the arrangement (IFRS 11, para 16).

In terms of the classification between a JO and a JV, if the joint arrangement is structured through a separate vehicle such as a company or any other separately identifiable entity, then the arrangement might be either a JO or a JV. In this case, the Islamic bank must further consider the legal form and the terms of the contractual arrangement with the separate vehicle as well as any other relevant information. If there is no separately identifiable vehicle, then the arrangement will be classified as a JO.

A JV is accounted for using the equity method (described earlier), whereas a JO requires all parties to account for their own assets, liabilities, revenues, and expenses in relation to their interest in the JO (IFRS 11, para 20).

Box 7.17 Practical Insight: Issues in the Application of IFRS 9

IFRS 9 sets out two conditions for classifying a financial asset. The **contractual cash flows test** refers to the payments of “principal and interest on the principal outstanding”, where interest incorporates a “consideration for the time value of money, for the credit risk associated with the principal amount outstanding during a particular period of time and for other basic lending risks and costs, as well as a profit margin” (IFRS 9, par. B4 1.7A).

A key point here is that *Shariah*-compliant transactions do not include any interest (*Riba*) component. They generate returns through trading activities (such as *Murabaha*), rentals (such as *Ijarah*), or profit-sharing transactions (such as *Mudaraba* or *Musharakah*). Therefore, the application of IFRS 9 and particularly the use of amortised cost for valuing these assets can be debated for Islamic finance instruments. Having said this, Islamic banks can take their own interpretation based upon the specific contract terms, and practically some banks have adopted IFRS 9 for their financial instruments stating that they meet the contractual cash flows characteristics test and hence qualify for measurement under amortised cost. However, in keeping with the requirements of the users, the term “profit” replaces “interest” in the financial statements.

Box 7.18 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false:

- 1) Under IFRS, the Islamic bank will recognise the *Mudaraba* initially at the fair value of the funds and assets in kinds invested in the *Mudaraba*.
- 2) Expenses incurred in the process of forming a *Mudaraba* contract should be added to the *Mudaraba* financing by the Islamic bank.
- 3) In the case of multi-period *Mudaraba* financing, the Islamic bank will recognise its share of the revenue and expenses at the end of each accounting period.
- 4) In general, *Mudaraba* contracts are structured to ensure determinable repayments and hence are normally measured at fair value.
- 5) A condition for **joint control** is that decisions that significantly affect the returns of the arrangement require the unanimous consent of all parties that collectively control the arrangement.

Solution:

- 1) True.
- 2) False. Both parties may incur some expenses in the pre-*Mudaraba* period that are related to the *Mudaraba*. These expenses should not be included in the *Mudaraba* capital but should be charged to the profit and loss account of the respective entity.
- 3) True.
- 4) False. Practically, *Mudaraba* contracts are structured to ensure determinable repayments and hence are normally measured at amortised cost.
- 5) True.

7.5 Chapter Summary

- A *Mudaraba* is a partnership between two parties where one party provides the investment for the business and the other party manages the business. (LO 1)
- The proportion of profit to be distributed between or among partners must be agreed upon at the time of effecting the contract. Partners can agree to any profit-sharing mechanism and ratios of their own choosing. However, only the provider of capital will bear all the losses. (LO 2)

- The accounting treatment for *Mudaraba* mainly involves three stages: investment, profit-/loss-sharing, and subsequent measurement of investment and liquidation. (LO 3)
- In the investment stage, the IFI as *Mudarib* records it as a quasi-equity. In the profit-/loss-sharing stage, any profits or losses are allocated between the parties based on the agreed-upon ratio and are recorded accordingly. Finally, in the liquidation stage, the *Mudaraba* is terminated, and any remaining profits or losses are distributed to the parties based on the agreed-upon ratio. (LO 3)
- Under IFRS, an IFI may account for an investment in a *Mudaraba* in any of the following ways depending upon how exactly the transaction is structured:
 - 1 As a financial asset
 - 2 As an investment in a subsidiary or associate
 - 3 As a joint arrangement (LO 4)

7.6 Key Terms and Definitions

- **Capital:** The money given by the provider of funds to the *Mudarib* for investment.
- **Historical cost:** (In the context of *Mudaraba*) the sum of the capital, in cash or in kind, invested by a partner in a *Mudaraba* at the time of inception of the *Mudaraba*.
 - ***Mudaraba*:** A partnership in profit between capital and labour. It is conducted between investment account holders as owners of capital and the Islamic bank as a *Mudarib*. A *Mudaraba* contract may also be entered between the Islamic bank, as a provider of capital on behalf of itself or on behalf of investment account holders, and business owners and other craftsmen, including farmers, traders, and others.
 - ***Mudarib*:** A person who receives *Mudaraba* investment from the provider of *Mudaraba* financing and manages the business.
 - ***Rab al-Maal*:** The provider of capital in a *Mudaraba* contract.

7.7 Review Questions

- 1 Under a *Mudaraba* contract:
 - a) Profit-sharing ratios are decided by the *Rab al-Maal* at the start of the contract.
 - b) The *Rab al-Maal* bears all losses except those incurred due to the negligence of the *Mudarib*.
 - c) All parties are required to contribute capital.
 - d) One party provides the investment for the business and other party manages the business for a fixed fee.

2 FAS 3 applies to:

- a) Where the Islamic bank is acting as *Rab al-Maal*
- b) The accounting of the *Mudaraba* transactions in the books of *Mudarib*
- c) Accounting treatment of unrestricted investment accounts characterised as *Mudaraba*
- d) Gains and losses attributable to *Mudaraba* contracts

3 Under an unrestricted *Mudaraba* contract:

- a) The investment account holder authorises the Islamic bank to invest their funds in a manner deemed appropriate by the Islamic bank.
- b) Certain limitations are placed as to where, how, and for what purpose the funds should be invested.
- c) The Islamic bank cannot commingle the investment account holders' funds with its own funds.
- d) All gains and losses are borne by the investment account holders.

4 Subsequent to initial recognition, *Mudaraba* capital must:

- a) Be recognised at fair value
- b) Continue to be recognised at initial recognition cost
- c) Be remeasured periodically
- d) Be amortised over time using an appropriate amortisation method

5 If there is a loss at *Mudaraba* liquidation:

- a) The *Rab al-Maal* can require a *Mudarib* to provide a guarantee against his/her negligence if there has been any.
- b) If a *Mudarib* fails to pay the cash on liquidation or losses are due to misconduct or his/her negligence, the Islamic bank should not record a receivable.
- c) The bank should not recognise it if the loss is not caused by the misconduct or negligence of the *Mudarib*.
- d) The bank will debit *Mudaraba* capital and the loss on liquidation and credit cash.

6 On 12 April, 2023, Tayeb Islamic Bank transferred cash of USD 400,000 and an apartment to a client as contribution to a *Mudaraba* arrangement. The bank acquired the apartment for USD 300,000, and the current book value of the apartment is equal to USD 250,000. Partners in *Mudaraba* agreed that the apartment was worth USD 300,000. What is the total contribution of the Tayeb Islamic Bank in the *Mudaraba*?

- a) USD 500,000
- b) USD 650,000
- c) USD 550,000
- d) USD 700,000

- 7 On 23 March, 2023, Somer Islamic Bank transferred cash of USD 400,000 and an apartment to a client as contribution to a *Mudaraba* arrangement. The bank acquired the apartment for USD 300,000, and the current book value of the apartment is equal to USD 250,000. Partners in *Mudaraba* agreed that the apartment was worth USD 300,000. What would Somer recognise as gain/loss?
- a) USD 50,000
 - b) USD 100,000
 - c) USD 150,000
 - d) USD 200,000
- 8 On 12 January, 2023, Half Islamic Bank signed a *Mudaraba* contract with a client for the construction of a housing unit. The bank provided USD 500,000 for the construction. Both parties agreed to a profit-sharing ratio of 70:30. Because of the damage to the property, the business suffered a loss of USD 50,000 in the second year. Which of the following accounting entries will the bank use to record the transactions at the end of the second year?
- a) Debit: Cash = USD 50,000, Credit: *Mudaraba* Capital = USD 50,000
 - b) Debit: Loss on *Mudaraba* = USD 50,000, Credit: Cash = USD 50,000
 - c) Debit: Loss on *Mudaraba* = USD 50,000, Credit: *Mudaraba* Capital = USD 50,000
 - d) Debit: Cash = USD 35,000, Credit: *Mudaraba* Capital = USD 35,000
- 9 Tamaam Islamic Bank made a five-year *Mudaraba* investment on January 12, 2023. The total *Mudaraba* investment capital provided by the bank was USD 200,000. On liquidation, only USD 160,000 could be recovered. The loss was due to normal business factors. How will the bank recognise the transaction at the time of liquidation of the *Mudaraba* contract?
- a) Debit: Cash = USD 200,000, Credit: *Mudaraba* Capital = USD 200,000
 - b) Debit: Cash = USD 160,000, *Mudaraba* loss = USD 40,000, Credit: *Mudaraba* Capital = USD 200,000
 - c) Debit: Cash = USD 160,000, *Mudaraba* Receivable = USD 40,000, Credit: *Mudaraba* Capital = USD 200,000
 - d) Debit: Cash = USD 160,000, Credit: *Mudaraba* Capital = USD 160,000
- 10 Al-Ain Islamic Bank provided financing of USD 4,000,000 to a client under a multi-period *Mudaraba* contract. During the first year of operations, the *Mudaraba* earned a profit of USD 500,000. The profit-sharing ratio between the bank and the client is 80% and 20%, respectively. The

bank received its share of the profit from the client on December 31, 2022. What journal entry will the bank pass to record the profit?

- a) Debit: Cash/Bank (Asset) = USD 400,000
Credit: *Mudaraba* Financing (Asset) = USD 400,000
- b) Debit: *Mudaraba* Financing (Asset) = USD 400,000
Credit: Cash (Asset) = USD 400,000
- c) Debit: Cash/Bank (Asset) = USD 400,000
Credit: *Mudaraba* Profit (Income) = USD 400,000
- d) Debit: *Mudaraba* Financing (Asset) = USD 400,000
Credit: *Mudaraba* Profit (Income) = USD 400,000

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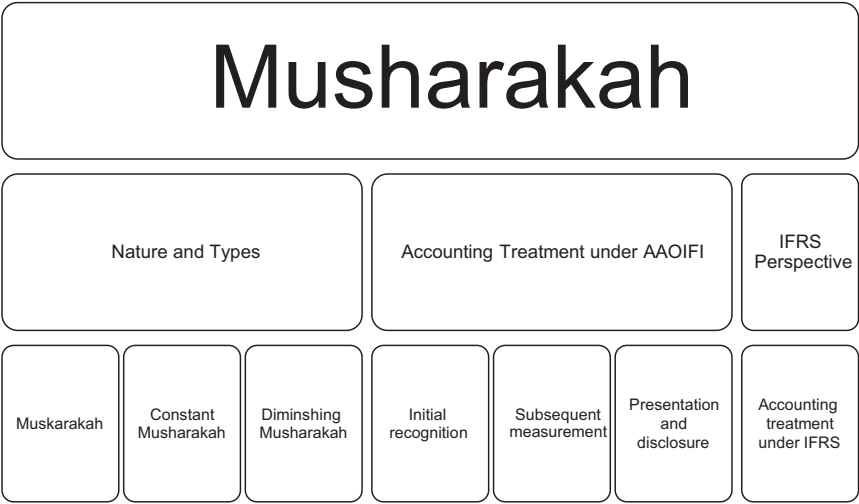
8 Musharakah

Learning Objectives

After going through this chapter, you should be able to:

- 1 Describe the nature of a *Musharakah*.
- 2 Understand the process and challenges in *Musharakah*.
- 3 Describe the accounting entries, presentation, and disclosure requirements for the *Musharakah* transaction under FAS 4: *Musharakah Financing*.
- 4 Identify the key differences between IFRS and FAS accounting for *Musharakah*.

Chapter Preview



Cover Story

In Lahore, Pakistan, in 2015, the Punjab Food Department faced a financing challenge. It needed to procure wheat in a *Shariah*-compliant manner. Traditional interest-based financing was not an option. The department needed a solution that aligned with Islamic finance principles, and Meezan Bank, Pakistan's leading Islamic bank, stepped in to help.

Meezan Bank proposed a *Musharakah* transaction, which is a form of partnership where the financier acts as a partner of the subject company and shares in the profit based on a pre-agreed profit-sharing ratio. The transaction was valued at PKR 9.5 billion, making it the largest *Musharakah* transaction ever executed in the history of Islamic banking in Pakistan. Punjab Food Department was able to finance its procurement of wheat in a *Shariah*-compliant manner. The success of this transaction also demonstrated the dominance of Meezan Bank and Islamic banking in Pakistan.

Meezan Bank's *Musharakah* transaction also significantly increased the percentage of its total financing portfolio under *Shirkat Al-Aqd*. As of July, 2015, the bank had offered 25% of its financing through *Musharakah*, up from 16% at the end of 2014. This is one of the largest percentages of *Shirkat Al-Aqd*-based financing in the financing portfolio of any Islamic bank in the world.

The successful *Musharakah* transaction between Meezan Bank and the Punjab Food Department serves as an excellent example of the application of *Musharakah* in Pakistan. It demonstrates that Islamic finance principles can be applied to large-scale transactions and shows the potential for Islamic banking to grow and flourish in Pakistan and beyond (Meezan Bank, 2015).

8.1 Introduction to *Musharakah*

Musharakah is a form of partnership between the Islamic bank and its clients whereby each party contributes to the capital of the partnership to establish a new project or share in an existing one with agreed-upon shares in profits, which may not be in the same ratio as the contributed capital (Figure 8.1). However, losses are shared in proportion to the contributed capital. It is not permissible to stipulate otherwise. The partnership may continue with fixed capital or an arrangement whereby the client(s) continue to buy a share of the capital of the Islamic bank with periodic payments. The treatment for *Musharakah* financing is prescribed in FAS 4.

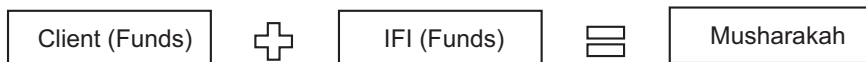


Figure 8.1 Structure of a *Musharakah* Contract

Source: Diagram by the authors.

In *Musharakah*, the partnership can be concluded between two or more parties. The proportion of profit to be distributed between or among partners must be agreed upon at the time of the contract. It is not permissible to defer the determination of the profit percentage share of each partner until the realisation of profit. As discussed before, the partners can divide the partnership's profit in any manner that seems fit to them, irrespective of their capital contribution. However, the proportions of losses borne by partners must be equal to the proportions of their capital contributions.

Box 8.1 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false

- 1) In order to enter a *Musharakah* contract, a person should have the qualities to act as an agent.
- 2) The capital contributed to the *Musharakah* may be in the form of a currency or an asset.
- 3) In a *Musharakah*, losses must be shared in the same proportion as the profits of the business.
- 4) In a *Musharakah*, the profit-sharing ratio should always be equal to the capital contribution ratio of the partners.
- 5) In conventional financing, investors can benefit or lose from the effects of financial leverage, but in a *Musharakah*, they cannot.

Solution

- 1) True.
- 2) True.
- 3) False. In a *Musharakah*, losses are not shared in the same proportion as the profits of the business. Losses, in a *Musharakah* contract, are always shared among the partners according to their share of the equity capital.
- 4) False. In a *Musharakah*, the profit-sharing ratio is not always required to be equal to the capital contribution ratio of the partners. Partners can divide the partnership's profit in any manner that seems fit to them.
- 5) True.

8.2 Types of *Musharakah*

There are two types of *Musharakah* contracts:

- Constant *Musharakah*
- Diminishing *Musharakah*

Constant *Musharakah* is a contract in which the ratio of capital and ownership remains the same over the life of *Musharakah* (Figure 8.2).

Diminishing *Musharakah* is a contract in which one party gradually transfers the ownership of the *Musharakah* asset to the other party (Figure 8.3).

Two parties decided to construct a commercial plaza. Party A will invest USD 1,300,000 and Party B will invest USD 700,000. Both parties agreed that profit and loss will be shared in the proportion of the equity each partner holds. However, Party A also agreed to purchase an equity share of Party B over a period of seven years. At the end of each year, Party A will make a payment of USD 100,000 to acquire 10% of further equity. For profit-sharing, the percentage at the start of the period will be used.

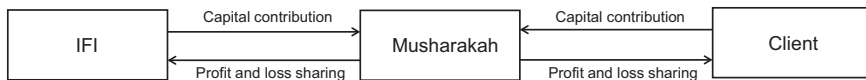


Figure 8.2 Structure of Constant *Musharakah*

Source: Diagram by the authors.

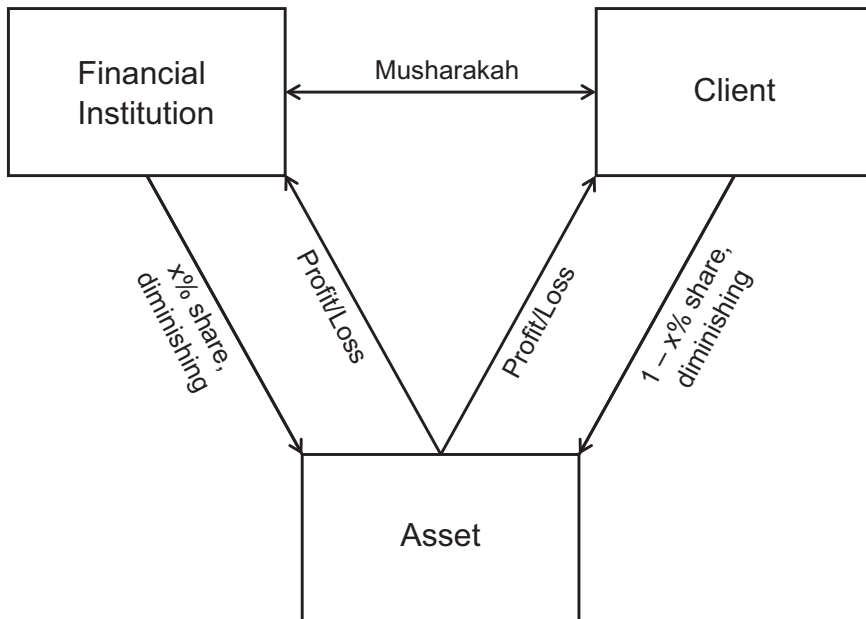


Figure 8.3 Structure of Diminishing *Musharakah*

Source: Diagram by the authors.

Box 8.2 Practical Insight: Bank Alfalah Home *Musharakah*

Alfalah Home *Musharakah* is a *Shariah*-compliant housing finance solution that adheres to the principles of *Shari'ah*, ensuring it is free from *Riba*. It follows the concept of diminishing *Musharakah*. The solution offers various options such as purchasing a property, financing for builders, home renovation, balance transfer, and green finance for solar energy solutions. It provides flexible tenures of up to 25 years, financing of up to 80% of the property value, and offers both equal and unequal monthly instalment unit purchase options. The option to include a co-applicant is available, and the documentation and processing fee requirements are minimal (Bank Alfalah, 2023).

Box 8.3 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) Debt financing introduces an element of leverage in the business.
- 2) An institution that provides equity financing is never responsible for losses of the business.
- 3) In a *Musharakah*, losses are shared in the same proportion as the profits of the business.
- 4) The profit-sharing ratio cannot change in constant *Musharakah*.
- 5) In a diminishing *Musharakah*, the equity share of one partner is transferred completely to another over a fixed period.

Solution:

- 1) True.
- 2) False. The institution that provides the equity financing becomes an equity holder of the business. Hence, it takes on all the responsibilities of equity holders. One of those responsibilities is to share in the losses of the business.
- 3) False. In a *Musharakah*, losses are not shared in the same proportion as the profits of the business. Losses, in a *Musharakah* contract are always shared among the partners according to their share of the equity capital.
- 4) False. In a constant *Musharakah*, the profit-sharing ratio can change. But the equity shares of partners always remain constant.
- 5) True.

8.3 AAOIFI Accounting Treatment

8.3.1 Initial Recognition and Measurement

Initial recognition of *Musharakah* capital is similar for all types of *Musharakah* contracts. An Islamic bank should recognise the *Musharakah* financing capital when it is made available to the client (who is also the partner in the *Musharakah* contract). In the case of a single payment, it should be recognised when cash is paid, or funds are transferred to the client account. In the case of instalments, then each instalment shall be recognised at the time of its payment.

Box 8.4 Illustration 8.1 Initial Recognition of *Musharakah* Capital

An Islamic bank agreed on Jan 1, 2023, to provide finance to the client through a *Musharakah* contract. After completion of the formal process and documentation, on Jan 25, 2023, the bank processed the transfer of funds to the client's account. The funds were successfully transferred to the client's account on Feb 1, 2023.

Requirement: When should the *Musharakah* contract be recognised by the bank?

Solution:

The Islamic bank should recognise the *Musharakah* capital on Feb 1, 2023.

8.3.1.1 Measurement of *Musharakah* Costs (Pre-*Musharakah*)

Both parties may make some expenses in the pre-*Musharakah* period. These expenses should not be included in the *Musharakah* capital but rather should be charged to the profit and loss account of the respective entity. However, if it is agreed between both parties, these expenses may be added to the *Musharakah* capital.

Box 8.5 Illustration 8.2 Recording *Musharakah* Expenses

Al-Meezan Islamic Bank hired a consultant to conduct a feasibility study of a commercial plaza to evaluate the profitability of the project proposed by the client in December. It paid PKR 40,000 to the consultant. Both parties agreed that the bank can add this amount to *Musharakah* capital. The bank provided PKR 760,000 under the *Musharakah* financing contract.

Requirement: How should the bank recognise the *Musharakah* capital and associated costs?

Solution:

The Islamic bank should recognise the *Musharakah* capital with the total funds delivered and the cost incurred in this respect. The accounting entry will be:

	Dr.	Cr.
Dec 15 <i>Musharakah</i> Capital (Asset)	800,000	
Cash/Bank (Asset)		760,000
Preliminary Expenses (Expense)		40,000
<i>(To record the payment of funds and preliminary expenses as Musharakah capital)</i>		

Box 8.6 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) *Musharakah* capital is recognised when the bank expresses its intention to provide *Musharakah* financing to a client.
- 2) Initially, *Musharakah* capital is recognised at the face value of the funds provided to the client.
- 3) If the *Musharakah* financing is provided in kind, that is, some tangible asset other than cash, then *Musharakah* capital is always recognised at the book value of the asset provided.
- 4) In *Musharakah*, if the book value of the asset and the value at which *Musharakah* capital is recognised are different, then the difference is capitalised by the bank.
- 5) Expenses incurred in the pre-*Musharakah* period that are related to the *Musharakah* should always be charged to the profit and loss account of the respective entity, unless otherwise agreed by the parties.

Solution:

- 1) False. An Islamic bank should recognise the *Musharakah* financing capital when it is made available to the client (who is also the partner in the *Musharakah* contract). It means that when the funds have been paid to the client or have been made available on account to the client.

- 2) True.
- 3) False. In the case of funds in kind, it is usually possible that the value agreed between the client and the bank is different from the book value of the asset. In a case, where the asset has been recognised at fair value or the value agreed between the client and the bank, the difference between the value agreed and the book value of the asset will be recognised in the profit and loss account for the period.
- 4) False. In a case where the asset has been recognised at the value agreed between the client and the bank, the difference between the value agreed and the book value of the asset will be recognised in the profit and loss account for the period.
- 5) True.

8.3.1.2 Measurement of Musharakah Capital

Islamic banks should measure the *Musharakah* capital paid in cash at the face value of cash paid. However, if all or part of the fund is in kind, such assets should be measured at the value agreed between the bank and the client. The accounting entry to record this capital is shown in Illustration 8.3.

Box 8.7 Illustration 8.3 Measurement of *Musharakah* Capital

On May 21, 2023, Berhad Islamic Bank provided MYR 100,000 in cash and an office apartment to a *Musharakah* for investment in a real estate project. The fair value of the apartment was determined to be MYR 300,000.

Requirement: How should the bank recognise the *Musharakah* capital in its books?

Solution:

Berhad Islamic Bank should recognise the *Musharakah* capital at a value equal to the cash funds transferred to the *Musharakah* and the agreed value of the apartment. The accounting entry will be:

	Dr.	Cr.
May 21		
<i>Musharakah</i> Capital (Asset)	400,000	
Cash/Bank (Asset)		100,000
Office Apartment (Asset)		300,000
<i>(To record the payment of cash and an office apartment as Musharakah capital)</i>		

However, if the agreed value is different from the book value of the asset, the difference should be recognised in the profit and loss account for the period.

Box 8.8 Illustration 8.4 Recording Profit on Musharakah Capital

On Jul 17, 2023, Al-Riyadh Financiers transferred a commercial plot to its customer under *Musharakah* financing. The bank purchased this property last year at SAR 100,000 and was reporting it in its financial statements using the historical cost method. Both parties agreed on the value of the property for the purpose of the *Musharakah* will be SAR 175,000.

Requirement: How should the bank recognise the *Musharakah* capital in its books?

Solution:

The Islamic bank should recognise the *Musharakah* capital at the value agreed with the customer. The accounting entry will be:

	<i>Dr.</i>	<i>Cr.</i>
Jul 17 <i>Musharakah</i> Capital (Asset)	175,000	
Office Apartment (Asset)		100,000
Gain (Income)		75,000
<i>(To record the payment of apartment as Musharakah capital)</i>		

8.3.2 Subsequent Measurement of Constant Musharakah

8.3.2.1 Single-Period Musharakah

Islamic banks should recognise the profit/(loss) resulting from a *Musharakah* investment in the year in which it was earned. For a single-period *Musharakah* (that commences and ends during a single accounting period), whether constant *Musharakah* or diminishing *Musharakah*, the profit or loss shall be recognised at the time of liquidation of the *Musharakah*.

Box 8.9 Illustration 8.5 Single-Period Musharakah

Marhaba Islamic Bank signed a short-term *Musharakah* contract with a client to import and sell a product. The funds were transferred on Jan 3, 2023, and the transaction cycle was completed on Apr 30, 2023. The *Musharakah* investment made by the bank was MYR 700,000, and the net profit earned on the investment was MYR 80,000. The profit-sharing ratio was 70:30 (bank:customer).

Requirement: How should the bank record liquidation of the *Musharakah* in its books?

Solution:

Marhaba Bank should recognise the profit of MYR 56,000 (USD 80,000 \times 70%) on the liquidation of *Musharakah* on Apr 30, 2023. The accounting entry will be:

	Dr.	Cr.
Apr 30	Cash (Asset)	756,000
	Gain on <i>Musharakah</i> (Income)	56,000
	<i>Musharakah</i> Capital (Asset)	700,000
	<i>(To record the profit earned on Musharakah investment)</i>	

8.3.2.2 Multi-Period Musharakah

In the case of multi-period constant *Musharakah* financing (that continues for more than an accounting period), Islamic bank's share of profit should be recognised when it is distributed. However, at distribution, the IFI may choose to reinvest the profit back into the venture.

Box 8.10 Illustration 8.6 Multi-Period *Musharakah*

Al-Hamd Al-Sani Islamic Bank signed a multi-period *Musharakah* contract with a client. The contract was signed on Jan 1, 2023, and the bank provided financing of SAR 3,000,000. At the end of the first year of operations, the *Musharakah* earned a profit of SAR 400,000. The profit-sharing ratios of the bank and client are 60% and 40%, respectively.

Requirement: How should the bank recognise the profit on the *Musharakah* at the end of the first year in its books?

Solution:

The Islamic bank should recognise the profit of SAR 240,000 (USD 400,000 \times 60%) when received by the bank. The accounting entry will be:

	Dr.	Cr.
Dec 31	Cash (Asset)	240,000
	Profit on <i>Musharakah</i> (Income)	240,000
	<i>(To record the profit on Musharakah investment)</i>	

Box 8.11 Illustration 8.7 Profit on Musharakah

In the aforementioned example, the management of the *Musharakah* came to know an opportunity to reinvest the profits in the business. After securing the consent of the bank, the management reinvested the whole profit of SAR 400,000 to enhance the production capacity of the business.

Requirement: Should the bank recognise the profit in its books?

Solution:

The Islamic bank should not recognise any profit in the period.

In case of loss to the *Musharakah* entity, the Islamic bank should recognise the loss by paying in cash or adjusting the loss to the *Musharakah* capital.

Box 8.12 Illustration 8.8 Loss on Musharakah Capital

Tabarak El-Rehm Bank provided *Musharakah* capital of PKR 350,000 to a client for a business start-up. At the end of the first year of operations, the start-up incurred a loss of AED 200,000.

Requirement: How should the bank recognise the loss in its books?

Solution:

The Islamic bank should recognise a loss of AED 200,000. The accounting entry will be:

		Dr.	Cr.
Dec 31	Loss on <i>Musharakah</i> (Expense)	200,000	
	<i>Musharakah</i> Capital (Asset)		200,000
	<i>(To record the loss on Musharakah investment)</i>		

8.3.3 Subsequent Measurement of Diminishing Musharakah

8.3.3.1 Year-End Measurement of Musharakah Capital

Islamic banks should continue recognising the *Musharakah* capital at its historical cost at which it was initially recognised. However, in the case of diminishing *Musharakah*, the value of the investment in the books of the Islamic

bank should be reduced by the amount of the repayment of *Musharakah* capital by the client.

Box 8.13 Illustration 8.9 Year-End Measurement of *Musharakah* Capital

Al-Najoom First Islamic Bank advanced BHD 300,000 to a client under a *Musharakah* arrangement and owned 30% of the equity of the business. At the end of the period, on Dec 31, as stipulated in the contract, the client paid back BHD 100,000 of the principal.

Requirement: How should the bank adjust the *Musharakah* capital in its books at the end of the period?

Solution:

The bank should reduce the amount of its *Musharakah* capital by BHD 100,000. The accounting entry will be:

		Dr.	Cr.
Dec 31	Cash (Asset)	100,000	
	<i>Musharakah</i> Capital (Asset)		100,000
	<i>(To record the reduction of Musharakah capital)</i>		

8.3.3.2 Multi-Period Diminishing Musharakah

In a multi-period diminishing *Musharakah* (when the financing is done for more than one accounting period), profit or loss is recognised for each period and the *Musharakah* investment account is also reduced.

Box 8.14 Illustration 8.10 Multi-Period Profit in Diminishing *Musharakah*

Tehwar Islamic Bank signed a diminishing *Musharakah* contract with a client for the construction of a housing unit. Tehwar provided AED 200,000, and the client invested AED 300,000. Both parties agreed to share profit and loss proportionate to their capital ratios.

The rent agreed in the contract is AED 100,000 per annum. It is further agreed that the client will purchase an equity share of the bank worth AED 100,000 each year.

Requirement: How should the Islamic bank recognise this in its books?

Solution:

The Islamic bank will recognise its share of income and decline in its ownership. The bank will recognise a *Musharakah* income of AED 40,000 ($100,000 \times 40\%$). The accounting entry will be:

		Dr.	Cr.
Jun 30	Cash (Asset)	40,000	
	Gain on <i>Musharakah</i> (Income)		40,000
	<i>(To record the profit on Musharakah investment)</i>		

The bank will also recognise the proceeds of AED 100,000 against the sale of 20% of the equity capital. The accounting entry will be:

		Dr.	Cr.
Jun 30	Cash (Asset)	100,000	
	<i>Musharakah</i> Capital (Asset)		100,000
	<i>(To record the sale of equity capital on Musharakah investment)</i>		

8.3.4 Accounting on Liquidation

On liquidation of both diminishing and constant *Musharakah*, an Islamic bank will recover its capital invested in the *Musharakah*. The profit/loss, which is not due to the misconduct or negligence of the client, should be recognised at the time of liquidation. However, if the client fails to pay the cash on liquidation or if losses are due to misconduct or negligence, the Islamic bank should record a receivable from the client.

Box 8.15 Illustration 8.11 Liquidation of *Musharakah*

An Islamic bank has a *Musharakah* investment of BHD 100,000. On liquidation, only BHD 80,000 could be recovered. The loss was due to normal business factors.

Requirement: How should the Islamic bank recognise the liquidation in its books?

Solution:

At the year-end, the Islamic bank should recognise a loss of BHD 20,000 on liquidation that will be charged to the profit and loss account. The accounting entry will be:

		Dr.	Cr.
Dec 31	Cash/ <i>Musharakah</i> Receivable (Asset)	80,000	
	Loss on <i>Musharakah</i> (Expense)	20,000	
	<i>Musharakah</i> Capital (Asset)		100,000
	<i>(To record the loss on liquidation of Musharakah investment)</i>		

Box 8.16 Practical Insight: *Musharakah Mutanaqisah* (MM)

Although MM seems to be a great alternative for property financing in Malaysia, its implementation is surrounded by several legal challenges. It has been revealed in research that the legal challenges in an MM contract relate to the concerns regarding legal ownership of the MM property, restrictions imposed on the duties and responsibilities of the bank and the customer by the Malaysian legal system and its maintenance and repairs. Some of the restrictions imposed by the government include the legal requirement to get Foreign Investment Committee's recommendation with regard to MM partnerships in case the customer is foreign under Malaysian laws. Moreover, property financing for uncompleted assets is subject to several legal and operational risks such as determinations of rights and obligations of the parties, the commencement of a "diminishing" portion of the shares from the bank to be acquired by the customer and the risks of projects being uncompleted (Nor et al., 2019).

8.4 Presentation and Disclosure

The following sample balance sheet shows how *Musharakah* is typically presented in the statement of financial position of Islamic banks.

Ihsan Islamic Bank		
Statement of Financial Position as at 31 December 2023		
	2022	2023
	USD	USD
Assets		
Receivables	xx	xx
Musharakah Capital	xx	xx
Investments	xx	xx
Ijarah Muntahia Bittamleek	xx	xx
Salam Financing	xx	xx
Investment in Real Estate	xx	xx
Building and Fixtures	xx	xx
Goodwill	xx	xx
Other Assets	xx	xx
Liabilities		
Bills Payable	xx	xx
Borrowings	xx	xx
Deposits and Other Accounts	xx	xx
Parallel Salam	xx	xx
Accrued Expenses and Other Payables	xx	xx
Due to Related Parties	xx	xx
Subordinated Debts	xx	xx
Deferred Tax Liabilities	xx	xx
Other Liabilities	xx	xx

In addition to the disclosure requirements of FAS 1: General Presentation and Disclosure in the Financial Statement of Islamic Bank and Financial Institutions, FAS 4 requires an Islamic bank to make appropriate disclosure in the notes to the financial statements regarding the decline in the value of *Musharakah* investments.

Box 8.17 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) In case of a constant *Musharakah*, Islamic banks should continue to recognise the *Musharakah* capital at its cash equivalent price.
- 2) For a single-period *Musharakah*, different accounting treatments are used to recognise profit for the constant and diminishing *Musharakah*.
- 3) In the case of multi-period constant *Musharakah* financing, an Islamic bank’s share of profit should be recognised when it is distributed.

- 4) For a diminishing *Musharakah*, the Islamic bank will recognise the decline in the *Musharakah* capital at the end of each year, and all the profit/loss will be recognised at the time of liquidation of the *Musharakah*.
- 5) On liquidation of *Musharakah*, the Islamic bank will recover its capital invested in the *Musharakah*. The profit/loss, which is not due to the misconduct or negligence of the client, should be recognised at the time of liquidation.

Solution:

- 1) False. In case of a constant *Musharakah*, Islamic banks should continue to recognise the *Musharakah* capital at its historical cost at which it was initially recognised.
- 2) False. For a single-period *Musharakah*, different accounting treatments are used to recognise profit for the constant and diminishing *Musharakah*, though the underlying concept remains the same. For a single-period *Musharakah* (a *Musharakah* that commences and ends during a single accounting period), the profit or loss shall be recognised at the time of liquidation of the *Musharakah*.
- 3) True.
- 4) False. In the case of diminishing *Musharakah*, the Islamic bank will recognise its share of the profit and will also recognise the decline in the *Musharakah* capital at the end of each year, in addition to liquidation.
- 5) True.

8.5 IFRS Perspective

The IFRS Perspective for Shirkah contracts (Mudaraba and Musharakah) is covered in Chapter 7.

Box 8.17 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) Under IFRS, the Islamic bank will recognise the *Musharakah* initially at the fair value of the funds and assets in kinds invested in the *Musharakah*.
- 2) Expenses incurred in the process of forming a *Musharakah* contract should be added to the *Musharakah* capital by the Islamic bank.

- 3) In the case of multi-period *Musharakah* financing, Islamic banks will recognise their share of the revenue and expenses at the end of each accounting period.
- 4) For a diminishing *Musharakah*, the Islamic bank will recognise the decline in the *Musharakah* capital at the end of each year, and all the profit/loss will be recognised at liquidation of the *Musharakah*.
- 5) On liquidation of *Musharakah*, the Islamic bank will recover its capital invested in the *Musharakah*. The profit/loss, which is not due to the misconduct or negligence of the client, should be recognised at the time of liquidation.

Solution:

- 1) True.
- 2) False. Both parties may incur some expenses in the pre-*Musharakah* period that are related to the *Musharakah*. These expenses should not be included in the *Musharakah* capital but rather should be charged to the profit and loss account of the respective entity.
- 3) True.
- 4) False. In the case of diminishing *Musharakah*, at the end of each accounting period, the Islamic bank will recognise its share of the profit and also the decline in the *Musharakah* capital at the end of each year.
- 5) True.

8.6 Chapter Summary

- *Musharakah* is a form of partnership between the Islamic bank and its clients, whereby each party contributes to the capital of the partnership in equal or varying degrees to establish a new project or share in an existing one and whereby each of the parties becomes an owner of the capital on a permanent or declining basis and shall have his due share of profits. However, losses are shared in proportion to the contributed capital. It is not permissible to stipulate otherwise. (LO 1)
- There are two types of *Musharakah* contracts, constant *Musharakah* and diminishing *Musharakah*. Constant *Musharakah* is a contract in which the ratio of capital and ownership remains the same over the life of *Musharakah*. Diminishing *Musharakah* is a contract in which one party gradually transfers the ownership of the *Musharakah* asset to the other party. (LO 2)
- It is recognised as a capital investment. Initial recognition of *Musharakah* capital is similar for both types of *Musharakah* contracts. An Islamic

bank should recognise the *Musharakah* financing capital when it is made available to the client (who is also the partner in the *Musharakah* contract). In the case of a single payment, it should be recognised when the cash is paid, or funds are transferred to the client account. In the case of instalments, each instalment shall be recognised at the time of its payment. (LO 3)

- Islamic banks should continue recognising the *Musharakah* capital at its historical cost at which it was initially recognised. However, in the case of diminishing *Musharakah*, the value of investment should be reduced if there is any repayment of *Musharakah* capital by the client. For a single-period *Musharakah* (that commences and ends during a single accounting period), whether constant *Musharakah* or diminishing *Musharakah*, the profit or loss shall be recognised at the time of liquidation of the *Musharakah*. (LO 3)
- In addition to the disclosure requirements of FAS 1: General Presentation and Disclosure in the Financial Statement of Islamic Bank and Financial Institutions, FAS 4 requires an Islamic bank to make appropriate disclosure in the notes to the financial statements regarding the decline in the value of investments. (LO 3)
- Under IFRS, an IFI may account for an investment in a *Musharakah* in any of the following ways depending upon how exactly the transaction is structured:
 - 1 As a financial asset
 - 2 As an investment in a subsidiary or associate
 - 3 As a joint arrangement (LO 4)

8.7 Key Terms and Definitions

- **Constant *Musharakah*:** A *Musharakah* in which the partners' shares in the capital remain constant throughout the period as specified in the contract.
- **Diminishing *Musharakah*:** A *Musharakah* in which the Islamic bank agrees to transfer gradually to the other partner its (the Islamic bank's) share in the *Musharakah* so that the Islamic bank's share declines and the other partner's share increases until the latter becomes the sole proprietor of the venture.
- ***Musharakah*:** A form of partnership between the Islamic bank and its clients whereby each party contributes to the capital of partnership in equal or varying degrees to establish a new project or share in an existing one, and whereby each of the parties becomes an owner of the capital on a permanent or declining basis and shall have his due share of profits. However, losses are shared in proportion to the contributed capital. It is not permissible to stipulate otherwise.

8.8 Appendix: *Musharakah* Around the World

The following table shows an overview of *Musharakah* practices by banks around the world (Moriguchi et al., 2016).

<i>Country</i>	<i>Practices</i>	<i>Bank Name</i>
Ireland	Diminishing <i>Musharakah</i> /Hire Purchase	Regulation only
Luxembourg	<i>Musharakah</i> Deposit <i>Sukuk al-Musharakah</i> Undertakings for Collective Investments in Transferable Securities (UCITS) Specialised Investment Funds (SIF)	KBL European Private Bankers (KBL EPB)/Islamic Liquidity Management Blackrock Alliance for Luxembourg Islamic Finance (ALIF) SEDCO Capital
Turkey	<i>Sukuk al-Musharakah</i>	Regulation only
United Kingdom	<i>Sukuk al-Musharakah</i> Diminishing <i>Musharakah</i>	Sanctuary Building/Lloyds TSB Al Rayan Bank
USA	<i>Sukuk al-Musharakah</i> Diminishing <i>Musharakah</i>	East Cameron Gas Devon Bank Zayan Finance Guidance Residential La <i>Riba</i> – American Finance House/Bank of Whittier
Saudi Arabia	Equity Financing <i>Musharakah</i> Letter of Credit (L/C) <i>Musharakah</i> for Corporate Finance	Islamic Development Bank (IDB) Al-Hamd Al-Sani Bank
Oman	<i>Musharakah</i> in Agricultural Sector Diminishing <i>Musharakah</i> : Business Diminishing <i>Musharakah</i> : Property Diminishing <i>Musharakah</i> : Home Financing	Government Policy MUZN Islamic Banking MEETHAQ Islamic Banking
Kuwait	Diminishing <i>Musharakah</i> : Home Financing	Kuwait Finance House
Bahrain	<i>Musharakah</i> Financing	Islamic Bank of Bahrain
UAE	<i>Musharakah</i> Financing Cooperate <i>Sukuk</i> : Al <i>Musharakah</i>	Abu Dhabi National Bank Tabarak El-Rehm Bank Emirates Islamic Bank
Egypt	<i>Musharakah</i> Business Financing (Agriculture, Industry)	Al Baraka Bank Egypt A.T. Asset Management A.T. Brokerage Faisal Islamic Bank Ridge Islamic Capital
South Africa	<i>Musharakah</i> Business Property Financing	Absa Islamic Banking (Islamic Window) Tehwar Bank

<i>Country</i>	<i>Practices</i>	<i>Bank Name</i>
Morocco	Diminishing <i>Musharakah</i> <i>Musharakah</i> Business Financing	Attijari Wafa Bank Banque Populaire BMCE BMCI
Sudan	<i>Musharakah</i> Business Financing (Agriculture, Industry, Trading) <i>Sukuk Al Musharakah</i>	African Bank for Trade and Development Agricultural Bank Animal Resources' Bank
Malaysia	<i>Sukuk Musharakah</i> Diminishing <i>Musharakah</i> Outward Letter of Credit	Bank Islam Malaysia Berhad Maybank Islamic Affin Islamic Bank AmIslamic Bank CIMB Islamic Bank Public Islamic Bank RHB Islamic Bank Bank Muamalat Malaysia
Indonesia	Diminishing <i>Musharakah</i> <i>Sukuk</i> Diminishing <i>Musharakah</i>	PT Bank Muamalat Indonesia PT Bank Syariah Mandiri PT Mega Bank Syariah PT Bank Syariah BRI PT Bank Syariah Bukopin PT Panin Bank Syariah PT Bank Victoria Syariah PT BCA Syariah PT Bank Jabar dan Banten PT Bank Syariah BNI PT Maybank Indonesia Syariah PT Bank Tabungan Pensiunan Nasional Syariah
Singapore	<i>Sukuk Musharakah</i> Diminishing <i>Musharakah</i>	UOB Majlis Ugama Islam Singapura (MUIS) Monetary Authority of Singapore (MAS) (Diminishing <i>Musharakah</i> – only regulation in place)
Brunei	Diminishing <i>Musharakah</i> (Home Financing) <i>Musharakah</i> Corporate Financing BIBD <i>Musharakah Musahamah</i> Al-Bai Tradable <i>Musharakah</i> Certificate	Bank Islam Brunei DarusSalam (BIDB)

8.9 Review Questions

- Two parties decided to construct a commercial building. Party A will invest SAR 1,500,000, and Party B will invest SAR 850,000. Both parties agreed that profit and loss will be shared in proportion of the equity each partner holds. In addition, Party A also agreed to purchase the equity

share of Party B over a period of five years. At the end of each year, Party A will make a payment of SAR 170,000 to acquire equity from Party B. This is an example of which type of contract.

- a) Constant *Musharakah*
 - b) Diminishing *Musharakah*
 - c) Multi-period constant *Musharakah*
 - d) Single-period diminishing *Musharakah*
- 2 On Mar 23, 2023, MLA Islamic Bank transferred cash of PKR 300,000 and an apartment to a client. The bank had acquired the apartment for PKR 200,000, and the current book value of the apartment is equal to PKR 150,000. Partners in *Musharakah* agreed that the apartment was worth PKR 300,000. What is the total contribution of the bank in the *Musharakah*?
- a) 500,000
 - b) 350,000
 - c) 450,000
 - d) 600,000
- 3 On May 12, 2023, TRS Islamic Bank transferred cash of SAR 300,000 and an apartment to a client. The bank had acquired the apartment for SAR 200,000, and the current book value of the apartment is equal to SAR 150,000. Partners in *Musharakah* agreed that the apartment was worth SAR 300,000. What would TRS recognise as gain/loss?
- a) 150,000
 - b) 200,000
 - c) 100,000
 - d) 300,000
- 4 HUK Islamic Bank advanced BD 200,000 to a client under a *Musharakah* arrangement and owns 40% of the equity of the business. At the end of the period, on December 31, 2023, as stipulated in the contract, the client paid back BD 100,000 of the principal. The accounting entry will be:
- a) Debit Cash by 100,000, Credit *Musharakah* Capital by 100,000
 - b) Debit *Musharakah* Capital by 100,000, Credit Cash by 100,000
 - c) Debit Cash by 120,000, Credit *Musharakah* Capital by 120,000
 - d) Debit *Musharakah* Capital by 120,000, Credit Cash by 120,000
- 5 For a single-period *Musharakah*, whether constant *Musharakah* or diminishing *Musharakah*, the profit or loss shall be recognised:
- a) When the profit is distributed to the partners
 - b) At the year-end

- c) When the *Musharakah* is liquidated
 d) At the start of the accounting period
- 6 On January 3, 2023, LFA Islamic Bank signed a diminishing *Musharakah* contract with a client for the construction of a housing unit. The bank contributed AED 200,000 and the client invested AED 300,000. Both parties agreed to share profit and loss in proportion of their capital ratios at the start of the year. The rent agreed in the contract is AED 100,000 per annum. At the end of each period, AED 50,000 of *Musharakah* will be transferred from the bank to the client. What will be the share of profit of the bank at the end of the second year?
- a) 20,000
 b) 50,000
 c) 30,000
 d) 25,000
- 7 TAR Islamic Bank made a five-year-long *Musharakah* investment on January 12, 2023. The total *Musharakah* investment capital provided by the bank was SAR 100,000. On liquidation, only USD 80,000 could be recovered. The loss was due to normal business factors. How will the bank recognise the transaction at the time of liquidation of *Musharakah* contract?
- a) Debit: Cash = SAR 100,000
 Credit: *Musharakah* Capital = SAR100,000
 b) Debit: Cash = SAR 80,000, *Musharakah* Loss = SAR 20,000
 Credit: *Musharakah* Capital = SAR 100,000
 c) Debit: Cash = SAR 100,000, *Musharakah* Receivable = SAR 20,000
 Credit: *Musharakah* Capital = SAR 100,000
 d) Debit: Cash = SAR 80,000,
 Credit: *Musharakah* Capital = SAR 80,000
- 8 On February 3, 2023, Tehwar Islamic provided AED 100,000 in cash and a commercial apartment as *Musharakah* capital for investment in a real estate project. At the time of the transfer, the fair price of the apartment was AED 300,000, and the book value of the apartment is AED 200,000. Under IFRS, how will the Islamic bank recognise the transaction on February 3, 2023?
- a) Debit: *Musharakah* Capital = 300,000
 Credit: Cash = 100,000, Office Apartment = 200,000
 b) Debit: *Musharakah* Capital = 400,000
 Credit: Cash = 100,000, Office Apartment = 300,000
 c) Debit: *Musharakah* Capital = 300,000
 Credit: Office Apartment = 300,000
 d) Debit: *Musharakah* Capital = 100,000
 Credit: Cash = 100,000

- 9 A joint arrangement whereby the parties that have joint control of the arrangement have rights to the assets, and obligations for the liabilities, relating to the arrangement is known as:
 - a) Joint venture
 - b) Joint operation
 - c) Joint control
 - d) Joint arrangement
- 10 To classify a joint arrangement as either a joint operation or a joint venture, the Islamic bank should consider:
 - a) Structure and legal form of any separate vehicle
 - b) Expenses, including its share of any expenses incurred jointly
 - c) Assets, including its share of any assets held jointly
 - d) Liabilities, including its share of any liabilities incurred jointly

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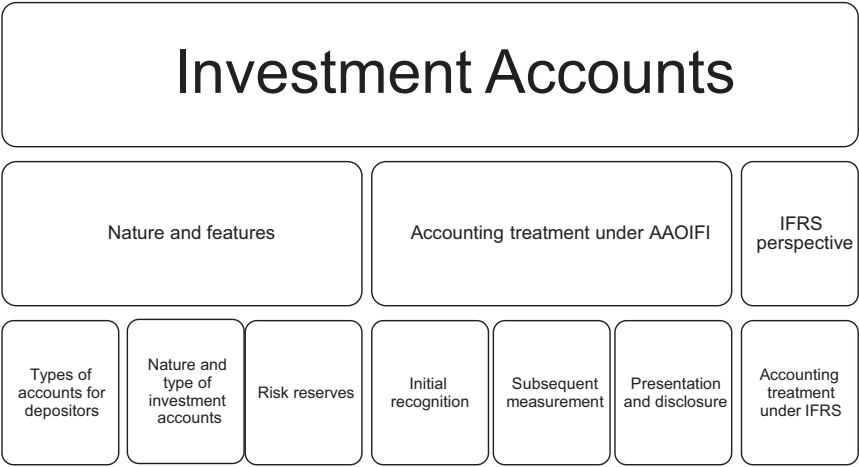
9 Investment Accounts

Learning Objectives

After going through this chapter, you should be able to:

- 1 Describe the nature of investment accounts.
- 2 Describe the accounting entries, presentation, and disclosure requirements of investment accounts under FAS 27: Investment Accounts.
- 3 Describe the accounting entries, presentation, and disclosure of risk reserves under FAS 35: Risk Reserves.
- 4 Identify the key difference between IFRS and AAOIFI accounting for investment accounts and risk reserves.

Chapter Preview



Cover Story

Bank Nizwa, the leading Islamic bank in Oman, offers a diverse array of savings and investment solutions that cater for the diverse needs of individuals. In addition to conventional options like current and savings accounts, the bank provides a range of innovative products such as *Mudaraba* investment accounts, *Wakalah* investment, and recurring deposit accounts, amongst others. The *Mudaraba* investment account enables customers to grow their funds at highly competitive profit rates, offering an attractive opportunity for wealth accumulation. For individuals seeking long-term savings solutions, such as retirement planning or saving for their families, the recurring deposit option offers higher profit rates, ensuring better returns over time.

Bank Nizwa's investment account portfolio not only facilitates the practice of saving but also encourages individuals to invest and grow their funds. These accounts are designed to minimise risks and operate within the principles of *Shariah*-compliant financing, providing customers with a sense of security and peace of mind. By aligning its offerings with Islamic principles, Bank Nizwa enables customers to make financial choices that are in line with their values (Bank Nizwa, 2020).

9.1 Introduction to Types of Accounts for Depositors

The primary role of a bank is that of an intermediary: attracting funds from depositors with excess cash and advancing the same to financing customers who are in need of financing. All banks, including Islamic banks, offer different types of deposit accounts with distinct features, facilities, risks, and rewards. In general, the accounts offered by a bank can be classified into two main categories: current and investment accounts. These are briefly discussed in the next subsections.

9.1.1 Current Accounts

A current account is used for parking the client's funds for the safety of the money against the guarantee of the bank. The bank will return the money whenever demanded by the customer. Therefore, a current account is sometimes also called the "Demand Deposit Account". Due to the short-term nature of these accounts, the funds in current accounts do not earn any return.

In Islamic banking, the banks generally use *Qard* as an underlying contract to obtain funds for the current account. Under the *Qard* arrangement, an Islamic bank is entitled to use the depositors' funds to finance its operations and guarantees the repayment of funds to the depositors whenever demanded by the depositor. However, no return, in any form and shape¹ is given to the customer on the principal amount invested in the current accounts, no matter how long the funds remain with the Islamic bank.



Figure 9.1 Contracts for Current Accounts

Source: Diagram by the authors.

A pictorial representation of contracts used for current accounts is shown in Figure 9.1.

9.1.2 Investment Accounts

Investment accounts are used for funds deposited with an Islamic bank for an extended period of time. From the point of view of the depositor, the investment accounts are less liquid than current accounts but earn profits for the investors not available in the current accounts. Investment accounts in Islamic banking are different from their conventional counterparts. In conventional banking, the funds in deposit accounts are considered a liability where the depositors are paid interest on the principal amount by the bank. In contrast, the customers in Islamic banks “invest” money with the bank through these investment accounts to earn profits.

Islamic banks may use different underlying contracts for the creation of these investment accounts. These contracts define the nature and major terms and conditions of these investment accounts, including the mode of distribution of profits on the investments. The most prominent investment accounts are *Mudaraba* and *Al-Wakalah Bi Al-Istithmar*.

Mudaraba is probably one of the most widely used contracts for investment accounts. It is a partnership contract between a client and a bank (discussed in Chapter 6). Profits are shared as per the agreed profit-sharing ratio between the depositors and an Islamic bank. Losses, if any, are borne by the depositors.

Wakalah is an “agency agreement” in which the depositor appoints the Islamic bank as an agent to invest the funds and earn a desired rate of return. Unlike *Mudaraba*, there is no profit-sharing. Instead, the depositors give an agency fee to the bank in return for its (investment agency) services.

Some Islamic banks may offer investment accounts based on *Mudaraba Muqayyadah* (restricted *Mudaraba*), which is also a partnership contract with certain restrictions on the Islamic bank regarding the utilisation and control of the funds.

Box 9.1 Practical Insight: Fidelity Investments’ Iman Fund

Fidelity Investments has introduced the Iman Fund, an investment fund in the United States that focuses on investing in common stocks and equity-related securities of both domestic and foreign issuers. The

fund follows Islamic principles and seeks to identify securities with the potential for long-term price appreciation. It adheres to guidelines that exclude certain industries such as alcohol, pornography, and gambling. Additionally, investments in interest-bearing debt obligations or businesses primarily reliant on interest income are avoided. The Iman Fund provides investors an opportunity to align their investments with Islamic principles while aiming for capital growth over time (Fidelity, 2023).

9.2 Nature and Types of Investment Accounts

9.2.1 *An Overview of the Investment Accounts Process*

Investors deposit cash with Islamic banks for investment purposes. These funds are channelled by the bank into a pool from where diversified investments are made in *Shariah*-compliant avenues. The investment pool generates a return (profit) which is distributed by the bank proportionately to each investor based on his/her share. Investment accounts may be restricted or unrestricted. The restriction is on the usage and control of the funds. In the case of **unrestricted accounts**, investors authorise the Islamic bank to invest the funds based on the *Mudaraba* contract without any restrictions on the deployment or management of the funds.

In **restricted accounts**, there are certain limitations as to the allocation and use of funds for investments. For instance, investment account holders (IAH) may wish to invest their funds in specific asset classes. Investors may also wish to invest a certain proportion in a specific currency. So the bank will need to follow all such restrictions imposed during the time of the contract. This simple process is illustrated in Figure 9.2.

9.2.2 *Investment Accounts Under Mudaraba Contract*

Investment accounts represent the funds received by the Islamic bank from the investors (*Rab al-Maal*) for investment under a partnership agreement. Investment accounts under a *Mudaraba* are also called profit-/loss-sharing accounts (Figure 9.3). Since the partnership under *Mudaraba* is an equity-based partnership, it is important to distinguish between owners' equity and the equity of investment account holders, termed "quasi-equity". Quasi-equity refers to the funds of investment account holders which have been placed with the bank to earn a return. These funds have some characteristics of equity such as profit- and loss-sharing. On the other hand, the terms owners' equity, bank's equity, or shareholders' equity are used interchangeably and refer to the funds that have been provided by the shareholders of the bank.

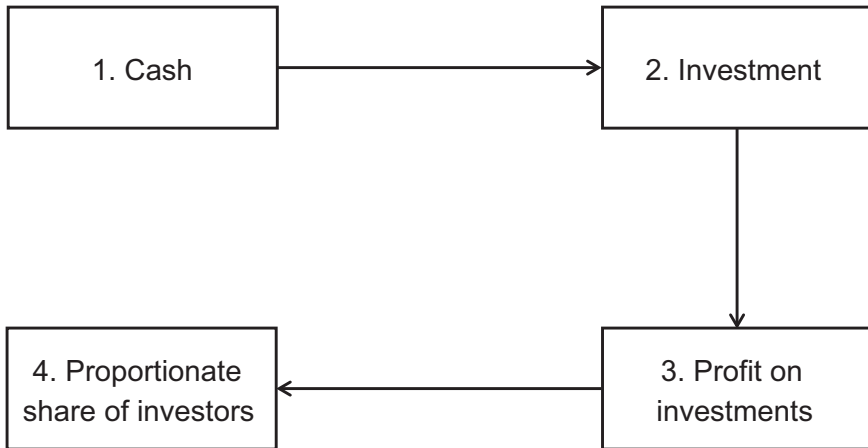


Figure 9.2 Investment Accounts Process

Source: Diagram by the authors.

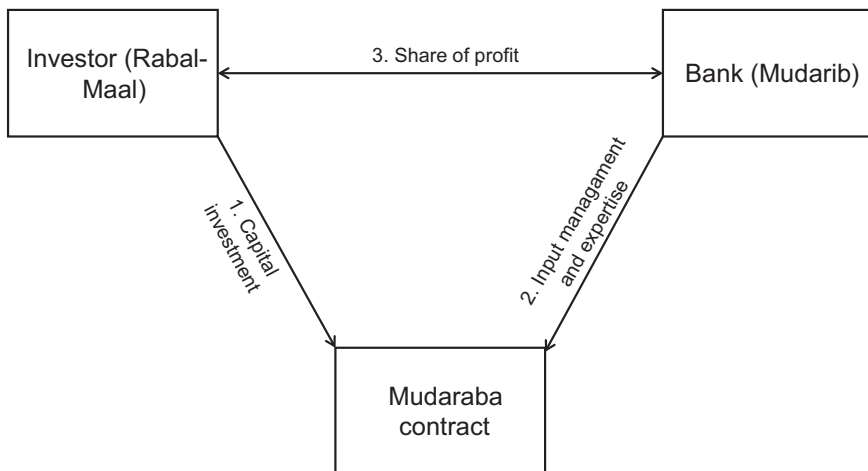


Figure 9.3 Mechanism of a *Mudaraba* Contract

Source: Diagram by the authors.

9.2.3 Investment Accounts Under *Al-Wakalah Bi Al-Istithmar*

Islamic banks may offer investment accounts based on *Al-Wakalah Bi Al-Istithmar* where the investment account holders appoint the bank to invest or grow their wealth. A fixed fee is charged by the Islamic bank for providing its services. Profits and losses belong to the investment account holders in their entirety.

Table 9.1 Comparison Between *Mudaraba* and *Al-Wakalah Bi Al-Istithmar*

<i>Description</i>	<i>Mudaraba</i>	<i>Al-Wakalah Bi Al-Istithmar</i>
Nature of contract	Partnership	Agency
Return type	Profit income (variable)	Fee income (fixed performance incentive may be given)
Profit entitlement	Shared between the depositor and Islamic bank as per the agreed ratio	Profit belongs to the depositor (principal) only
Loss-sharing	Loss belongs to the depositor (<i>Rab al-Maal</i>)	Loss belongs to the depositor (principal)

A performance incentive may be given to the Islamic bank provided a certain rate of return is achieved by the investment. Table 9.1 shows a comparison between *Mudaraba* and *Al-Wakalah Bi Al-Istithmar*.

9.2.4 Use of Risk Reserves for Investment Accounts

Islamic banks need to satisfy operational obligations and specific requirements of the investors and face risks in satisfying those obligations and requirements in a *Shariah*-compliant way. Unlike conventional banks, Islamic banks have a distinct structure because their capital and funding are based on a profit-and-loss-sharing basis – an aspect which changes their overall risk profile. To maintain smooth and market-comparable returns for depositors and other participating stakeholders and to safeguard their long-term interests, Islamic banks create reserves.

Risk reserves are specially designed to mitigate the risk for investment accounts. These are a component of equity that are meant for smoothing profits and providing a buffer against future decline in returns consequent to a decreased return on assets.

9.2.5 Types of Risk Reserves

Based upon the purpose and type of reserves, there are two main types of reserves in use by Islamic banks.

9.2.5.1 Profit Equalisation Reserve (PER)

The **Profit equalisation reserve** (PER) serves as a tool for managing the rate of return risk. To create the PER, an amount from the total *Mudaraba* profit is allocated (to the PER) before giving a share to the *Mudarib*. The PER is used for smoothing the level of returns for the IAHs and the Islamic bank when the rate of return falls below expectations.

9.2.5.2 Investment Risk Reserve (IRR)

The **Investment risk reserve (IRR)** is used to preserve the capital of IAHs. To create an IRR, a specific proportion of distributable profits is allocated after giving the *Mudarib's* share.

The rationale for creating an IRR from the share of investors' profit is that only the *Rab al-Maal* (the IAHs) should bear the loss of capital under a *Mudaraba* contract, and no loss should be transferred to the *Mudarib* (the bank). Accordingly, the funds from the IRR may be utilised to preserve the investment of the IAHs.

Box 9.2 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) *Mudaraba* and *Wakalah* contracts are used to generate funds for current accounts.
- 2) Quasi-equity refers to the funds of investment account holders which have been placed with the bank to earn a return.
- 3) Under unrestricted investment accounts based on *Mudaraba*, the Islamic bank can invest the funds obtained in different avenues, locations, and currencies at its discretion. However, a restriction on investment in a specific asset class is permitted.
- 4) The PER is used for smoothing the level of returns for the IAHs and the Islamic bank when the rate of return is above expectations.

Solution:

- 1) False. *Qard* contracts are used to generate funds for current accounts.
- 2) True.
- 3) False. Funds obtained under unrestricted investment accounts based on *Mudaraba* can be invested in any *Shariah*-compliant asset class.
- 4) False. The PER is used for smoothing the level of returns for the IAHs and the Islamic bank when the rate of return falls below expectations.
- 5) True.

9.3 Accounting Treatment of Investment Accounts

The accounting treatment for investment accounts under a *Mudaraba* contract is prescribed by AAOIFI's Financial Accounting Standard 27, and the presentation and disclosure requirements are prescribed in FAS 1.

Moreover, Islamic banks create two reserves (profit equalisation reserve and investment risk reserve) for hedging the risk in returns and capital of

investment accounts. Accounting for risk reserves is covered in FAS 35 “Risk Reserves”.

The accounting treatment for investment accounts under an investment agency (*Al-Wakalah Bi Al-Istithmar*) arrangement is covered under FAS 31 and is not discussed in this chapter.

9.3.1 *Initial Recognition of Investment Accounts*

Funds received under investment accounts are recognised when the following two conditions are satisfied:

- The cash or cash equivalent consideration has been received by the Islamic bank under a legally enforceable *Mudaraba* contract (or another contract identical to *Mudaraba*).
- There are no contingencies or conditions on which the validity of the contract depends, such as a condition that the contract will become valid only if the expected rate of return is forecasted to be above a certain percentage.

An investment account is initially recognised at the fair value of the consideration received on the date the contract is effective.

Mudaraba based on investment accounts that provide authority over the decisions with regard to the use of and deployment of the funds received by the IFI are treated as equity of investment account holders and are called **on-balance sheet investment accounts**. In case the investment account is categorised as **off-balance sheet**, then the fair value of the consideration received would be recognised once the recognition criteria are met. No journal entry is required to reflect this in the books since this would simply be kept off-balance sheet.

Box 9.3 Illustration 9.1 Recording an On-Balance Sheet Investment Account

On Jul 23, 2023, Mr Ali deposited PKR 100,000 in cash in Al-Subhan Bank as an investment under a *Mudaraba* contract. There are no pre-requisites for the contract. Moreover, the bank has the authority over decisions about the use and deployment of funds.

Requirement: What should be the accounting treatment for this deposit?

Solution:

Since the consideration is paid in cash, there are no pre-conditions for the validity of the contract, and the bank has the authority over

decisions about the use and deployment of the funds; it shall recognise this as quasi-equity.

The accounting entry shall be as follows:

		Dr.	Cr.
Jul 23	Cash (Asset)	100,000	
	Investment Accounts (Quasi-Equity)		100,000
	<i>(To record the on-balance sheet investment account)</i>		

Once the Islamic bank receives the funds from the IAHs, it will place these funds under *Shariah*-compliant investments to generate the desired return. In doing so, the bank records the following journal entry:

		Dr.	Cr.
Date	Investments (Asset)		xx
	Cash (Asset)		xx
	<i>(To record the investment of investment account funds by the Islamic bank)</i>		

9.3.2 Subsequent Measurement of Investment Accounts

Subsequent measurement of investment accounts requires consideration of any undistributed profits, profit equalisation reserves (or other special reserves created specifically for investment account holders) less any losses on assets attributable to investment account holders. Furthermore, investment accounts need to be tested for any possible impairment. Each of these scenarios is discussed here.

9.3.2.1 Accounting for Profits

The process of distributing the total earned profit between the *Mudarib* (the Islamic bank), the IAHs, and the reserves is as follows (Figure 9.4):

- 1 A certain percentage of total profits is allocated to the PER. This gives the distributable profit.
- 2 The Islamic bank keeps a predetermined percentage of profits as a *Mudarib*.
- 3 The remaining distributable profit belongs to the IAHs.
- 4 From the IAH's profit, a certain percentage of funds are allocated to the IRR.
- 5 After deduction of the IRR share, the balance is distributed amongst the IAH.

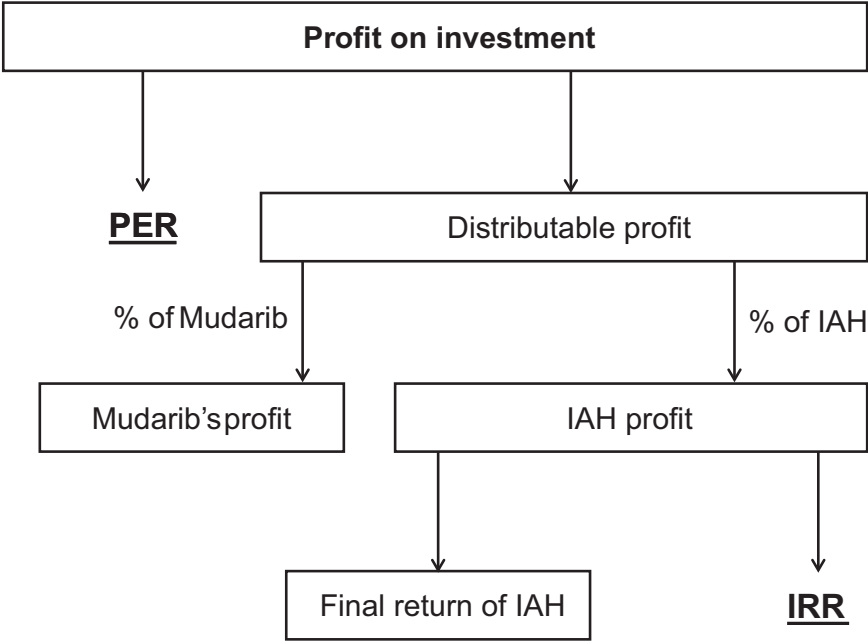


Figure 9.4 Allocation of Profit on Investment to PER and IRR

Source: Diagram by the authors.

When the Islamic bank earns a profit on the invested amount, the profit is distributed between the bank and the depositor in accordance with the pre-agreed profit distribution ratio. This should be agreed upon before the initiation of the contract. However, in some cases, the bank may give some share of its own profit to the investors as a *Hiba* (gift).

Hiba is permissible according to the rulings of *Shariah* and is usually done when the investments of the bank underperform, and the return falls. To avoid the risk of losing its customers and keep the fund's return lucrative for investors, the bank may compensate them using its own share of profits.

Box 9.4 Illustration 9.2 Comprehensive Example – Allocation of Profit

Al-Sufa Bank has received PKR 1,000 million worth of deposits in its unrestricted investment account, which is invested onwards in a range of assets financed by the bank. A profit-sharing ratio of 75:25 is agreed upon between the bank and the depositor, respectively.

During the period, the bank earned a return of PKR 100 million on the investment.

The bank created a profit equalisation reserve of PKR 20 million and an investment risk reserve of PKR 10 million.

Requirement: Calculate the profit attributable to the IAH and provide the journal entries for the recording of profit. Assume all entries are performed at the year-end (Dec 31, 2022).

Solution:

Distributable profit after PER attribution = 100 million – 20 million = 80 million

Mudarib's share (0.75×80 million) = 60 million

Amount net of *Mudarib's share* = 80 million – 60 million = 20 million

Net profit attributable to IAH (after IRR) = 20 million – 10 million = 10 million

Recording the profit on the investment account:

		Dr.	Cr.
Dec 31	Cash (Asset)	100,000,000	
	Profit on Investment Accounts (Income)		100,000,000
	<i>(To record the profit earned from the investment account)</i>		

Recording of PER:

		Dr.	Cr.
Dec 31	Profit on Investment Accounts (Income)	20,000,000	
	Profit Equalisation Reserve (Quasi-Equity)		20,000,000
	<i>(To record allocation of profit to PER)</i>		

Recording bank's share of profit:

		Dr.	Cr.
Dec 31	Profit on Investment Accounts (Income)	60,000,000	
	Bank's share of Investment Account profit (Income)		60,000,000
	<i>(To record the bank's share of profit from investment accounts)</i>		

Recording of IRR:

		<i>Dr.</i>	<i>Cr.</i>
Dec 31	Profit on Investment Accounts (Income)	10,000,000	
	Investment Risk Reserve (Quasi-Equity)		10,000,000
	<i>(To record allocation of profit to IRR)</i>		

Recording profit attributable to IAH:

		<i>Dr.</i>	<i>Cr.</i>
Dec 31	Profit on Investment Accounts (Income)	10,000,000	
	Profit Payable to IAH (Liability)		10,000,000
	<i>(To record profit attributable to IAH)</i>		

Box 9.5 Concept Check

Identify which of the following three statements are true or false. If a statement is false, indicate why this statement is false.

- 1) The accounting treatment for investment accounts is described in FAS 27.
- 2) An investment account is initially recognised at amortised cost.
- 3) Subsequent measurement of investment accounts requires consideration of any undistributed profits and profit equalisation reserves less any losses on assets attributable to investment account holders.
- 4) The profit-sharing ratio for investment accounts can be agreed upon after the initiation of the contract.
- 5) *Hiba* is permissible according to the rulings of *Shariah* and is usually done when the investments of the bank underperform, and the return falls.

Solution:

- 1) True.
- 2) False. An investment account is initially recognised at the fair value of the consideration received on the date the contract is effective.
- 3) True.
- 4) False. The profit-sharing ratio for investment accounts should be agreed upon before the initiation of the contract.
- 5) True.

9.3.2.2 Utilisation of Risk Reserves

Islamic banks may utilise the reserves for profit smoothing or preserving the investment value of investment account holders. If due to poor market conditions, the profit earned on the investment is less than the desired rate, the Islamic bank would transfer the amount from profit equalisation reserves to the profit account to smooth out the return on investment.

Box 9.6 Illustration 9.3 Recording Utilisation of PER by the IFI

On Dec 31, 2022, Bahrain Islamic Bank had an investment account worth BHD 1,500,000. The desired rate of return on the investment is set at 12% per annum. However, due to Covid-19, the bank was able to make only a 5% return on the investment. The bank has PER and IRR reserves worth BHD 1,000,000 and BHD 500,000, respectively. The bank intends to utilise the PER so that the profit distributed to the investment account holders is in line with the desired rate expectations.

Requirement: State the accounting treatment and entries for this situation.

Solution:

Since Bahrain Islamic Bank wants to smooth the total profit earned (attributed to both the IAH and the Islamic bank), the PER will be utilised.

The additional rate of return needed to achieve the desired level = $12\% - 5\% = 7\%$.

Calculating the amount of PER to be utilised = 7% of BHD 1,500,000 = BHD 105,000.

The accounting entry would be:

		Dr.	Cr.
Dec 31	Profit Equalisation Reserve (Quasi-Equity)	105,000	
	Profit on Investment Accounts (Income)		105,000
	<i>(To record the utilisation of PER for profit smoothing)</i>		

In case of a severe economic shock, there is a chance that a loss occurs on the investment made by the bank. Since the loss is to be transferred fully to the IAHs under *Mudaraba* contract, the original value of the investment (i.e., the principal amount) may be eroded. Therefore, the Islamic banks would allocate funds from the IRR to the IAH's equity to maintain the base

amount of capital. The accounting entries for the utilisation of IRR would be as follows:

Recording utilisation of IRR by IFI:

		Dr.	Cr.
Date	Investment Risk Reserve (Quasi-Equity)	xx	
	Investment Accounts (Quasi-Equity)		xx
	(To record the utilisation of IRR)		

9.3.2.3 Recognition of Loss

In case a loss remains even after the utilisation of the IRR, the value of the IAHs’ investment is reduced by the amount of the loss. The bank will recognise this by reducing the investment value of the IAH in its books. The accounting entry in case of loss is:

		Dr.	Cr.
Date	Investment Accounts (Quasi-Equity)	xx	
	Investments (Asset)		xx
	(To record the loss of invested capital)		

Box 9.7 Illustration 9.4 Comprehensive Example – Utilisation of PER/IRR

Yasir invested MYR 1,000,000 in an investment account with Al Khair Islamic Bank on Jan 1, 2021. The investment account is based on a *Mudaraba* contract. The bank invested the funds on the same date. The bank has PER and IRR reserves worth MYR 100,000 and MYR 50,000, respectively.

During the year ended Dec 31, 2021 (year 2), it was anticipated that the invested pool of funds would generate a return of MYR 75,000; however, a profit of MYR 40,000 was earned. Furthermore, the value of the investment in year 1 declined by MYR 20,000.

Requirement: State the accounting entries that the Islamic bank will make to record the above transactions and events.

Solution:

Since our anticipated return is lower than the expected return, the difference of MYR 25,000 (MYR 75,000 – MYR 40,000) will be transferred from the PER. Further, the IRR will be utilised to offset the reduction in the value of the investment.

Recording the deposit by the investment account holder:

		Dr.	Cr.
Jan 1	Cash (Asset)	1,000,000	
	Investment Accounts (Quasi-Equity)		1,000,000
	<i>(To record the deposit by the investment account holder)</i>		

Recording the investment by the Islamic bank:

		Dr.	Cr.
Jan 1	Investments (Asset)	1,000,000	
	Cash (Asset)		1,000,000
	<i>(To record the investment of the funds by the bank)</i>		

Recording the utilisation of the PER:

		Dr.	Cr.
Dec 31	Profit Equalisation Reserve (Quasi-Equity)	25,000	
	Profit on Investment Accounts (Income)		25,000
	<i>(To record the utilisation of PER for profit smoothing)</i>		

Recording the impairment of the investment:

		Dr.	Cr.
Dec 31	Investment Accounts (Quasi-Equity)	20,000	
	Investment (Assets)		20,000
	<i>(To record the impairment of the investment and reduction to fair value)</i>		

Recording the utilisation of the IRR:

		Dr.	Cr.
Dec 31	Investment Risk Reserve (Quasi-Equity)	20,000	
	Investment Accounts (Quasi-Equity)		20,000
	<i>(To record the utilisation of IRR against the impairment of the investment value)</i>		

Box 9.8 Illustration 9.5 Recording Loss on Invested Capital

Continuing the previous example, the investment incurred a loss of MYR 5,000 in March 2023. The proportionate share of the bank and the investor remains the same.

Requirement: Prescribe the accounting entries to record the loss.

Solution:

Since it is a *Mudaraba* contract, Mr Ali would incur the entire loss (the investment account holder).

		Dr.	Cr.
Jan 1	Equity of Investment Account Holders (Equity)	5,000	
	Investment Write-Off (Equity)		5,000
	(To write off the loss incurred by the investment account holder)		

9.3.3 Derecognition of Investment Accounts

Derecognition means removing the items from the balance sheet that were previously recognised by the institution. The Islamic bank should derecognise the investment accounts when it returns the investment amount to the investors. Upon derecognition, the cash is paid to the customers, and the equity of the respective IAH is removed from the books of the Islamic bank.

Box 9.9 Illustration 9.6 Derecognising the Investment Account

Mr Ali deposited MYR 100,000 in cash in YourBank as an investment under a *Mudaraba* contract on Jan 1, 2022. On Dec 31, 2022, Mr Ali demanded his money back from the bank.

Requirement: Record the derecognition of this investment.

Solution:

		Dr.	Cr.
Dec 31	Investment Accounts (Quasi-Equity)	100,000	
	Cash (Asset)		100,000
	(To record derecognition of the investment account)		

Box 9.10 Practical Insight: Fajr Capital – *Shariah*-Compliant Investments in the Middle East

Fajr Capital is a leading private equity and investment firm based in the Middle East and North Africa (MENA) region. The firm focuses on making strategic investments in sectors such as financial services, healthcare, education, and consumer goods. With a strong emphasis on *Shariah*-compliant investments, Fajr Capital aims to create sustainable value and drive growth in its portfolio companies. Fajr Capital's portfolio companies as of May 2023 include Biogen, Cravia, and Middle East Infrastructure. Through its investments, Fajr Capital seeks to capitalise on the potential of emerging markets, contribute to economic development, and create employment opportunities (Fajr Capital, 2023).

Box 9.11 Concept Check

Identify which of the following statements are true or false. If a statement is false, indicate why this statement is false.

- 1) An investment account is initially recognised at the fair value of the consideration received on the date the contract is effective.
- 2) If the investment account is categorised as off-balance sheet, then the fair value of the consideration received would be recognised through a journal entry.
- 3) *Hiba* is usually used when the investments of the bank outperform, and the return is higher than expected.
- 4) If a loss remains even after the utilisation of the IRR, the value of the IAHs' investment is reduced by the amount of the loss.
- 5) Upon derecognition of an investment account, the cash is paid to the customers, and the equity of the respective IAH is removed from the books of the Islamic bank.

Solution:

- 1) True.
- 2) False. If the investment account is categorised as off-balance sheet, then the fair value of the consideration received would be recognised once the recognition criteria are met, with no journal entry in the books.
- 3) False. *Hiba* is usually done when the investments of the bank underperform and the return falls.
- 4) True.
- 5) True.

9.4 Presentation and Disclosure

9.4.1 *Investment Accounts*

IFIs must present the equity of on-balance sheet investment account holders separately in the statement of financial position between liabilities and owners' equity. Information on equity of off-balance sheet investment account holders should be presented in the statement of changes in off-balance sheet investment accounts or in the footnotes of the statement of financial position. The financial statements must disclose the significant accounting policies and bases applied by the IFI in the allocation of profits between owners' equity and investment account holders, as well as the bases applied for charging provisions and the parties to whom they revert. The total administrative expenses charged to investment accounts along with a brief description of their major components should also be disclosed.

The percentage for profit allocation between owner's equity and various investment account holders applied in the current financial period must be disclosed, and if the IFI has increased its percentage of profits as a *Mudarib*, it too should be disclosed. The disclosure should also be made of whether the IFI has included investment accounts in the sharing of profit resulting from investing current accounts funds or any other funds, as well as in the sharing of revenue from banking operations. The IFI should disclose which of the two parties (owners' equity or investment account holders) was given priority in cases where it is unable to utilise all funds available for investing. The percentage of the funds of investment account holders that the IFI has agreed with them to invest to produce returns for them must be disclosed too.

9.4.2 *Provisions and Reserves*

Each category of stakeholders' share of risk reserves should be shown as an addition to their respective equity category, which is usually presented as different quasi-equity categories. If a portion of these reserves belongs to shareholders, it should be shown in the owners' equity category. The statement of off-balance sheet investments should disclose the risk reserves related to off-balance sheet investments.

An IFI should disclose the following information for each type of risk reserve and for each stakeholder category to which they relate:

- 1 The accounting policies applied to the risk reserves and any changes made to them.
- 2 A summary of the movement in the reserves, including opening and closing balances, amounts attributed to each stakeholder category (and shareholders where applicable), utilisation of the reserves, returns on their investments, and any other adjustments made, including transfers, with a description of their nature.

- 3 Any policy for investing such reserves, in line with contractual terms and *Shariah* principles.
- 4 The shortfall against the adequate level of reserves and the defined plan for bringing the reserves to the adequate level, as determined by the IFI.

If the incentive profits received from the profits of investment accounts are of material significance, the bases applied for determining them should also be disclosed. The financial statements should disclose specific provisions, general provisions towards potential loss, profit equalisation reserve, and investment risk reserve. The general disclosure requirements stated in FAS 1: General Presentation and Disclosure in the Financial Statements of Islamic Financial Institutions must be followed.

Box 9.12 Concept Check

Identify which of the following statements are true or false. If a statement is false, indicate why this statement is false.

- 1) The percentage of the funds of investment account holders that the IFI has agreed with them to invest in order to produce returns for them must be disclosed by IFIs.
- 2) The investment accounts are shown in the balance sheet as a component of the owner's equity.
- 3) The Islamic bank does not need to disclose the proportionate share of the bank and the investors in the profits on investments.
- 4) If any policy is created for the investment of the risk reserves, that policy must be disclosed in the financial statements of the IFI.
- 5) If the incentive profits received from the profits of investment accounts are of material significance, the bases applied for determining them should also be disclosed.

Solution:

- 1) True.
- 2) False. The investment accounts are shown between the liabilities and the owner's equity in the equity section of the balance sheet.
- 3) False. The Islamic banks must disclose the proportionate share of each party in the profits on investments.
- 4) True.
- 5) True.

9.5 IFRS Perspective

9.5.1 *Investment Accounts*

Funds deposited with an Islamic bank under a *Mudaraba* contract are entitled to earn returns on a risk-sharing basis with no guarantee of the return of the principal amount. Accordingly, it can be argued that these funds represent an equity investment since customers are entitled to a residual return after the reduction of any losses. This school of thought suggests that these funds should be classified within equity in the financial reports of the Islamic bank.

However, to remain competitive, Islamic banks do try to ensure that the principal funds are secure and returned to the client at the time of liquidation. A liability is defined under IFRS as a *present obligation of the entity to transfer an economic resource because of past events*. There may not be any legally enforceable obligation for an IFI to return the principal amount invested. However, the explanation given for an obligation does not restrict itself to one that is legally binding. Paragraph 4.31 of the IFRS Conceptual Framework states that obligations can also arise from an entity's customary practices, published policies, or specific statements if the entity has no practical ability to act in a manner inconsistent with those practices, policies, or statements. Such an obligation is termed a "constructive obligation". Therefore, in general, Islamic banks can be said to have a constructive obligation to return the principal funds and generate a certain level of return for their depositors. Further, under a *Mudaraba* arrangement, the *Mudarib* (in this case, the IFI) bears all losses which occur due to its negligence and even otherwise, banks often reduce their own share of the profits to provide an adequate and consistent return to the investors. These features make the funds like a conventional deposit account, and one can argue that in substance, these funds are like a liability for the IFI. In addition, *Mudaraba* investment account holders do not have the voting rights of shareholders.

Mudaraba investment accounts, therefore, have similarities with both debt and equity. However, IFRS does not have any intermediate element within which to classify and report such transactions (such as quasi-equity defined by AAOIFI). Under the IFRS framework, *Mudaraba* investment is usually classified as a puttable financial instrument, and all such instruments are usually classified as a liability even if they contain equity elements therein. Hence, the IFRS Framework classifies *Mudaraba* funds as financial liabilities under IFRS 9 Financial Instruments, and they are recorded at amortised cost.

9.5.2 *Reserves*

Just like Islamic financial institutions, established companies also create different types of reserves for different purposes. Some reserves are general-purpose reserves while others are for specific purposes. These reserves are disclosed as an addition to equity under IFRS.

Under AAOIFI and in the context of investment accounts, risk reserves are created to manage the return for IAHs and are shown as an addition to quasi-equity. Under IFRS, since investment accounts are treated as a liability, accordingly their reserves are also treated in the same way.

9.5.3 Further Developments

The IASB is currently looking to make amendments to IAS 32 Financial Instruments: Presentation. These changes are in response to a discussion paper, *Financial Instruments With Characteristics of Equity*, published by the IASB in June 2018, which set out the preferred approach to classifying a financial instrument as a liability or equity from an issuer's perspective. Also, it aims to further develop the presentation and disclosure requirements to give further information on the effect that the financial instrument has on the issuer's financial position and performance.

Box 9.13 Practical Insight: Profit-Sharing Contracts (AOSSG Reporting Under IFRS)

A review conducted in 2014 of 132 Islamic financial institutions' financial statements from 31 countries noted that 50 out of 79 samples – that is, 63% – reported amounts attributable to customers under *Mudaraba* contracts as financial liabilities measured at amortised cost. The rest of the samples reported it either as an intermediary element between liability and equity or as an off-balance sheet item. Interestingly, none reported such an item as equity (Asian-Oceanian Standard-Setters Group, 2015).

Box 9.14 Concept Check

Identify which of the following statements are true or false. If a statement is false, indicate why this statement is false.

- 1) Funds deposited with an Islamic bank under a *Mudaraba* contract are principal-guaranteed and hence fall within the definition of a liability under IFRS.
- 2) IFRS does not have a quasi-equity element as defined by AAOIFI.
- 3) Under IFRS, *Mudaraba* funds are usually classified as financial liabilities.
- 4) IFRS attributes risk reserves to the equity of the different stakeholders.
- 5) In conventional banks, reserves are created to manage the returns of a bank and not the investors.

Solution:

- 1) False. Funds deposited with an Islamic bank under a *Mudaraba* contract are entitled to earn returns on a risk-sharing basis with no guarantee of the return of the principal amount and hence arguably could fall within the definition of equity.
- 2) True.
- 3) True.
- 4) False. Under IFRS risk reserves are treated as a liability.
- 5) True.

9.6 Chapter Summary

- A current account is a very liquid account where people usually deposit funds for short-term purposes, whereas investment accounts are used to hold the money for an extended period to earn a profit on the deposited money for the investors. (LO1)
- *Mudaraba* and *Wakalah* are probably the most widely used underlying contracts for investment accounts. (LO1)
- There are two types of investment accounts.
 - Unrestricted investment accounts are those in which the investors authorise the Islamic bank to invest the account holder's funds based on the *Mudaraba* contract without any restrictions.
 - In restricted investment accounts, the investors put certain restrictions, such as type of activity, location, and currency on Islamic banks to invest the account holder's funds. (LO 2)
- Risk reserves are specially designed to mitigate the risk for the investment accounts. Risk reserves are composed of two types of reserves that minimise the variance in return on investments received by the investment account holders: PER and IRR. (LO 2)
- A profit equalisation reserve (PER) is used for smoothing the profit earned on the investments. An amount from the total *Mudaraba* profit is allocated to the PER before giving *Mudarib*'s share. (LO 2)
- An investment risk reserve (IRR) is used to preserve the capital of investment account holders. After giving *Mudarib*'s share, a specific proportion of distributable profits (after netting for *Mudarib*'s share) is allocated to IRR. Islamic banks create this separate reserve because the investment account holders are the providers of capital under *Mudaraba*. (LO 2)
- When the bank receives funds from the investor, it recognises the equity of the investors as an investment account. (LO 3)
- When the Islamic bank makes a profit on the invested amount, the profit must be distributed between the bank and the client in a predetermined proportion. (LO 3)

- If the loss is incurred by the bank on the investment, the entire loss is transferred to the investors. The rule of transferring the entire loss to the providers of capital is the basis of *Mudaraba* contract. (LO 3)
- Derecognition means removing the items from the balance sheet that were previously recognised by the institution. The Islamic bank should derecognise the investment accounts when it returns the total investment amount to the investors. The flow of accounting entries for the investment accounts (IA) according to the FAS 27 is as follows: (LO 3)

Sr. #	Events	Dr.	Cr.
1	Initial recognition of IA	Cash	Equity of investment Account holders
2	Subsequent measurement of IA in case of impairment	Equity of investment account holders	Investment under <i>Mudaraba</i>
3	Profit attributable to IAHs	Investment account holders' profit expense (IS)	Profit payable (SFP)
4	Allocation of loss to IAHs	Equity of investment account holders	Investment write-off (SFP)
5	Derecognition of IA	Equity of investment account holders	Cash

- The investment accounts that classify as on-balance sheet items must be shown as an independent section between the liabilities and the shareholders' equity section of the statement of financial position. (LO 3)
- The investment accounts that qualify for the off-balance sheet items must be placed under the heading of off-balance sheet investment accounts in the statement of changes or can be written in the footnotes of the balance sheet. (LO 3)
- The disclosure about the profit distribution ratio, accounting policy to distribute the profit, change of profit distribution percentage, and utilisation and provisions regarding funds must be made by the Islamic bank. (LO 3)
- An investment agency (*Al-Wakalah Bi Al-Istithmar*), a type of *Wakalah*, is an instrument in which the principal (*Muwakkil*) appoints an agent (*Wakeel*) to carry out an investment on behalf of the principal with or without conditions as regards how the funds may be invested. (LO 3)
- The investment accounts that qualify for off-balance sheet disclosure must be placed under the heading of off-balance sheet investment accounts in the statement of changes or can be written in the footnotes of the balance sheet. (LO 3)
- Investment accounts are alternatives to conventional deposit/saving accounts. While the latter are recognised as liabilities in the statement of financial position of banks, the former are recorded in an independent

category between liability and owner's equity. They are termed in the Islamic financial system as "quasi-equity". The concept of quasi-equity does not exist in IFRS; hence it would have been treated as a liability under IFRS. (LO 4)

9.7 Key Terms and Definitions

- ***Al-Wakalah Bi Al-Istithmar***: A type of *Wakalah* as an instrument in which the principal (*Muwakkil*) appoints an agent (*Wakeel*) to carry out an investment on behalf of the principal with or without conditions as regards how the funds may be invested.
- **Investment account**: An account for the holder of an instrument under a *Murabaha* or its equivalent representing funds received by the IFI for investment on behalf of another party (*Rab al-Maal*) with or without the conditions as regards how the funds may be invested.
- **Investment risk reserve (IRR)**: The amount appropriated to preserve the capital of investment account holders. To create an IRR, a specific proportion of distributable profits is allocated after giving *Mudarib*'s share.
- **Off-balance sheet assets under management**: Funds or assets held, managed, administered, or otherwise dealt with in an arrangement that gives the institution a fiduciary responsibility but not control.
- **On-balance sheet investment account**: *Mudaraba* based on investment accounts that provide authority over the decisions with regard to the use of and deployment of the funds received by the IFI are treated as equity of investment account holders.
- **Profit equalisation reserve (PER)**: The amount appropriated by an IFI out of the income arising from the assets pertaining to profit-and-loss-taking investors, to maintain a certain level of return on investment for such stakeholders (and the shareholders, as applicable) and hence is a tool for managing the rate of return risk (including the displaced commercial risk).
- **Quasi-equity**: The funds of investment account holders which have been placed with the bank to earn a return.
- **Restricted investment account**: An investment account in which the bank has the authority to invest the account holder's funds based on a *Mudaraba* contract or agency-based contract for investment but has certain restrictions as to where, how, and for what purpose the funds are to be invested.
- **Unrestricted investment account**: An investment account where the account holder authorises the Islamic bank to invest the account holder's funds based on *Mudaraba* contract in a manner that the Islamic bank deems appropriate without laying down any restrictions as to where, how, and for what purpose the funds should be invested.

9.8 Review Questions

- 1 To ensure that sufficient cash is available at any point in time to fund the withdrawal of cash by its clients, banks use:
 - a) Current account
 - b) Restricted investment account
 - c) Unrestricted investment account
 - d) Reserves
- 2 Profit equalisation reserve (PER) is used for:
 - a) Smoothing the profit earned on the investments
 - b) Minimising the variance in return on investments
 - c) Preserving the capital of investment account holders
 - d) Both a and b
- 3 After giving the *Mudarib's* share, a specific proportion of distributable profits is allocated to which reserve:
 - a) Profit equalisation reserve (PER)
 - b) Investment risk reserve (IRR)
 - c) Both a and b
 - d) None of the above
- 4 Accounting for risk reserves is covered in
 - a) FAS 35
 - b) FAS 31
 - c) FAS 27
 - d) FAS 1
- 5 The journal entry for the recognition of unrestricted investment account in the books of the IFI would be:
 - a) Debit cash, Credit liability
 - b) Debit cash, Credit investment account (quasi-equity)
 - c) Debit investment account, Credit liability
 - d) Debit cash, Credit investment risk reserve
- 6 The contribution to the IRR is made:
 - a) After allocating the *Mudarib's* share but before allocating the IAH's share
 - b) After allocating both the *Mudarib's* and IAH's share
 - c) Before allocating any share to the *Mudarib* or IAHs
 - d) After allocating the IAH's share but before allocating the *Mudarib's* share

- 7 The entry for recording the contribution to PER reserves from the profit earned by investment accounts by the IFI is as follows:
 - a) Debit profit on investment accounts (income), Credit cash
 - b) Debit profit on investment accounts (income), Credit PER (quasi-equity)
 - c) Debit PER (quasi-equity), Credit cash
 - d) Debit PER (quasi-equity), Credit profit on investment accounts (income)
- 8 The journal entry to record the utilisation of the Investment Risk Reserve (IRR) to maintain the base amount of investment funds attributable to the investment account holders would be:
 - a) Debit investment accounts (quasi-equity), Credit IRR (quasi-equity)
 - b) Debit IRR (quasi-equity), Credit investment accounts (quasi-equity)
 - c) Debit investment accounts (investor's equity), Credit cash
 - d) Debit cash, Credit investment accounts (investor's equity)
- 9 The Islamic bank should derecognise the investment accounts from its books when:
 - a) It pays the annual profit to its investors.
 - b) It returns the investment amount to the investors.
 - c) The investment accounts generate a loss.
 - d) The profit earned by the investment account exceeds the amount invested by the investors.
- 10 Under IFRS, deposits of investment account holders are treated by the Islamic bank as:
 - a) Equity
 - b) Asset
 - c) Quasi-equity
 - d) Liability

Note

- 1 For example, gifts or fee exemptions from those banking services that otherwise attract fees.

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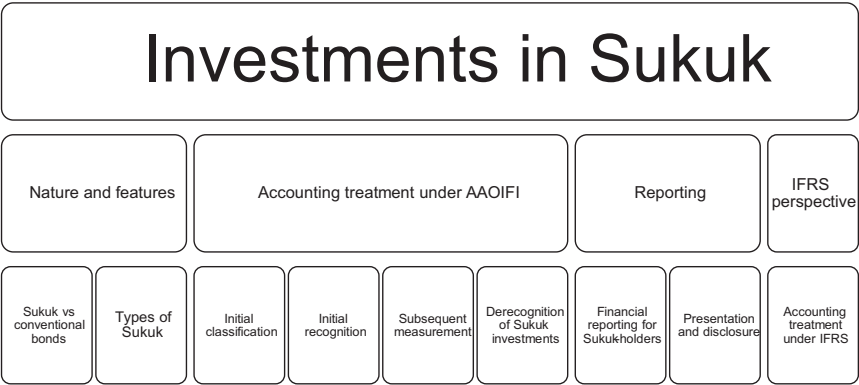
10 Investments in *Sukuk*

Learning Objectives

After going through this chapter, you should be able to:

- 1 Describe the nature of *Sukuk* and how it differs from conventional bonds.
- 2 Understand the process, structure, and types of *Sukuk*.
- 3 Describe the accounting entries, presentation and disclosure requirements for *Sukuk* in the books of the *Sukuk*-holder.
- 4 Understand the main differences in the accounting treatment of *Sukuk* under IFRS and AAOIFI.

Chapter Preview



Cover Story

Air Lease Corporation (ALC), a prominent aircraft leasing company based in Los Angeles, purchases new commercial aircraft and leases them to airline customers globally, providing customised leasing and financing solutions.

ALC completed its first-ever *Sukuk* issuance on March 15, 2023. This marked the largest *Sukuk* issuance from a US-based borrower and its entry into the Middle East market.

Sukuk are *Shariah*-compliant versions of conventional bonds. The ALC *Sukuk* offering involved the issuance of a USD 600 million aggregate principal amount of 5.85% trust certificates due on April 1, 2028. Profit payments were to be made semi-annually. The *Sukuk* certificates were rated “BBB” by S&P and Fitch with a stable outlook and were listed on the London Stock Exchange.

ALC’s banking partners included DIB, Al Rayan, Citi, Deutsche Bank, Emirates NBD, JPMorgan, KFH Capital, and Warba Bank. Legal guidance was provided by Allen & Overy and Clifford Chance. In the context of this transaction, ALC’s Senior Vice President and Treasurer underscored the liquidity of the Middle East region and the opportunity for investment-grade borrowers to raise funds at favourable rates. ALC aimed to strengthen its relationships with airlines in the Middle East and expand its funding presence in the region. The net proceeds from the *Sukuk* offering were to be used for general corporate purposes, including the acquisition of commercial aircraft and the repayment of existing debt obligations (AirLease Corporation, 2023).

10.1 Introduction

Businesses around the world need funds for various purposes. While some may want to expand their business, others may require money to carry out their day-to-day operations. Globally, firms have two ways to generate funds: through equity or by issuing debt. Funds can be generated through equity by issuing new shares to the market. Whereas for debt financing, firms issue bonds, which are fixed-income securities. Although issuing new shares is allowed in *Shariah*, raising money through bond issuance is impermissible in *Shariah* due to the involvement of *Riba* (interest). Therefore, IFIs cannot issue conventional bonds to raise capital through debt financing. To provide debt financing to the IFIs in a *Shariah*-compliant way, the concept of *Sukuk* was introduced.

Sukuk is the plural of the Arabic word *Sakk*, which means certificate. So the literal meaning of the word *Sukuk* is certificates. According to *Shariah* Standard No. 17, “Investment *Sukuk* are certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity”. In simple words, *Sukuk* are the trust certificates that give the right to the ownership or usufruct of an asset. *Sukuk* are a good alternative to conventional bonds and are like bonds in a way that they are sometimes fixed-income securities. Nonetheless, the nature and execution of a *Sukuk* are significantly different from those of a bond.

Figure 10.1 shows the value of global *Sukuk* issuances from 2010 to 2020.

Table 10.1 shows the major *Sukuk* issued in Malaysia and the amount raised from the issue for the years 1990–2008.

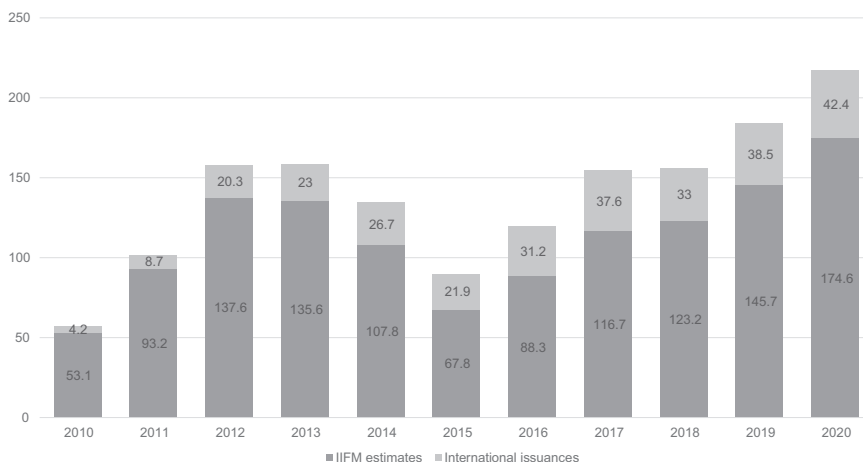


Figure 10.1 Global *Sukuk* Issuances (USD Billion), 2010–2020

Source: Kalimullina et al.

Table 10.1 List of Famous *Sukuk* Issuances in Malaysia

Issuer	Amount	Year
Shell MDS	MYR 125 million (USD 33 million)	1990
Kumpulan Guthrie Bhd	USD 150 million	2001
Government of Malaysia	USD 600 million	2002
International Finance Corporation (World Bank)	MYR 500 million (USD 132 million)	2004
Cagamas MBS Bhd	MYR 2.05 billion (USD 540 million)	2005
PLUS	MYR 9.17 billion (USD 2.86 billion)	2006
Khazanah Nasional	USD 750 million	2006
AEON Credit Service	MYR 400 million (USD 125 billion)	2007
Nucleus Avenue	MYR 8 billion (USD 2.5 billion)	2007
Khazanah Nasional	USD 850 million	2007
Maybank Berhad	USD 300 million	2007
Binariang GSM	MYR 15.35 billion (USD 4.8 billion)	2007
Islamic Development Bank	MYR 1 billion	2008

10.1.1 *Sukuk Versus Conventional Bonds*

The purpose of a *Sukuk* and a conventional bond is the same: to provide debt financing to companies. However, both instruments are structured differently. Table 10.2 shows some major differences between a *Sukuk* and a bond.

Table 10.2 *Sukuk* Versus Conventional Bonds

Sukuk	Conventional bond
<p>Parties involved Depending on the arrangement, two or three entities are involved in a <i>Sukuk</i> agreement:</p> <ol style="list-style-type: none"> 1) The Originator (the issuer) 2) The <i>Sukuk</i>-holders (the investors) 3) The SPV 	<p>There are two parties involved in a bond agreement:</p> <ol style="list-style-type: none"> 1) The bond issuer (the borrower) 2) The bondholder (the lender or investor)
<p>Utilisation of funds The funds generated from a <i>Sukuk</i> can be utilised to finance only the activities that are permissible in <i>Shariah</i>. The purpose of funds is decided and stated at the time of issuance of <i>Sukuk</i>.</p>	<p>The funds generated from a bond can be used to finance any form of activity irrespective of any <i>Shariah</i> compliance considerations. Moreover, the bond issuer does not need to state the utilisation of funds.</p>
<p>Nature of sale agreement In the sale of a <i>Sukuk</i>, a particular share of an asset is sold.</p>	<p>The sale of a bond is just the sale of the debt (i.e., providing financing services).</p>
<p>Calculation of returns The return earned on a <i>Sukuk</i> is not based on the interest rate. The returns are generated from the underlying assets in the <i>Sukuk</i>.</p>	<p>The return of a conventional bond is based on the interest rate agreed upon.</p>
<p>Ownership in the assets In certain <i>Sukuk</i> agreements, the investors of a <i>Sukuk</i> (<i>Sukuk</i>-holders) acquire ownership of the underlying asset, and the returns on the asset are recognised on a profit-sharing basis.</p>	<p>There is no concept of ownership or profit-sharing in conventional bonds. The bondholders are only entitled to an unconditional fixed or variable interest rate.</p>

10.1.2 Structure of a *Sukuk* and Parties Involved

In a conventional bond, only two parties are involved: the bond issuer and the bondholder. However, given the nature of a *Sukuk* agreement, generally the following three parties are involved in a *Sukuk* arrangement:

10.1.2.1 Originator

The originator is the party that needs the money for its operations or expansion. Originators are normally the companies and the governments that need *Shariah*-compliant debt financing. An originator may issue the *Sukuk* on its own or may create a Special Purpose Vehicle to issue the *Sukuk* on behalf of the originator.

10.1.2.2 Special Purpose Vehicle (SPV)

A Special Purpose Vehicle (SPV) is a temporary legal entity that is created by another company to execute a specific task. When the task is finished,

the SPV is also dissolved. An SPV can be created as a limited partnership entity, corporate entity, or trust. In the case of *Sukuk*, SPV is an intermediary party that acts as a bridge between the originator and the *Sukuk*-holder. SPV is created by the originator to handle the issuance of the *Sukuk*. So all the matters related to the issuance of *Sukuk* are handled by the SPV and not the originator.

10.1.2.3 *Sukuk-Holder (Investor)*

Sukuk-holders are investors who invest in *Sukuk* and provide the funds needed by the originator. *Sukuk*-holders receive a certificate (*Sukuk*) in exchange for the funds that they give under the *Sukuk* arrangement. The certificate gives them the right to own the asset or the usufruct of the asset. *Sukuk*-holders can be companies as well as individuals.

In some arrangements, only two parties are involved in a *Sukuk*: the originator and the *Sukuk*-holder. Such a type of *Sukuk* is called two-party *Sukuk*. In a two-party *Sukuk*, the originator may choose not to create an SPV, but in that case, the originator creates a trustee who assumes the role of an SPV. A trustee handles the issuance of the *Sukuk* and manages all the cash flows between the originator and the *Sukuk*-holders. The structure of a two-party *Sukuk* is shown in Figure 10.2.

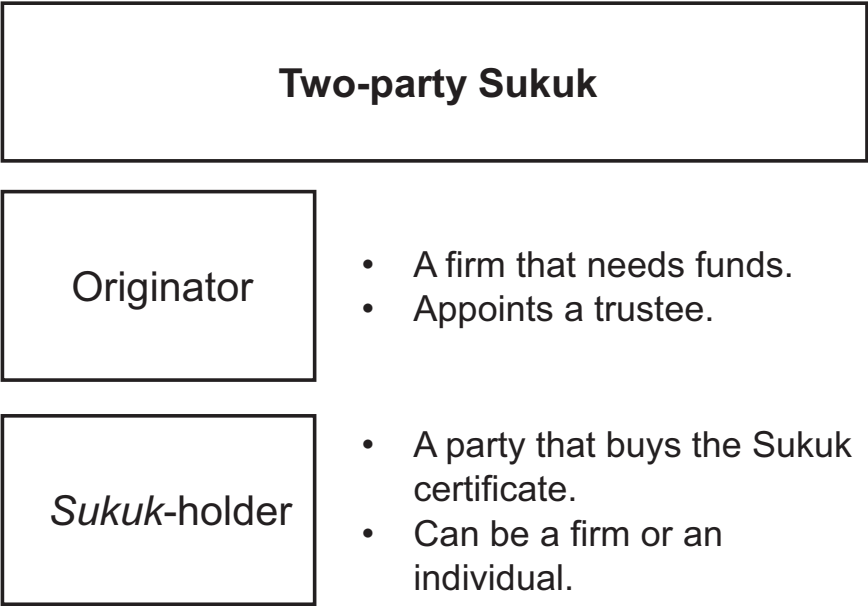


Figure 10.2 Two-Party *Sukuk*

Source: Diagram by the authors.

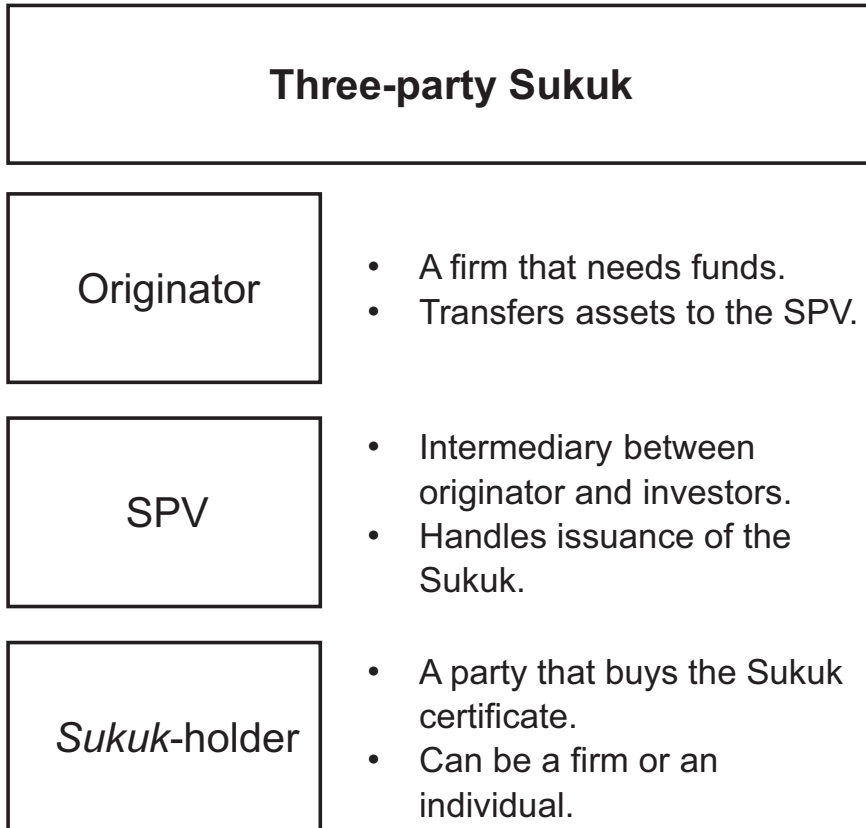


Figure 10.3 Three-Party Sukuk

Source: Diagram by the authors.

Sukuk can also be structured as shown in Figure 10.3, with three parties involved: the originator, the SPV, and the *Sukuk*-holder.

10.1.3 Overview of the Sukuk Process

The process of a *Sukuk* depends on the type of the *Sukuk*. There are various types of *Sukuk*, and we will discuss them in the next section. To explain the process of *Sukuk*, we will take the example of a *Sukuk* based on *Ijarah*.

As the name suggests, *Ijarah Sukuk* is based on the underlying *Ijarah* contract. First, the originator sells the *Ijarah* asset to the SPV at a predetermined price (purchase price), and the title of the asset is transferred to the SPV. In the second step, the SPV issues the *Sukuk* certificate to the investor in exchange for cash, as shown in step 2. The *Sukuk* is sold to the *Sukuk*-holders at a price equal to the purchase price of the asset. The proceeds from

selling the *Sukuk* are given to the originator who needs the funds. In the fourth step, the SPV makes a lease agreement with the originator (to rent out the underlying assets) in which the SPV acts as a lessor and the originator as a lessee. The originator agrees to pay fixed rental payments for a particular period, as depicted in step 5. Lastly, the SPV passes the rental payments to the investors as a return on the *Sukuk* investment. The last two steps keep on repeating until the maturity of the *Sukuk* or the term of the lease agreement. At the date of maturity, the originator buys back the asset from the SPV at a predetermined price. The purchasing price is then sent to the investor as the repayment of the principal amount. Upon dissolution of the *Sukuk* arrangement, the SPV is dissolved too. In this way, the transaction is completed under *Ijarah Sukuk*. Figure 10.4 summarises the process for *Sukuk*.

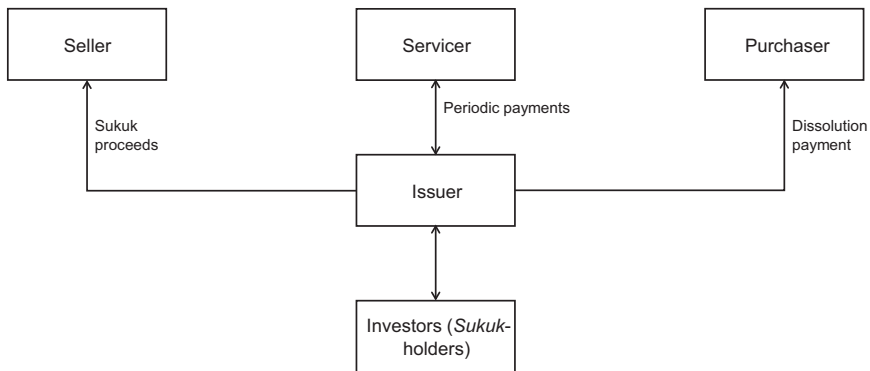


Figure 10.4 *Sukuk* Process

Source: Diagram by the authors.

Box 10.1 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) *Sukuk*-holders are the investors who invest in the *Sukuk* and provide the funds needed by the originator.
- 2) SPVs are entities which need *Shariah*-compliant debt financing.
- 3) In the case of *Sukuk*, SPV is an intermediary party that acts as a bridge between the originator and the *Sukuk*-holder.
- 4) *Sukuk* are trust certificates that give the right to the ownership or usufruct of an asset.
- 5) The proceeds from selling the *Sukuk* are deposited in the SPV.

Solution:

- 1) True.
- 2) False. Originators are normally the entities and the governments that need *Shariah*-compliant debt financing.
- 3) True.
- 4) True.
- 5) False. The proceeds from selling the *Sukuk* are given to the originator who needs the funds.

Box 10.2 Practical Insight: Current Issues of the Global *Sukuk* Market

Despite the existing size of the *Sukuk* market, there is a notable lack of liquidity in the secondary market for *Sukuk* instruments. It is crucial for governments to regularly issue sovereign *Sukuk* as part of their debt financing strategies to establish a complete yield curve for *Sukuk* products. This yield curve can then serve as a pricing benchmark as the corporate *Sukuk* market continues to develop. However, before incorporating *Sukuk* issuances into national debt management plans, there are various challenges related to public financial management that need to be addressed. While there are numerous complex *Sukuk* structures available, there is still a lack of international harmonisation regarding *Shariah* rulings and legal treatment of these instruments (Soylemez, 2016).

10.2 Types of *Sukuk*

Sukuk can be divided into three main categories depending on the nature of the underlying contract: *Sukuk* based on a lease agreement, sales agreement, and equity structure. *Sukuk Ijarah* has already been explained in the previous section. We will focus on the other two types of *Sukuks* here (Figure 10.5).

10.2.1 Sales Agreement/Asset-Based/Debt-Type Structures (Unsecured)

Sukuk based on sales agreements are also called asset-based or debt-type *Sukuk*. These types of *Sukuk* have been designed to replicate conventional bonds. In asset-based *Sukuk*, the *Sukuk*-holder does not get any share in the underlying asset of the *Sukuk* agreement, that is, there is no (proportionate) sale of the underlying asset. The ownership remains with the originator or the SPV, depending on the number of parties in the *Sukuk*. Therefore, in case of a default, the *Sukuk*-holders have recourse to the originator of the *Sukuk*

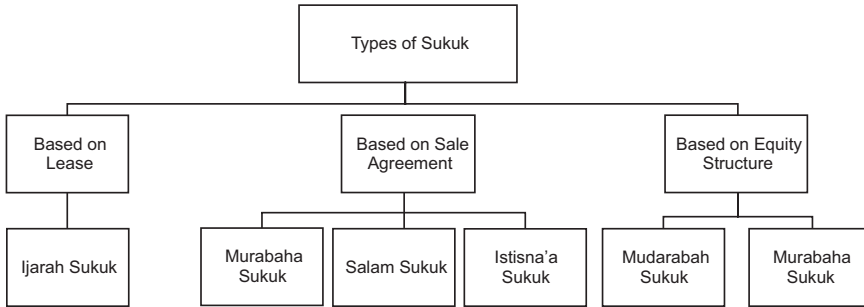


Figure 10.5 Types of *Sukuk*

Source: Diagram by the authors.

and not to the underlying asset. That is why *Sukuk* based on sales agreement focuses on the creditworthiness of the originator since they are liable in case of default. The following are some examples of asset-based *Sukuk*.

10.2.1.1 *Sukuk al-Murabaha*

Under *Sukuk Murabaha*, the originator or SPV issues the *Sukuk* certificates, and their proceeds are used to purchase assets. These assets are then sold at cost plus markup. The purchasers of these assets pay in instalments, which are then paid to *Sukuk*-holders – who have an ownership interest in the assets – after deducting the relevant expenses.

10.2.1.2 *Sukuk al-Salam*

Under *Sukuk Salam*, the originator issues *Sukuk* certificates in return for immediate cash payments. These certificates signify the ownership that *Sukuk*-holders have of the goods that are to be delivered at a future pre-determined date. This type of *Sukuk* is also treated as an investment by the *Sukuk*-holders for the same reason as *Sukuk Istisna'a* – its certificates cannot be sold or traded prior to their maturity date due to the impermissibility of the sale of debt.

10.2.1.3 *Sukuk al-Istisna'a*

Under *Sukuk Istisna'a*, the manufacturer of the goods issues *Sukuk* certificates, which signify the ownership interests in the goods that are to be manufactured. After the goods are delivered, the SPV sells them, giving the proceeds to the relevant *Sukuk*-holders. This type of *Sukuk* is treated as an investment by the *Sukuk*-holders since its certificates cannot be sold or traded prior to their maturity date due to the impermissibility of the sale of debt.

10.2.2 Asset-Backed/Equity-Type Structures (Secured)

Sukuk based on equity structure are also termed asset-backed *Sukuk*. It is because the equity-type *Sukuk* give a proportionate share of ownership to the *Sukuk*-holders. It means that the *Sukuk*-holders have recourse to the underlying asset in case of default of the originator – hence the term “asset-backed”. Major examples of equity-based *Sukuk* are *Mudaraba* and *Musharakah Sukuk*.

10.2.2.1 Sukuk al-Mudaraba

Under *Sukuk Mudaraba*, the *Sukuk*-holders are also the asset owners and the capital providers. The SPV merely acts as a manager between the *Sukuk*-holders and an entrepreneur, both of whom share the resulting business profits in an agreed-upon ratio.

10.2.2.2 Sukuk al-Musharakah

In *Musharakah*, parties agree to a joint arrangement of sharing profits and losses according to agreed-upon ratios and capital contributions of each partner, respectively. Thus, under *Sukuk Musharakah*, *Sukuk* certificate holders become the owners of the assets or the projects (whether the project is new or an existing one is being developed) according to their respective shares. Unlike *Sukuk Istisna'a* and *Sukuk Salam*, *Musharakah* certificates can be traded in the secondary market at any time as negotiable instruments.

Box 10.3 Practical Insight: Securitised *Sukuk*

In July 2004, the Islamic Development Bank (IDB) introduced a new type of *Sukuk* called *Sukuk Al-Istithmar*, issuing it for the global market at a value of USD 400 million. This marked the first Islamic securitisation in which the underlying pool of assets included various instruments. Previous global *Sukuk* offerings primarily relied on revenue from real estate asset rentals, specifically *Ijarah* bonds. However, the IDB *Sukuk* consisted of both real and debt-based assets, including *Murabaha* and *Istisna'a*. Nevertheless, the asset portfolio was structured in a way that the *Ijarah*-based portion, accounting for 66% of the total, dominated. It was also considered important for *Ijarah* assets to comprise more than half of the portfolio. Due to the inclusion of *Murabaha* and *Istisna'a* receivables in the IDB's portfolio, the return on these certificates was predetermined and fixed at 3.625% per annum (Kamali, 2007).

Box 10.4 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) Under *Sukuk Ijarah*, the originator transfers the underlying assets to the *Sukuk*-holder.
- 2) In asset-based *Sukuk*, the *Sukuk*-holder gets a proportionate share in the underlying asset of the *Sukuk* agreement.
- 3) Under *Sukuk Istisna'a*, the manufacturer of the goods issues *Sukuk* certificates, which signify the ownership interests in the goods that are to be manufactured.
- 4) Major examples of equity-based *Sukuk* are *Istisna'a* and *Ijarah Sukuk*.
- 5) Under *Sukuk Musharakah*, *Sukuk* certificate holders become the owners of the assets or the projects.

Solution:

- 1) False. Under *Sukuk Ijarah*, the originator transfers the underlying assets to the SPV.
- 2) False. In asset-based *Sukuk*, the *Sukuk*-holder does not get any share in the underlying asset of the *Sukuk* agreement.
- 3) True.
- 4) False. Major examples of equity-based *Sukuk* are *Mudaraba* and *Musharakah Sukuk*.
- 5) True.

10.3 Accounting in the Books of Sukuk-Holder

FAS 33 *Investment in Sukuk, Shares and Similar Instruments* establishes guidelines for the classification, recognition, measurement, presentation, and disclosure of IFIs' investments in *Sukuk*, shares, and other comparable instruments.

10.3.1 Initial Classification

Each investment is to be categorised as an investment in:

- **Equity-type instruments** include instruments which entitle the holder to a residual interest in the assets of an entity (e.g., shares in another entity).
- **Monetary and non-monetary debt-type instruments**
 - Monetary debt-type instruments are those which result in the creation of a financial liability (e.g., *Murabaha* payable).

- Non-monetary debt-type instruments are those which result in the creation of a non-financial liability such as the delivery of goods at a future date (e.g., *Salam*).
- **Other investment instruments** are those instruments not falling into the above two categories (Figure 10.6).

An institution should classify investments as subsequently measured at amortised cost or fair value through equity or fair value through the income statement on the basis of two conditions given in FAS 33. The first condition relates to the institution's business model for managing the investments, and the second relates to the expected cash flow characteristics of the investment.

10.3.1.1 Amortised Cost

An investment is measured at amortised cost if the investment is held within a business model whose goal is to hold the investment to collect expected cash flows until the instrument's maturity, and the investment represents either a debt-type instrument or another investment instrument with a reasonably determinable effective yield.

10.3.1.2 Fair Value Through Equity

An investment is measured at fair value through equity if it is held within a business model whose goal is achieved by both collecting expected cash flows and selling the investment and it is a non-monetary debt-type instrument or other investment instruments with a reasonably determinable effective yield.

10.3.1.3 Fair Value Through Income Statement

An investment should be measured at fair value through the income statement unless it is measured at amortised cost or at fair value through equity or if irrevocable classification choices at initial recognition are applied.

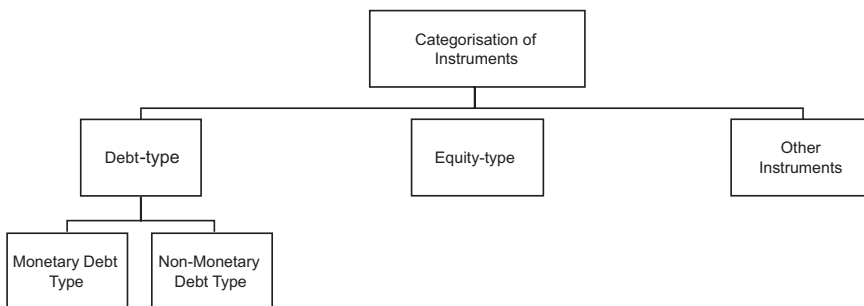


Figure 10.6 Categorisation of Instruments

Source: Diagram by the authors.

10.3.2 *Choices at Initial Recognition*

10.3.2.1 *Investments in Non-Monetary Debt-Type Instruments or Other Investment Instruments*

FAS 33 allows investments in non-monetary debt-type instruments (those which result in the creation of a non-financial liability such as the delivery of goods at a future date (e.g., *Salam*) or other investment instruments (instruments which do not meet the definition of either debt-type or equity-type instruments) to be classified under:

- a) Investments at amortised cost.
- b) Investments at fair value through equity; or
- c) Investments at fair value through income statement if the irrevocable classification choice at initial recognition is exercised, that is, an institution has made an irrevocable election to designate a particular investment, at initial recognition, being a non-monetary debt-type instrument or other investment instrument – as measured at fair value through income statement.

10.3.2.2 *Investment in Monetary Debt-Type Instruments*

Such instruments reflect a debt at the back end and shall be classified and measured under FAS 33 at cost, till the time the transaction at the back end is executed and at amortised cost thereafter.

10.3.2.3 *Investment in Equity-Type Instruments*

Investment in equity-type instruments may be classified under:

- a) Investments at fair value through income statement, or
- b) Investments at fair value through equity if the irrevocable classification choice at initial recognition is exercised, that is, an institution has made an irrevocable election to designate a particular investment, at initial recognition, being an equity-type instrument that would otherwise be measured at fair value through income statement – to present subsequent changes in fair value in equity.

10.3.2.4 *Investment Held for Trading Purposes*

Such investments shall always fall in fair value through income statement classification.

10.3.3 *Initial Recognition*

The investments in *Sukuk* must be recognised upon transfer of control to the investor. Except for assets recognised at fair value through the income

statement, all investments must be initially recognised at their fair value plus transaction expenses.

	Dr.	Cr.
Date <i>Sukuk</i> Investment (Asset)	xx	
Cash (Asset)		xx
<i>(To record the investment in Sukuk)</i>		

When transaction expenses for investments at fair value through the income statement are incurred, they are charged to the income statement.

	Dr.	Cr.
Date <i>Sukuk</i> Transaction Cost (Expense)	xx	
Cash (Asset)		xx
<i>(To record transaction expenses for investment in Sukuk at fair value through Income Statement)</i>		

Box 10.5 Illustration 10.1 Initial Recognition of *Sukuk* Investments

Waseeh Bank invests PKR 14,000,000 in a government *Sukuk* offering on Jan 1, 2023. Transaction expenses incurred upon investing in the *Sukuk* amount to PKR 100,000.

Requirement: State the journal entries for recording this investment in the books of Waseeh Bank.

Solution:

Waseeh Bank will pass the following entries.

	Dr.	Cr.
Jan 1 <i>Sukuk</i> Investment (Asset)	14,000,000	
<i>Sukuk</i> Investment (Expense)	100,000	
Cash (Asset)		14,100,000
<i>(To record investment in Sukuk and associated transaction expenses)</i>		

10.3.4 Subsequent Measurement

10.3.4.1 Amortised Cost

The effective profit rate approach is used to re-measure investments held at amortised cost at the end of each reporting period. The income statement

records all gains and losses resulting from the amortisation process, as well as those resulting from the derecognition or impairment of the investment. If the investment is made at the subscription stage of the instrument or at any point before the commencement of such a transaction, the effective profit rate method considers the transaction’s start date as the date of initial cash outflow.

	Dr.	Cr.
Date		xx
<i>Sukuk Amortisation (Expense)</i>		
<i>Sukuk Investment (Asset)</i>		xx
<i>(To record amortisation of Sukuk investment)</i>		

For each reporting period, investments carried at amortised cost must be evaluated for impairment in line with FAS 30 “Impairment, credit losses, and onerous commitments”.

Box 10.6 Illustration 10.2 Subsequent Measurement – Amortised Cost

Ijlal Bank invests USD 1,000,000 in *Sukuk* on Feb 1, 2023. The bank carries *Sukuk* investments at amortised cost and uses the effective rate method to measure its *Sukuk* investments, using a 10% rate of return. The amortisation during the first year amounts to USD 90,000.

Requirement: State the journal entries for recording this amortisation in the books of Ijlal Bank.

Solution:

Ijlal Bank will pass the following entries.

	Dr.	Cr.
Feb 1		
<i>Sukuk Amortisation (Expense)</i>	90,000	
<i>Sukuk Investment (Asset)</i>		90,000
<i>(To record amortisation of Sukuk investment)</i>		

10.3.4.2 Fair Value Through Income Statement

At the end of each reporting period, investments carried at fair value through the income statement must be re-measured at fair value. The resulting re-measurement gain or loss, if any, is recognised in the income statement as the difference between the carrying amount and the fair value. The income

statement must account for all other revenue and expenses resulting from these investments.

		Dr.	Cr.
Date	<i>Sukuk</i> Investment (Asset)	xx	
	Revaluation Gain on <i>Sukuk</i> Investment (Income) (To record gain on <i>Sukuk</i> investment using FV through Income Statement)		xx
Date	Revaluation Loss on <i>Sukuk</i> Investment (Expense) <i>Sukuk</i> Investment (Asset) (To record loss on <i>Sukuk</i> investment using FV through Income Statement)	xx	xx

Box 10.7 Illustration 10.3 Subsequent Measurement – Fair Value Through Income Statement

Zein el Abidine Bank has MYR 2,000,000 in *Sukuk* investments as of Mar 31, 2023. The bank measures *Sukuk* investments using fair value through income statement. The gain on this investment during the first year amounts to USD 90,000.

Requirement: State the journal entries for recording this amortisation in the books of Zein el Abidine Bank at the year-end, Dec 31.

Solution:

Zein el Abidine Bank will pass the following entries.

		Dr.	Cr.
Dec 31	<i>Sukuk</i> Investment (Asset)	90,000	
	Revaluation Gain on <i>Sukuk</i> Investment (Income) (To record gain on <i>Sukuk</i> investment using FV through Income Statement)		90,000

Items accounted for in the income statement for investment at fair value through income statement should be recognised taking into account the split between the portion related to owners' equity and the portion related to the equity of profit-and-loss-taking stakeholders, including investment account holders.

10.3.4.3 Fair Value Through Equity

At the conclusion of each reporting period, investments carried at fair value through equity must be re-measured at fair value. The difference between the

carrying amount and the fair value, if any, is directly recognised in equity under “investments fair value reserve” taking into account the split between the portion related to owners’ equity and the portion related to equity of profit-and-loss-taking stakeholders, including investment account holders.

		Dr.	Cr.
Date	Investments Fair Value Reserve – IAH (Equity)	xx	
	Investments Fair Value Reserve – IFI (Equity)	xx	
	<i>Sukuk Investment (Asset)</i>		xx
	<i>(To record loss on Sukuk investment measured using FV through Equity)</i>		
Date	<i>Sukuk Investment (Asset)</i>	xx	
	Investments Fair Value Reserve – IAH (Equity)		xx
	Investments Fair Value Reserve – IFI (Equity)		xx
	<i>(To record gain on Sukuk investment measured using FV through Equity)</i>		

Box 10.8 Illustration 10.4 Subsequent Measurement – Fair Value Through Equity

Osmaniyeh Bank has *Sukuk* investments on its books carried at a value of TRY 9,000,000 as on Jan 1, 2023. The bank measures *Sukuk* investments using fair value through equity. At the end of the reporting period on Dec 31, 2023, the carrying value after accounting for amortisation is TRY 8,950,000. At the same date, the fair value of the investments is ascertained to be TRY 8,730,000.

Requirement: State the journal entries for recording gain or loss on *Sukuk* investment in the books of Osmaniyeh Bank. The split between the portion related to IFI’s equity and the equity of profit-and-loss-taking stakeholders is 50:50.

Solution:

Difference between the carrying amount and fair value = 8,950,000 – 8,730,000 = 220,000.

Osmaniyeh Bank will pass the following entries.

		Dr.	Cr.
Dec 31	Investments Fair Value Reserve – IAH (Equity)	110,000	
	Investments Fair Value Reserve – IFI (Equity)	110,000	
	<i>Sukuk Investment – SFP</i>		220,000
	<i>(To record loss on Sukuk investment measured using FV through Equity)</i>		

In accordance with FAS 30 “Impairment, credit losses, and onerous commitments”, investments carried at fair value through equity should be evaluated for impairment at each reporting period.

10.3.5 Derecognition of Sukuk Investments

The difference between the carrying amount and the net proceeds from the sale or at the maturity of each investment is used to calculate realised profits or losses from the sale or maturity of that investment. Please note that the sample entries in this section assume a loss on derecognition. In the case of a gain, a credit entry would be made in the income statement instead of credit.

10.3.5.1 Amortised Cost

For instruments accounted for using amortised cost, the instrument is derecognised, and any gain or loss is recorded in the income statement.

		Dr.	Cr.
Date	Loss on <i>Sukuk</i> Investment (Expense)	xx	
	Cash (Asset)	xx	
	<i>Sukuk</i> Investment (Asset)		xx
	<i>(To record derecognition of Sukuk investment using amortised cost)</i>		

10.3.5.2 Fair Value Through Income Statement

For investments valued using fair value through income statement, the gain or loss on disposal of the investment must be recognised in the income statement.

		Dr.	Cr.
Date	Loss on <i>Sukuk</i> Investment (Expense)	xx	
	Cash (Asset)	xx	
	<i>Sukuk</i> Investment (Asset)		xx
	<i>(To record derecognition of Sukuk investment using FV through Income Statement)</i>		

10.3.5.3 Fair Value Through Equity

For investments valued using fair value through equity, the resulting gains or losses, as well as the balance of the “investments fair value reserve” account, must be recognised in the income statement for the current reporting period.

		Dr.	Cr.
Date	Loss on <i>Sukuk</i> Investment (Expense)	xx	
	Cash (Asset)	xx	
	Investments Fair Value Reserve – IAH (Equity)	xx	
	Investments Fair Value Reserve – IFI (Equity)	xx	
	<i>Sukuk</i> Investment (Asset)		xx
	<i>(To record derecognition of Sukuk investment measured using FV through equity)</i>		

Box 10.9 Illustration 10.5 Comprehensive Example – Derecognition of *Sukuk*

JDMT Bank has a *Sukuk* investment with a carrying value of USD 100,000 on its books. On Mar 6, 2023, it disposes of the investment for USD 110,000.

Requirement: Pass the entries for derecognition of the *Sukuk* investments if JDMT classifies its *Sukuk* investments using:

- a) Amortised cost
- b) Fair value through income statement
- c) Fair value through equity. Assume the balance in the Investments Fair Value Reserve is USD 40,000.

Solution:

JDMT Bank will pass the following entries.

- a) Amortised cost:

		Dr.	Cr.
Mar 6	Cash (Asset)	110,000	
	Gain on <i>Sukuk</i> Investment (Income)		10,000
	<i>Sukuk</i> Investment (Asset)		100,000
	<i>(To record derecognition of Sukuk investment using amortised cost)</i>		

- b) Fair value through income statement:

		Dr.	Cr.
Mar 6	Cash (Asset)	110,000	
	Gain on <i>Sukuk</i> Investment (Income)		10,000
	<i>Sukuk</i> Investment (Asset)		100,000
	<i>(To record derecognition of Sukuk investment using FV through income statement)</i>		

c) Fair value through equity:

		Dr.	Cr.
Mar 6	Cash (Asset)	110,000	
	Investments Fair Value Reserve – IAH and IFI (Equity)	40,000	
	<i>Sukuk Investment (Asset)</i>		100,000
	<i>Gain on Sukuk Investment (Income)</i>		50,000
	<i>(To record derecognition of Sukuk investment using FV through equity)</i>		

Box 10.10 Practical Insight: Trends in Green and ESG Sukuk

In 2022, while the global issuance of *Sukuk* experienced a slight decline, ESG *Sukuk* saw significant growth, increasing by 35% compared to the previous year. The issuance of ESG *Sukuk* reached USD 8.1 billion in 2022, up from USD 6 billion in 2021. The Green and Sustainability *Sukuk* Report 2022: Financing a Sustainable Future by Refinitiv stated that the demand for green and sustainability *Sukuk* reached a new peak, driven by investors with a focus on ESG factors. Noteworthy issuances during this period included the debut issuance of sustainable *Sukuk* worth USD 750 million by Saudi National Bank, the largest lender in the kingdom. In addition, Riad Bank successfully concluded an Additional Tier 1 (AT1) sustainability *Sukuk* worth USD 750 million, becoming the first global issuer of a sustainable AT1 *Sukuk* (Refinitiv, 2023).

10.4 Financial Reporting for Sukuk-Holders

FAS 34 *Financial Reporting for Sukuk-Holders* prescribes the reporting requirements as well as the accounting principles for the assets and business underlying the *Sukuk*. The purpose is to ensure transparency and fair reporting for all stakeholders, primarily the *Sukuk*-holders.

FAS 34 applies to *Sukuk* issued by an originator either directly or via the use of an SPV or similar mechanism. The originator may choose not to apply this standard to *Sukuk* that are held on the balance sheet in accordance with the requirements of FAS 29 “*Sukuk* in the books of the originator”.

FAS 34 has the following scope for application:

- It is applicable only to the *Sukuk* instruments, which are issued under the rulings of *Shariah*.
- It is applicable to both the two-party *Sukuk* and three-party *Sukuk* (issued through SPV). This standard can be applied if the *Sukuk* is issued using any other similar structure.

For accounting and reporting, FAS 34 classifies the *Sukuk* into two classes: business *Sukuk* and non-business *Sukuk*. We will discuss both classes one by one in detail.

10.4.1 *Business Sukuk*

Business *Sukuk* is the *Sukuk* arrangement in which the certificates reflect an underlying business. The underlying business can be in the form of a single investment contract, a trade transaction, or any similar activity. The investment contract includes the *Mudaraba* and *Musharakah* contracts. Trade transactions, on the other hand, may include a *Salam* or *Murabaha* transaction. Additionally, the underlying business can also be in the form of a mix of investment and transaction contracts (called compound contracts).

10.4.1.1 *Financial Reporting*

For the purposes of financial reporting, any firm can be divided into Islamic finance transactions and/or assets, goods, and services that are not related to Islamic finance transactions. The type of an institution's business determines its financial reporting and financial statement characteristics.

The set of financial reports for a business *Sukuk* comprises the statement of financial position, income statement (duly disclosing earnings per *Sukuk* unit), and notes to the financial statements (refer to presentation and disclosures section) including any movements in reserves, if any.

10.4.1.2 *Presentation and Disclosures*

The general presentation and disclosures include:

- Nature of business, its assets, its main activities, and the structure for *Sukuk* or other instruments of investment
- Value of the underlying asset(s) and information necessary to ascertain its tradability in line with *Shariah* principles, depending on the nature of the instrument
- Transfer of legal ownership from the originator to the SPV
- Ownership and control of the SPV, particularly, if it is controlled by the originator
- Fair valuation of the business and the significant assets along with disclosures of valuation techniques used to determine fair value, with the level of observable inputs used in line with GAAP
- At the time of liquidation of the *Sukuk* entity, the details of the transaction execution
- Charity and its movement, if any, and its disposal
- *Zakah* funds, if any

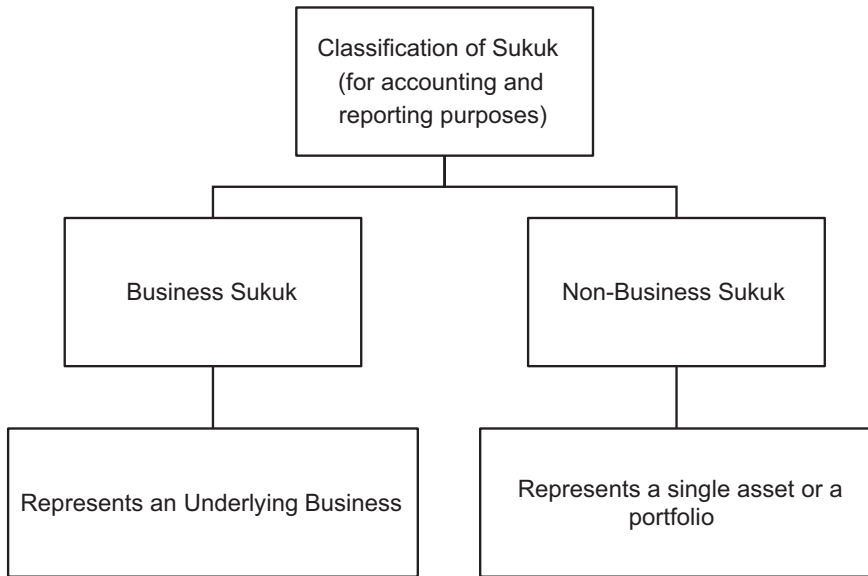


Figure 10.7 Classification of *Sukuk* for Accounting and Reporting Purposes

Source: Diagram by the authors.

10.4.2 Non-Business Sukuk

Sukuk that do not have any underlying business are classified as **non-Business Sukuk**. They are also called “Assets *Sukuk*” because they mostly involve an underlying asset. The most common example of non-business *Sukuk* is the *Ijarah Sukuk*, in which there is no underlying business. Instead, the *Ijarah* asset is involved whose ownership remains with the issuer, and only usufruct is given to the *Sukuk*-holders, and the *Sukuk*-holders receive their profit on a contractual basis (Figure 10.7).

10.4.2.1 Accounting Treatment

At the time of initial recognition, underlying assets are valued at cost, which is the amount paid or payable for them.

Following initial recognition, the underlying assets must be measured at fair value at each reporting date, except for Islamic financing transactions, which cannot be held at fair value.

When fair value cannot be ascertained or objective evidence exists that the fair value does not differ considerably from the carrying value, the underlying assets are measured at cost or amortised cost adjusted for any impairment in the value of the underlying assets at each reporting date. Fair asset valuation is established with appropriate regularity to ensure that stakeholders’ decision-making is not influenced by information obsolescence.

The resulting revenues, expenses, gains, and losses arising from the underlying assets should be measured and accounted for, respectively, according to the nature of the contract(s), in accordance with the requirements of respective or similar FAS applicable to such transactions in accordance with the framework or GAAP.

10.4.2.2 *Financial Reporting*

The set of financial reports for non-business *Sukuk* comprises a statement of net assets with a net asset value (NAV) disclosure, statements of changes in net assets, and notes to the financial statements.

10.4.2.3 *Presentation and Disclosures*

Minimum disclosure requirements include:

- Type of asset, the main activity and underlying contracts, if any, and significant investment policies
- Accounting policy to recognise revenues, fair value changes, and expenses
- Transfer of legal ownership from the issuer to SPV or the holders of the instrument
- Value of the underlying asset and its tradability which, along with other factors, depends on the nature of such assets and the underlying contracts
- NAV at each reporting date – to be made on the face of the statement of net assets
- Valuation techniques used to determine the fair value along the level of observable inputs used in line with the generally accepted accounting principles
- At the time of liquidation of the *Sukuk* entity, the details of the transaction execution
- Any charity and its movement, including any income taken to charity, if any, and its disposal
- *Zakah* fund and its movement, including any income taken to *Zakah*, if any, and its disposal

Box 10.11 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) Business *Sukuk* is the *Sukuk* arrangement in which the certificates reflect an underlying business.
- 2) The financial reports for non-business *Sukuk* comprise the statement of financial position, income statement, and notes to the financial statements.

- 3) Non-business *Sukuk* are also called “Assets *Sukuk*” because they mostly involve an underlying asset.
- 4) In non-business *Sukuk*, at the time of initial recognition, underlying assets are valued at fair value.
- 5) For non-business *Sukuk*, an entity must disclose the valuation techniques used to determine the fair value along the level of observable inputs.

Solution:

- 1) True.
- 2) False. The financial reports for business *Sukuk* comprise the statement of financial position, income statement, and notes to the financial statements.
- 3) True.
- 4) False. In non-business *Sukuk*, at the time of initial recognition, underlying assets are valued at cost, which is the amount paid or payable for them.
- 5) True.

10.5 Presentation and Disclosure

The presentation and disclosure requirements for *Sukuk*-holders under FAS 33 require that investments must be stated individually as a line item in the asset section of the statement of financial position. The principal components of each form of investment must be disclosed either on the face of the balance sheet or in the notes.

Income and gains/losses from all types of investments must be reported in the income statement under “income or gains/losses from investments”, with the split between the portion related to owners’ equity and the portion related to profit-and-loss-taking stakeholders, such as investment accountholders, taken into account. In the notes to the financial statements, the income and gains/losses from the principal components of each form of investment must be disclosed separately.

General disclosures include:

- Accounting policies for classification, recognition, and measurement have been adopted
- Any limitations or encumbrances on investments, profits, or sales
- Investments in which the institution does not have the legal title
- Investment portfolios are divided by valuation through amortised cost, fair value through income statement, and fair value through equity
- Details on the nature of each kind of investment
- Summary and amounts of graded investments, as well as their corresponding ratings

- The cumulative “investments fair value reserve” shows the balance at the start of the financial period, changes during the period, and the balance at the end of the financial period, with proper attribution to the owners’ equity and the equity of profit-and-loss-taking stakeholders, including investment account holders

Box 10.12 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) Investments that are held to maturity with the intent to collect all cash flows are carried using amortised cost.
- 2) An investment is measured at fair value through equity if it is held within a business model whose goal is achieved only by selling the investment.
- 3) The investments in *Sukuk* must be recognised upon agreement of a date to transfer control to the investor.
- 4) At the end of each reporting period, investments carried at fair value through the income statement must be re-measured at fair value.
- 5) For investments carried at FV through equity, the difference between the carrying amount and the fair value is recognised in equity under “revaluation gains”.

Solution:

- 1) True.
- 2) False. An investment is measured at fair value through equity if it is held within a business model whose goal is achieved by both collecting expected cash flows and selling the investment.
- 3) False. The investments in *Sukuk* must be recognised upon transfer of control to the investor.
- 4) True.
- 5) False. For investments carried at FV through equity, the difference between the carrying amount and the fair value is recognised in equity under “investments fair value reserve”.

10.6 IFRS Perspective

Under IFRS a *Sukuk* is considered similar to a conventional bond in substance and therefore an entity investing in *Sukuk* will account for these as a financial asset under **IFRS 9 Financial Instruments**. As mentioned in earlier chapters, the measurement of a financial asset under IFRS 9 is dependent

upon two conditions, which are the **business model test** and the **contractual cash flows characteristics test**. Briefly, the business model test is concerned with the intention of the entity making the investment. If the intention is to hold the asset to benefit from the contractual cashflows (as opposed to selling it), then this test is satisfied. The second condition requires that the entity will receive cashflows from the asset which are the principal and the interest on the principal, and the timings of the receipts are known.

If both tests are satisfied, the asset is recorded at *amortised cost*. If, however, the business model objective of the entity is to receive cashflows from both selling the asset and the principal and interest cashflows, then the asset is recorded at *fair value through other comprehensive income* (known as FVOIC). In other words, any gains or losses on revaluation of the asset at the end of each reporting period are reported in the Other Comprehensive Income Statement. Finally, in case the business model objective of the entity is to sell the asset, then the asset is recorded at *fair value through profit or loss* (known as FVPL). Accordingly, an entity acquiring *Sukuk* must evaluate the above criteria, which will determine the accounting treatment of the asset.

For an equity investment (e.g., shares in another company), again the measurement criteria are based on the business model which the entity has chosen for that investment. If the entity intends to keep the shares, then IFRS 9 allows the use of FVOIC (provided the entity elects to do this). However, if the shares are held for trading purposes and are intended to be sold, then FVPL will be used.

The provisions relating to the derecognition of financial assets are given in detail and subject to various conditions under IFRS 9. In general, a financial asset should be derecognised either when the contractual rights to receive cashflows from the asset have expired or the entity has transferred ownership or risks and rewards relating to the ownership of the asset.

FAS 33 also allows three measurement classifications being amortised cost, fair value through equity, and fair value through income statement. These are again based on two tests which are similar (but not identical) to those given under IFRS 9. The main difference relates to the cashflows characteristics test since conventional interest is not permitted under *Shariah*, and so the wording used in FAS 33 is that the instrument should have a “reasonably determinable effective yield”.

Box 10.13 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) *Sukuk* are considered to be the equivalent of conventional bonds, hence a debt instrument under IFRS.

- 2) *Sukuk* held by an entity will be measured at amortised cost if either the business model test or the contractual cash flows test is satisfied.
- 3) If both the business model test and the contractual cash flows characteristics test are satisfied, the asset is recorded at FVOIC.
- 4) The main difference between IFRS and AAOIFI in relation to the cashflows characteristics test is that since conventional interest is not permitted under *Shariah*, FAS 33 requires that the instrument should have a “reasonably determinable effective yield”.
- 5) Similar to IFRS, FAS 33 also allows three measurement classifications being amortised cost, fair value through equity, and fair value through income statement.

Solution:

- 1) True.
- 2) False. Both tests must be satisfied for a financial asset to be recorded at amortised cost.
- 3) False. If both tests are satisfied, the asset is recorded at amortised cost.
- 4) True.
- 5) True.

10.7 Chapter Summary

- The main parties involved in *Sukuk* are:
 - The originator is the party that needs the money for its operations or expansion.
 - *Sukuk*-holders are the investors who invest in the *Sukuk* and provide the funds needed by the originator.
 - In a three-party *Sukuk*, Special Purpose Vehicle (SPV) is a temporary legal entity that is created by another company to execute a specific task. When the task is finished, the SPV is also dissolved. (LO 1)
- The process of a *Sukuk* varies on the basis of the type of the *Sukuk*.
- The main types of *Sukuk* are:
 - Lease agreement
 - Sales agreement/asset-based/debt-type structures (unsecured)
 - Asset-backed/equity-type structures (secured) (LO 2)
- FAS 34 “Financial Reporting for *Sukuk*-Holders” prescribes the accounting treatment and reporting of the underlying assets in a *Sukuk* transaction. (LO 3)

- An institution is said to **control** an asset or business when it has substantially all of the risks and rewards associated with ownership of such asset or business and meets the following conditions:
 - It is directly exposed to, or has rights to, variable returns from its involvement with such assets or business.
 - It can influence those returns through its power over the assets or business. (LO 3)
- The set of financial reports for a business *Sukuk* comprises the statement of financial position, income statement (duly disclosing earnings per *Sukuk* unit), and notes to the financial statements. (LO 3)
- The set of financial reports for non-business *Sukuk* comprises a statement of net assets with a net asset value (NAV) disclosure, statements of changes in net assets, and notes to the financial statements. (LO 3)
- AAOIFI requires that fair value changes of investments classified as fair value through equity investments are taken to “investment fair value reserve” under equity. Under IFRS such changes are recorded in other comprehensive income. (LO 4)

10.8 Key Terms and Definitions

- **Business *Sukuk*:** The *Sukuk* arrangement in which the certificates reflect an underlying business.
- **Control:** An institution controls an asset or business when it has all risks and rewards incidental to ownership of such asset or business substantially, duly meeting both of the following conditions:
 - It is directly exposed to or has rights to variable returns (negative or positive, respectively) from its involvement with such assets or business.
 - It can affect those returns through its power over the assets or business.
- **Fair value:** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
- **Non-Business *Sukuk*:** *Sukuk* that do not have any underlying business.
- **On-Balance Sheet *Sukuk*:** *Sukuk* in which the institution has decision-making authority over the use and deployment of money, among other things, in relation to the underlying assets or business.
- **Originator:** An IFI or other institution that issues the *Sukuk* in line with *Shariah* principles and rules, directly or using an SPV or a similar mechanism.
- **Special Purpose Vehicle (SPV):** Also termed a Special Purpose Entity (SPE), a legal entity (corporate entity, trust or limited partnership, etc.) created to fulfil narrow, specific, or temporary financial objectives. An SPV, in the context of *Sukuk*, is not a pass-through entity and rather is an

entity in itself, meeting the definition of a business, usually managing the virtual *Sukuk* entity.

- ***Sukuk*:** Certificates of equal value representing undivided shares in the ownership of tangible assets, usufructs, and services or (in the ownership of) the assets of projects or special investment activity. Such special investment activity is referred to as a business in this standard. *Sukuk* may be tradable or not tradable according to the nature of the governing contract or arrangement, as well as the nature of the underlying assets or business.
- ***Sukuk* entity:** A real or virtual entity having the *Sukuk*-holders as owners and owning the underlying *Sukuk* assets.
- ***Sukuk*-holders:** Investors who own the underlying assets or business for *Sukuk* issuance by virtue of owning the *Sukuk* certificates.

10.9 Review Questions

- 1 Which of the following is not a characteristic of *Sukuk*?
 - a) The returns are generated from the underlying assets in the *Sukuk*.
 - b) In the sale of *Sukuk*, a particular share of an asset is sold.
 - c) There is no concept of ownership or profit-sharing in *Sukuk*.
 - d) The purpose of funds is decided and stated at the time of issuance of *Sukuk*.
- 2 Which of the following is incorrect regarding the parties involved in *Sukuk*?
 - a) The originator is the party that needs the money for its operations or expansion.
 - b) SPV is a temporary legal entity that is created by another company to execute a specific task.
 - c) *Sukuk*-holders receive a certificate (*Sukuk*) in exchange for the funds that they give under the *Sukuk* arrangement.
 - d) When the task for which an SPV is created is finished, the SPV is retained on the balance sheet of the issuer.
- 3 Under *Sukuk Ijarah*, the originator:
 - a) Does not transfer the underlying assets to the SPV
 - b) Pays an amount equivalent to the initial financing obtained from the investors to buy back the asset from the SPV at the maturity date of the *Sukuk*
 - c) Does not share the ownership of the *Ijarah* assets with investors
 - d) Cannot initiate a *Sukuk* without creating an SPV
- 4 *Sukuk* based on sales agreements:
 - a) Are also called liability-based *Sukuk*
 - b) Are not designed to replicate conventional bonds

- c) Focus on the creditworthiness of the originator
 - d) Involve proportionate sale of the underlying asset to the *Sukuk*-holder
- 5 Common examples of equity-based *Sukuk* are:
- a) *Musharakah* and *Mudaraba Sukuk*
 - b) *Ijarah* and *Salam Sukuk*
 - c) *Murabaha* and *Ijarah Sukuk*
 - d) *Musharakah* and *Wakalah Sukuk*
- 6 FAS 34 “Financial Reporting for *Sukuk*-Holders”:
- a) Applicable to both *Shariah* and non-*Shariah*-compliant *Sukuk* instruments
 - b) Applicable only to two-party *Sukuk*
 - c) Applicable to both the two-party *Sukuk* and three-party *Sukuk*
 - d) Covers accounting treatment but not financial reporting of the underlying assets in a *Sukuk* transaction
- 7 An institution is said to control an asset or business when:
- a) It has substantially all the risks and rewards associated with ownership of such asset.
 - b) It is not exposed to variable returns from its involvement with such assets or business.
 - c) It cannot influence those returns through its power over the assets or business.
 - d) It has all the rewards associated with ownership of such asset but not risks.
- 8 *Sukuk*-holders receive returns in the form of:
- a) Interest payments
 - b) Dividends
 - c) Profit-sharing
 - d) Principal repayment
- 9 Which of the following is not a type of *Sukuk* classification in the books of the *Sukuk*-holder?
- a) Amortised cost
 - b) Fair value through equity
 - c) Fair value through income statement
 - d) *Sukuk* based on revaluation model
- 10 In a non-business *Sukuk*:
- a) The underlying assets must be measured at fair value at each reporting date following initial recognition.
 - b) The required set of financial reports comprises statement of financial position, income statement, and notes to the financial statements.

- c) There is no underlying asset or business.
- d) Disclosure of accounting policy to recognise revenues, fair value changes, and expenses is not required.

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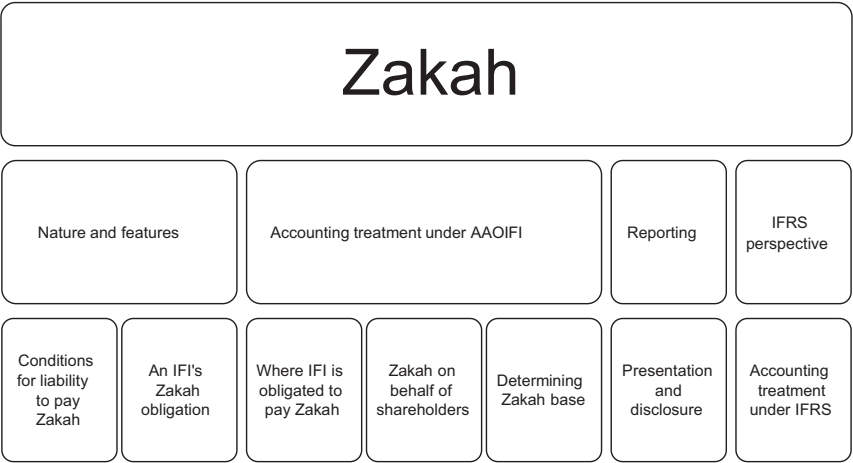
11 Zakah

Learning Objectives

After going through this chapter, you should be able to:

- 1 Describe the nature of *Zakah*.
- 2 Understand the conditions for liability to pay *Zakah* for an IFI.
- 3 Describe the accounting entries, presentation, and disclosure requirements for *Zakah* under FAS 9, as well as other considerations.
- 4 Identify the key differences between IFRS and FAS accounting for *Zakah*.

Chapter Preview



Cover Story

In 2022, Sudan was hit by devastating floods resulting in a devastating loss of life, with over 100 fatalities and a similar number of injuries since the start of the rainy season. The UN estimated that around 258,000 individuals had been

impacted by the floods in 15 out of Sudan's 18 provinces, leaving many villages in ruins and vast areas of land submerged. Egypt's Al-Azhar, the leading religious authority in the country, announced that the Egyptian Zakat and Charity House (EZCH) would be sending a substantial amount of *Zakah* (charity) to Sudanese residents affected by the destructive floods. EZCH was established in 2014 and operates with financial and administrative independence to collect charitable donations from Muslims and distribute them in accordance with legal regulations, promoting solidarity and compassion within society. *Zakah* is an Islamic obligation that emphasises the giving of alms and plays a crucial role in the charitable activities of the EZCH. EZCH provided significant aid to Sudan, including tens of tons of food items such as flour, pasta, sugar, and canned goods. Additionally, the aid package consists of thousands of relief items, such as mattresses, blankets, medicines, and medical supplies, essential for addressing the immediate needs of the affected population.

The *Zakah* provided by the EZCH, alongside the government's efforts, highlights the solidarity and support extended to Sudan in their time of need. The Egyptians' commitment to stand by their Sudanese brothers and sisters demonstrated the impact of *Zakah*, fostering a sense of unity and shared humanity. Such acts of compassion and collaboration are essential in addressing the immediate challenges brought about by natural disasters and in facilitating the recovery and resilience of affected communities (Ahram Online, 2022).

11.1 Introduction to *Zakah*

Zakah, in literal terms, means blessing, purification, increase, and cultivation of good deeds. It is one of the fundamental pillars of Islam, and its payment is deemed mandatory for individuals who have more than a certain amount of wealth. Muslims believe *Zakah* blesses the wealth it is paid from and protects it. The government of a country is responsible for collecting the *Zakah* and spending it on people who are eligible for *Zakah*. As far as the shareholders of an IFI are concerned, the government may authorise them to pay their *Zakah* themselves or instruct the IFIs to pay it on behalf of their shareholders. Once the IFI has paid the *Zakah* on behalf of its shareholders, the shareholders no longer have an obligation to pay it. *Zakah* can be paid through cash or through the equivalent value of goods. *Zakah* needs to be paid out of kosher or *halal* assets of an IFI. If a certain amount is earned through non-*Shariah*-compliant sources, then the entire amount of such funds is to be donated to charity. This does not count towards the payment of *Zakah*.

11.1.1 Conditions for *Zakah*

Before moving on to the calculation of *Zakah*, let us look at the conditions laid down by *Shariah* for the payment of *Zakah*.

- **Attainment of *Nisab*:** *Nisab* is defined as the minimum amount of wealth on which *Zakah* becomes liable. If an individual's wealth is below *Nisab* for one lunar year, no *Zakah* payment is required. The *Nisab* for gold is

85 grams of gold while the *Nisab* for silver is 595 grams of silver. The *Nisab* for cash and trading goods is also drawn from gold, that is, 85 grams of gold. There is different *Nisab* prescribed in *Shariah* for live-stock, horticultural produce, and agriculture which are mentioned in the Appendix to this chapter.

- **The passing of *Hawl* (year):** It is required to pay *Zakah* when a lunar year is completed, starting from the day *Nisab* is attained. The *Zakah* is paid on the closing value of the prescribed assets.
- ***Zakah* rate:** The prescribed *Zakah* rate is 2.5% of the *Zakah*-able wealth. However, if an IFI or an individual follows the solar calendar, an adjustment should be made for the difference between the lunar and solar calendars. In the case of the solar calendar, the rate used to compute *Zakah* increases to 2.5775% instead of the 2.5% used by those observing the lunar calendar.

Box 11.1 Practical Insight: Islamic Relief USA

Islamic Relief USA is a global charitable organisation that collects *Zakah* donations to provide humanitarian assistance. They established their first field office in Khartoum, Sudan, in their second year of operation, focusing on supporting drought-affected individuals in rebuilding their lives. With over 100 offices in 40 countries, including Afghanistan, Bosnia, Pakistan, Palestine, Somalia, Syria, and the United States, Islamic Relief offers disaster relief and sustainable development programmes. Their initiatives include winter aid, access to water and food, shelter, healthcare, education, support for orphans and children, employment opportunities, livelihood development, and community resilience against future disasters (Islamic Relief USA, 2023).

Box 11.2 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) *Zakah* is required to be paid for a property irrespective of whether its owner can dispose of it or not.
- 2) No *Zakah* applies to public and endowment (*Waqf*) funds since they do not have a specific owner.
- 3) The *Nisab* for cash and trading goods is calculated using their cash equivalent value and its comparison to the *Nisab* of gold.
- 4) *Zakah* is applicable only to assets that cannot achieve growth in real terms or by estimation.
- 5) If the lunar calendar is observed, 2.5775% is charged for *Zakah*, and if the solar calendar is followed, the rate is 2.5%.

Solution:

- 1) False. No *Zakah* is required to be paid for a property whose owner cannot dispose of it.
- 2) True.
- 3) True.
- 4) False. *Zakah* is applicable only to assets that can achieve growth in real terms or by estimation.
- 5) False. If the lunar calendar is observed, 2.5% is charged for *Zakah*, and if the solar calendar is followed, the rate is 2.5775%.

11.1.2 Zakah on Different Types of Assets

IFIs are required to compute their *Zakah* in the same way as a “normal person”. In other words, assets subject to *Zakah* are identified and quantified using the *Nisab* formula applicable to different categories of assets, such as cash, livestock, agricultural and horticultural products, trading commodities, and so on.

11.1.2.1 Zakah on Accounts Receivables

Zakah must be paid on accounts receivables which are collectable. In case of doubtful debts, *Zakah* is payable only when the accounts receivables are recovered and not during the years when the receivables may have remained unpaid.

11.1.2.2 Zakah on Livestock

Zakah is required to be paid on camels, cows, sheep, and goats, if they are not used for work (ploughing or draught animals), their market values have reached the requisite *Nisab* and a *Hawl* has passed. Details of *Nisab* and *Zakah* rates on different types of livestock are presented in Appendix 11.7 in this chapter.

11.1.2.3 Zakah on Agricultural or Horticultural Produce

Zakah levied on agricultural activity is called *Ushr*. The compulsory rate of *Ushr* is 10% in cases of irrigation by natural rainwater and 5% in cases of irrigation by artificial means.

11.1.3 An IFI's Zakah Obligation

There can be two main scenarios regarding an IFI's *Zakah* obligation:

- 1 IFI is obliged to pay the *Zakah*.
- 2 IFI pays *Zakah* on behalf of its shareholders.

11.1.3.1 The Obligation of IFI to Pay Zakah

The following are the cases under which the Islamic bank is required to pay *Zakah*:

- When state laws require the IFI to pay *Zakah*.
- When the shareholders have collectively passed a resolution requiring the IFI to fulfil the *Zakah* obligation.
- When the IFI is bound by its charter or by-laws to satisfy the *Zakah* obligation.

In any of the above cases, *Zakah* will be treated as a non-operating expense in the income statement of an IFI.

11.1.3.2 Payment of Zakah on Behalf of the Shareholders

Islamic banks may be required to pay *Zakah* on behalf of their shareholders in two scenarios. If one or more shareholders request the bank to act as their agent in fulfilling their *Zakah* obligation from their share of the distributable profits, the bank must deduct the *Zakah* from their portion of the profits.

However, if there are insufficient profits to meet the *Zakah* obligation on behalf of shareholders, the bank must record a receivable from the shareholders, representing the *Zakah* amount.

In all these cases described till now, *Zakah* is no longer treated as a non-operating expense of the IFI. Instead, it is adjusted from the shareholders' profits (Figure 11.1).

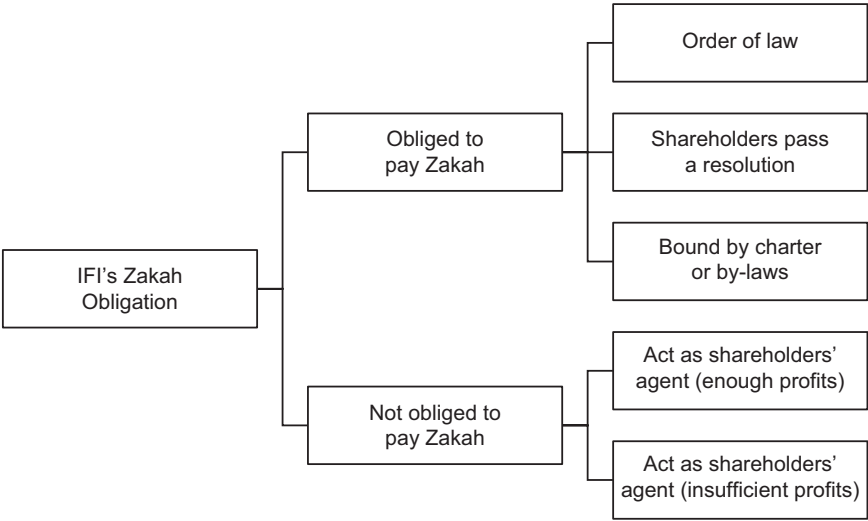


Figure 11.1 An IFI's *Zakah* Obligation

Source: Diagram by the authors.

Box 11.3 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false:

- 1) *Zakah* is payable on accounts receivable from debtors who are able to pay.
- 2) The IFI is obliged to pay *Zakah* when the IFI is bound by its charter or by-laws to satisfy the *Zakah* obligation.
- 3) If the IFI is obliged to pay *Zakah* due to the order of law, it is treated as an operating expense in the IFI's income statement.
- 4) If some or all the shareholders request the IFI to act as their agent in fulfilling the *Zakah* obligation from their profits, then the *Zakah* will be deducted from the shareholders' portion of distributable profits.
- 5) If some or all the shareholders request the IFI to act as their agent in fulfilling the *Zakah* obligation from their profits and the IFI agrees, even when there are insufficient profits to meet the *Zakah* obligation, the difference is recorded as an expense to the IFI.

Solution:

- 1) True.
- 2) True.
- 3) False. If the IFI is obliged to pay *Zakah* due to the order of law, it is treated as a non-operating expense in the IFI's income statement.
- 4) True.
- 5) False. If some or all the shareholders request the IFI to act as their agent in fulfilling the *Zakah* obligation from their profits and the IFI agrees, even when there are insufficient profits to meet the *Zakah* obligation, a receivable must be recorded from the shareholders.

11.2 Accounting Treatment of *Zakah*

The previous section discusses the two possible situations, that is, an IFI is obliged to pay *Zakah* or an IFI is not obliged to pay *Zakah* but is doing so on behalf of its shareholders. This section focuses on the accounting treatment of *Zakah* under these two scenarios.

11.2.1 Recognition of *Zakah* Expense

If an IFI is required to pay *Zakah* on its wealth, the IFI treats the *Zakah* as a non-operating expense.

Box 11.4 Illustration 11.1 Recording *Zakah* Payable by an IFI

On Jul 31, 2023, Alma Islamic Bank calculated that it had to pay USD 120,000 in *Zakah* for the year. The financial year of IFI ended on Dec 31, 2023; however, the *Zakah* remained unpaid till Feb 5, 2024. According to the laws, the IFI was responsible for satisfying the *Zakah* obligation.

Requirement: How will the IFI record this in their books?

Solution:

The IFI will record the *Zakah* expense for the year ended Dec 31, 2023 and create a liability against it since the IFI has not yet made the payment.

	Dr.	Cr.
Dec 31 <i>Zakah</i> Expense (Expense)	120,000	
<i>Zakah</i> Payable (Liability)		120,000
<i>(To record the unpaid Zakah)</i>		

11.2.2 Recording *Zakah* Payment on Behalf of Shareholders

In this case, the *Zakah* is not an expense but is taken out of the shareholders' portion of distributable profits. If the amount of *Zakah* due exceeds the shareholders' profit, the IFI will record a receivable in the name of the shareholder.

Box 11.5 Illustration 11.2 Payment of *Zakah* on Behalf of Shareholders

The shareholders of Saleh Islamic Bank requested the IFI to meet the *Zakah* obligation on their behalf. Shareholders had to pay MYR 145,000 for the *Zakah* for the year. For the current financial year, the distributable profits to shareholders amounted to MYR 97,000.

Requirement: How will the IFI record this in their books?

Solution:

Since the IFI is asked to act as shareholders' agent, the payment of *Zakah* will be made from the distributable profit. However, since the

profit is less than the *Zakah* due, the remaining amount will be recorded as receivables by the IFI.

		Dr.	Cr.
Dec 31	Dividends Payable (Liability)	97,000	
	Receivable From Shareholders (Asset)	48,000	
	Cash/Bank (Asset)		145,000
	(To record a receivable for Zakah)		

Box 11.6 Practical Insight: Al Rajhi Bank

In the income statement for the year ending 2020, Al Rajhi Bank has deducted *Zakah* totalling SAR 1.2 billion. In the notes to the financial statements, the uses of *Zakah* payment were stated, such as supporting households who lost their income due to Covid-19. The bank also paid *Zakah* around SAR 2 billion on behalf of its shareholders (Al Rajhi Bank, 2020).

11.2.3 Determination of Zakah Base and Amount

The amount on which *Zakah* is calculated is called the *Zakah* base. *Zakah* base is determined using either of the two methods: the net assets method or the net invested funds method. If the IFI or an individual follows the lunar calendar, a rate of 2.5% must be applied on the *Zakah* base to calculate the amount of *Zakah* due. However, if a solar calendar is observed, a rate of 2.5775% must be applied on the *Zakah* base to determine the *Zakah* amount.

11.2.3.1 Net Assets Method

The following formula is used to calculate the *Zakah* base according to FAS 9:

Zakah base = Assets subject to *Zakah* – (Current liabilities + Equity of unrestricted investment accounts + Equity owned by government + Minority interest + Equity owned by endowment fund + Equity owned by charities + Equity owned by non-profit organisations excluding those belonging to individuals)

Table 11.1 provides details regarding the items included in the *Zakah* calculation and their basis of valuation.

As shown in the table, in the net assets method, assets subject to *Zakah* include cash and cash equivalents, receivables, financing assets (e.g., *Mudaraba*,

Table 11.1 Items Included in *Zakah* Calculation – Net Assets Method

<i>Net assets method</i>	<i>Items included in the calculation</i>	<i>Basis of valuation</i>
Assets		
Cash and cash equivalents	Yes	Cash equivalent value
Receivables, net of provision	Yes	Cash equivalent value
<i>Istisna'a</i>	Yes	Cash equivalent value
<i>Mudaraba</i> financing	Yes	Cash equivalent value
<i>Musharakah</i> financing	Yes	Cash equivalent value
Real estate for trading	Yes	Cash equivalent value
Inventory for trading	Yes	Cash equivalent value
Marketable securities for trading	Yes	Cash equivalent value
<i>Salam</i>	Yes	Cash equivalent value
Investments not for trading	No	N/A
Other investments for trading	Yes	Cash equivalent value
Fixed assets	No	N/A
Assets for rent	No	N/A
Liabilities, equity of unrestricted investment, minority interest, owner's equity		
Current accounts	Yes	Book value
Payables during the next financial year	Yes	Book value
Other liabilities during the next financial year	Yes	Book value
Long-term liabilities	No	N/A
Provision for investment risk	No	N/A
Equity of unrestricted investment account holders	Yes	Book value
Minority interest	Yes	Book value
Owner's equity		
Paid-up capital	No	N/A
Reserves	No	N/A
Retained earnings	No	N/A
Net income	No	N/A

Istisna'a), and trading assets. For assets to be classified for trading, the following conditions should be met:

- Assets should be acquired via purchase, exchange, or through a debt transaction for resale or for being used in manufacturing.
- Only assets which are acquired with the intention of trading are liable for *Zakah*. Therefore, fixed assets are not considered for *Zakah* except when they are sold, and the cash proceeds exceed the *Nisab*.

Now let us look at a detailed example to calculate *Zakah* due based on the net assets method.

Box 11.7 Illustration 11.3 Calculating Zakah Base – Net Assets Method

Peacemakers Islamic Bank

Statement of Financial Position as at 31 December 2024

<i>Assets:</i>	<i>USD</i>	<i>USD</i>
Cash and cash equivalents		205,000
Receivables	730,250	
Less: Provisions for Doubtful Debts	(162,170)	568,080
<i>Mudaraba</i> financing		30,000
<i>Musharakah</i> financing		25,000
<i>Istisna'a</i>		28,000
Real estate (for trading)		12,780
Inventory (for trading)		11,000
Marketable securities (for trading)		127,000
Investments (for trading)		40,500
Other investments (not for trading)		32,400
Assets for rent		84,600
Fixed assets		13,200
Total assets		1,177,560
Liabilities, Equity of Unrestricted Investment, Minority Interest, Owner's Equity		
Liabilities:		
Current accounts	41,300	
Payables during the next financial year	62,000	
Other liabilities during the next financial year	76,000	
Long-term liabilities	100,500	
Provision for investment risk	15,400	
Total liabilities		295,200
Equity of unrestricted investment accounts		545,000
Minority interest		17,000
Owner's equity		
Paid-up capital	202,000	
Retained earnings	88,000	
Reserves	15,360	
Net income	15,000	
Total owners' equity		320,360
Liabilities, equity of unrestricted investment, minority interest, owner's equity		1,177,560

Additional information:

- 1 Equity owned by endowment and governmental bodies amounting to USD 4,000 was included in the owners' equity.
- 2 The following are the cash equivalent values for trading assets:

<i>Assets</i>	<i>Book value</i>	<i>Cash equivalent value</i>	<i>Difference</i>
Real estate	12,780	14,380	1,600
Inventory	11,000	16,000	5,000
Marketable securities	127,000	132,000	5,000
Investment	40,500	46,500	6,000
Total	191,280	208,880	17,600

Requirement: Calculate the *Zakah* base using the net assets method.

Solution:

Under the net assets method, the *Zakah* base and amount will be calculated as follows:

<i>Assets:</i>	<i>USD</i>	<i>USD</i>
Cash and cash equivalents	205,000	
Receivables	568,080	
<i>Mudaraba</i> financing	30,000	
<i>Musharakah</i> financing	25,000	
<i>Istisna'a</i>	28,000	
Real estate (for trading)	14,380	
Inventory (for trading)	16,000	
Marketable securities (for trading)	132,000	
Investments (for trading)	46,500	
Total		1,064,960
Less:		
Current accounts	41,300	
Payables during the next financial year	62,000	
Other liabilities during the next financial year	76,000	
Equity owned by endowment and government bodies	4,000	
Minority interest	17,000	
Equity of unrestricted investment accounts	545,000	
Total		(745,300)
<i>Zakah</i> base		319,660
<i>Zakah</i> amount due = $319,660 \times 2.5775\%$		8,239

11.2.3.2 Net Invested Funds Method

In the net invested funds method, the following formula is used to calculate the *Zakah* base according to FAS 9:

***Zakah* base** = Paid-up capital + Reserves + Provisions not deducted from assets + Retained earning + Net income + Long-term liabilities – (Net fixed assets + Investments not acquired for trading, e.g., real estate for rent + Accumulated losses)

If there is any difference between the book value and the cash equivalent value of the trading assets, it must be adjusted in the *Zakah* base calculation.

Table 11.2 provides details regarding the items included in the *Zakah* calculation and their basis of calculation:

Box 11.8 Illustration 11.4 Calculating *Zakah* Base Using Net Invested Funds Method

Refer to the same information stated earlier for Peacemakers Islamic Bank.

Requirement: Calculate the *Zakah* under the net invested funds method.

Solution:

Total owners' equity	320,360	
Less: Equity owned by endowment and governmental bodies	(4,000)	
	316,360	
Add:		
Difference between the cash equivalent value and the book value of trading assets	17,600	
Long-term liabilities	100,500	
Provision for investment risk	15,400	
Total equity		449,860
Less:		
Other investments not for trading	32,400	
Assets for rent	84,600	
Fixed assets	13,200	
Total		(130,200)
<i>Zakah</i> base		319,660
<i>Zakah</i> amount due = $319,660 \times 2.5775\%$		8,239

Box 11.9 Practical Insight: Bahrain Islamic Bank (BisB)

The Bahrain Islamic Bank displays its sources and uses of *Zakah* in its financial statements. The bank uses the net invested funds method to calculate its *Zakah* base. Moreover, in the notes to the financial statements of BisB, it is stated that the Group pays the *Zakah* based on the consolidated figures of the general reserve, statutory reserves, and retained earnings, and the remaining amount is paid by the individual shareholders. Furthermore, the bank does not take the responsibility of *Zakah* on the equity of investment account holders. For the financial year 2020, BisB had a total of BHD 401,000 in *Zakah* liability (Bahrain Islamic Bank, 2020).

Table 11.2 Items Included in *Zakah* Calculation – Net Invested Funds Method

<i>Net invested funds method</i>	<i>Items included in the calculation</i>	<i>Basis of valuation</i>
Assets		
Cash and cash equivalents	No	N/A
Receivables, net of provision	No	N/A
<i>Istisna'a</i>	No	N/A
<i>Mudaraba</i> financing	No	N/A
<i>Musharakah</i> financing	No	N/A
Real estate for trading	No	N/A
Inventory for trading	No	N/A
Marketable securities for trading	No	N/A
<i>Salam</i>	No	N/A
Investments not for trading	Yes	Book value
Other investments for trading	No	N/A
Fixed assets	Yes	Book value
Assets for rent	Yes	Book value
Liabilities, equity of unrestricted investment, minority interest, owner's equity		
Current accounts	No	N/A
Payables during the next financial year	No	N/A
Other liabilities during the next financial year	No	N/A
Long-term liabilities	Yes	Book value
Provision for investment risk	Yes	Book value
Equity of unrestricted investment account holders	No	N/A
Minority interest	No	N/A
Owner's equity		
Paid-up capital	Yes	Book value
Reserves	Yes	Book value
Retained earnings	Yes	Book value
Net income	Yes	Book value

Box 11.10 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) In calculating the *Zakah* base, both trading assets and liabilities are valued at their cash equivalent values.
- 2) For assets to be classified for trading, assets should be acquired via purchase, exchange, or a debt transaction for resale or for being used in manufacturing.
- 3) The net assets method and the net invested funds method can have different amounts for the *Zakah* calculation.
- 4) The net assets method does not consider owners' equity.
- 5) Both net assets and net invested funds methods include trading assets in the *Zakah* base calculation.

Solution:

- 1) False. In the calculation of the *Zakah* base, trading assets are valued at their cash equivalent values, and liabilities are valued at their book value.
- 2) True.
- 3) False. Both methods are strictly equivalent, that is, under both methods, the amount of *Zakah* base will remain the same.
- 4) True.
- 5) False. Only the net assets method uses trading assets in the *Zakah* base calculation.

11.3 Presentation and Disclosure

11.3.1 Presentation

Presentation and disclosure requirements of FAS 1 should be strictly followed by the IFI, which states that disclosure should be made in the financial statements of any amount that the Islamic bank is obliged to deposit with others as compensating balance. Moreover, unpaid *Zakah* of IFI is presented under the liabilities section in the statement of financial position.

11.3.2 Disclosure

The following disclosures must be made in the notes to the financial statements of the IFI, in addition to the disclosure requirements in FAS 1:

- The method chosen for the calculation of the *Zakah* base
- Ruling on issues not covered in the Standard
- Payment of *Zakah* for subsidiaries as holding company
- If *Zakah* is not paid, disclosure of *Zakah* due from each share
- Information regarding whether the IFI as a holding company pays for its subsidiaries' *Zakah* obligations
- The amount of *Zakah* due from the equity of investment account holders
- Information regarding whether the IFI pays *Zakah* on behalf of its investment account holders and other accounts
- Details of any restrictions imposed in determining the *Zakah* base by the *Shariah* Supervisory Board

11.4 IFRS Perspective

If the IFI makes the *Zakah*, the impact will be shown in the income statement as it impacts the overall profit of the company. Under IFRS, *Zakah* is treated

as a non-operating expense and deducted from operating profit before reaching the net income for the year.

11.5 Chapter Summary

- *Zakah*, in literal terms, means “blessing, purification, increase, and cultivation of good deeds”. It is one of the fundamental pillars of Islam, and its payment is deemed mandatory for individuals who have more than a certain amount of wealth. (LO 1)
- Conditions laid down by Sharia for the payment of *Zakah* include: (LO 2)
 - Full ownership of the asset
 - Attainment of *Nisab*
 - The passing of *Hawl* (year)
- There can be two scenarios regarding an IFI’s obligation to pay *Zakah*: where the IFI is obligated to pay *Zakah* and where it pays *Zakah* on behalf of shareholders. (LO 3)
- If the IFI or an individual is following the lunar calendar, a rate of 2.5% must be used to calculate the amount of *Zakah* due. However, if the solar calendar is observed, a rate of 2.5775% must be employed. (LO 3)
- Unpaid *Zakah* of IFI is presented under the liabilities section in the statement of financial position. The method was chosen for the calculation of the *Zakah* base, and information regarding whether the IFI as a holding company pays for its subsidiaries’ *Zakah* obligations and the amount of *Zakah* due from the equity of the investment account holder must be disclosed. (LO 3)
- In IFRS, if the IFI makes the *Zakah* payment, the impact will be shown in the income statement as it impacts the overall profit of the company. (LO 4)

11.6 Key Terms and Definitions

- **Cash and cash equivalents:** Include local and foreign currency and deposits with the central bank and other institutions, which the Islamic bank can withdraw in full on demand. For *Zakah* purposes, cash and cash equivalents include, in addition to the aforementioned, gold and silver in the form of currencies, bullion, and others.
- ***Nisab*:** The minimum amount not liable for the payment of *Zakah*.
- ***Zakah*:** Literally, blessing, purification, increase, and cultivation of good deeds. It is called *Zakah* because it blesses the wealth from which it is paid and protects it. In *Shariah*, *Zakah* is an obligation in respect of funds paid for a specified type of purpose and specified categories. It is a specified amount prescribed by Allah, the Almighty, for those who are entitled to *Zakah* as specified in the Quran. The word *Zakah* is also used to indicate the amount paid from the funds that are subject to *Zakah*.

11.7 Appendix: Nisab and Zakah Rate on Livestock

11.7.1 Nisab and Zakah Rate on Camels

<i>From</i>	<i>To</i>	<i>Obligatory Zakah rate</i>
1	4	Nothing
5	9	1 goat
10	14	2 goats
15	19	3 goats
20	24	4 goats
25	35	<i>Bint Makhad</i> camel (at the second year of age)
36	45	<i>Bint Labun</i> camel (at the third year of age)
46	60	<i>Hiqqah</i> camel (at the fourth year of age)
61	75	<i>Jaza'ah</i> camel (at the fifth year of age)
76	90	2 <i>Bint Labun</i>
91	120	2 <i>Hiqqah</i>
121	129	3 <i>Bint Labun</i>
130	139	1 <i>Hiqqah</i> + 2 <i>Bint Labun</i>
140	149	2 <i>Hiqqah</i> + 1 <i>Bint Labun</i>
150	159	3 <i>Hiqqah</i>
160	169	4 <i>Bint Labun</i>
170	179	1 <i>Hiqqah</i> + 3 <i>Bint Labun</i>
180	189	2 <i>Hiqqah</i> + 2 <i>Bint Labun</i>
190	199	3 <i>Hiqqah</i> 1 <i>Bint Labun</i>
200	209	4 <i>Hiqqah</i> or 5 <i>Bint Labun</i>
210	219	1 <i>Hiqqah</i> + 4 <i>Bint Labun</i>
220	229	2 <i>Hiqqah</i> + 3 <i>Bint Labun</i>
230	239	3 <i>Hiqqah</i> + 2 <i>Bint Labun</i>
240	249	4 <i>Hiqqah</i> + 1 <i>Bint Labun</i>
For more than 249, one <i>Hiqqah</i> for every 50 camels and one <i>Bint Labun</i> for every 40 camels.		

11.7.2 Nisab and Zakah Rate on Cows

<i>From</i>	<i>To</i>	<i>Obligatory Zakah Rate</i>
1	29	Nothing
30	39	<i>Tabee'a</i> or <i>Tabee'ah</i> (at second year of age)
40	59	<i>Musinnah</i> (at third year of age)
60	69	2 <i>Tabee'a</i> or 2 <i>Tabee'ah</i>
70	79	<i>Musinnah</i> + <i>Tabee'a</i> or <i>Tabee'ah</i>
80	89	2 <i>Musinnah</i>
90	99	3 <i>Tabee'a</i> or 3 <i>Tabee'ah</i>
100	109	<i>Musinnah</i> + 2 <i>Tabee'a</i> or 2 <i>Tabee'ah</i>
110	119	2 <i>Musinnah</i> + <i>Tabee'a</i> or <i>Tabee'ah</i>
120	129	3 <i>Musinnah</i> or 4 <i>Tabee'a</i> or 4 <i>Tabee'ah</i>
For more than 129, one <i>Tabee'a</i> or one <i>Tabee'ah</i> for every 30 cows and one <i>Musinnah</i> for every 40 cows.		

11.7.3 Nisab and Zakah Rate on Goats

<i>From</i>	<i>To</i>	<i>Obligatory Zakah Rate</i>
1	39	Nothing
40	120	1 goat
121	200	2 goats
201	399	3 goats
400	499	4 goats
For more than 499, one goat for every 100 goats.		

11.8 Review Questions

- Which of the following is not a condition for liability to pay *Zakah*?
 - Full ownership
 - Attainment of *Zakah*
 - No change in the value of the assets
 - Passing of the *hawl* (year)
- Under which case(s) is an IFI required to pay *Zakah*?
 - When the law orders the IFI to satisfy the *Zakah* obligation
 - When the shareholders have collectively passed a resolution requiring the IFI to fulfil the *Zakah* obligation
 - When the IFI is bound by its charter or by-laws to satisfy the *Zakah* obligation
 - All of the above
- What will be the entry for the *Zakah* payment made by the IFI?
 - Dr. Cash/Bank Cr. *Zakah* payable
 - Dr. *Zakah* payable Cr. Cash/Bank
 - Dr. *Zakah* expense Cr. Cash/Bank
 - Dr. Cash/Bank Cr. *Zakah* expense
- What is the required entry for unpaid *Zakah* by the IFI?
 - Dr. *Zakah* expense Cr. *Zakah* payable
 - Dr. *Zakah* payable Cr. *Zakah* expense
 - Dr. *Zakah* expense Cr. Cash/Bank
 - None of the above
- What is the entry for *Zakah* payment made by the IFI on behalf of the shareholders?
 - Dr. *Zakah* expense Cr. Cash/Bank
 - Dr. Dividends payable Cr. Cash/Bank
 - Dr. Cash/Bank Cr. Dividends payable
 - Dr. Cash/Bank Cr. *Zakah* expense

- 6 Which account is debited by the IFI when the amount of shareholders' *Zakah* exceeds their distributable profits?
 - a) Cash/Bank
 - b) Payables
 - c) Receivables
 - d) *Zakah* expense
- 7 Which item is not included in the net assets method to calculate *Zakah*?
 - a) *Mudaraba* financing
 - b) Investments for trading
 - c) Fixed assets
 - d) Receivables
- 8 Which of the following is NOT a category of wealth subject to *Zakah*?
 - a) Gold and silver
 - b) Cash and bank balances
 - c) Business investments
 - d) Personal belongings
- 9 When calculating *Zakah* according to the lunar calendar, the following rate is used:
 - a) 2.6%
 - b) 2.5%
 - c) 2.5775%
 - d) 2.55%
- 10 When calculating *Zakah* according to the solar calendar, the following rate is used:
 - a) 2.6%
 - b) 2.5%
 - c) 2.5775%
 - d) 2.55%

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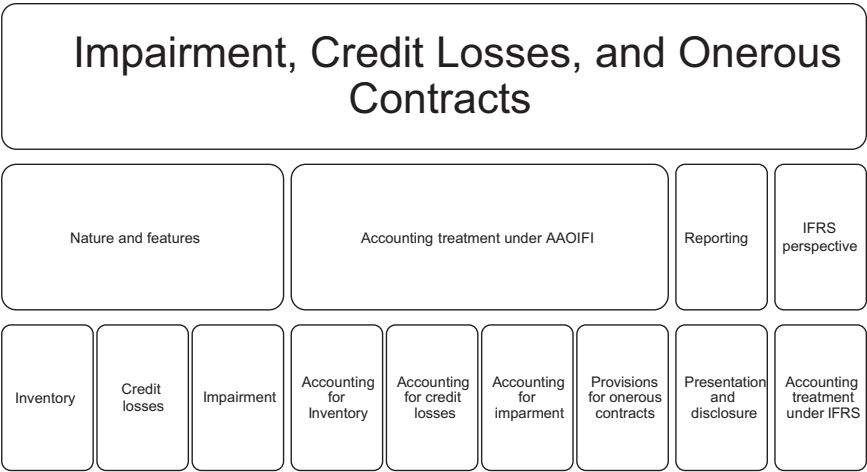
12 Impairment, Credit Losses, and Onerous Contracts

Learning Objectives

After going through this chapter, you should be able to:

- 1 Describe the impairment and credit losses on various assets of an IFI and provisions against onerous contracts.
- 2 Understand the accounting principles and process for impairment and credit losses and provisions against onerous contracts.
- 3 Describe the accounting entries, presentation, and disclosure requirements under **FAS 30: Impairment, Credit Losses, and Onerous Contracts**.
- 4 Understand the main differences in the accounting treatment of impairment, credit losses, and onerous contracts under IFRS and AAOIFI.

Chapter Preview



Cover Story

In the financial year 2020, Dubai Investment Bank (DIB) and Emirates Islamic Bank (EIB), two leading Islamic banks in the UAE, experienced an increase in impairment losses. DIB reported impairment losses of AED 4.552 billion (USD 1.239 billion), compared to AED 1.764 billion in 2019. Meanwhile, EIB's financial results indicated impairment losses on financial assets amounting to AED 1.434 billion in 2020, a significant rise from AED 439 million in 2019. Additionally, impairment losses on non-financial assets reached AED 52 million in 2020, up from AED 43 million in 2019.

The banking sector in the UAE faced a multitude of challenges even before the pandemic, including a weak property sector and low global interest rates. However, the Covid-19 pandemic exacerbated these issues and caused a significant shock to the industry. For the first time in five years, the cumulative net income of listed banks in the UAE contracted by 42% in 2020. This decline was primarily driven by higher loan loss provisions, which increased by 68% compared to the previous year (Economist Intelligence Unit, 2021).

First Abu Dhabi Bank (FAB), Emirates NBD, Abu Dhabi Commercial Bank (ADCB), and Dubai Islamic Bank reported significant reductions in their net profit for 2020. The combination of record low interest rates and a deterioration in asset quality due to the pandemic forced banks to allocate larger provisions for potential loan losses and face higher impairment charges. Emirates Islamic, Mashreq, and the National Bank of Fujairah even reported net losses for 2020 due to margin compression, increased provisions, and the economic stress caused by the pandemic. It is important to note that these declines primarily reflect the challenges posed by the pandemic rather than a fundamental solvency issue within the banking sector (Zawya, 2021).

These scenarios highlight the importance of corporate financial reporting and how it plays a pivotal role in the functioning of modern businesses, serving as a vital tool for transparency, accountability, and decision-making. It serves as a crucial means of communication between a company and its various stakeholders, fostering trust, credibility, and confidence in the organisation. The accuracy, transparency, and timeliness of corporate financial reporting are critical for fostering trust, facilitating informed decision-making, and maintaining the integrity of the business environment.

12.1 Introduction

The statement of financial position of an IFI is likely to show many categories of assets; for example, receivables, financing contracts, other long-term assets, and even inventories (owing to the trading nature of many of the products). Most assets are initially recorded at their face value or historical cost. However, different assets are subject to various risks which might reduce the expected benefit they will generate and hence require a downward adjustment to the carrying value of the asset. For example, receivables bear

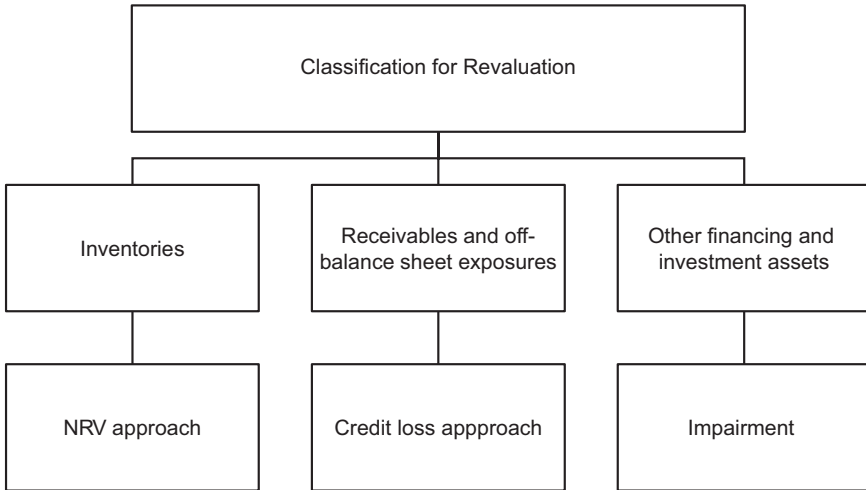


Figure 12.1 Classification of Assets

Source: Diagram by the authors.

the risk of default and inventories bear the risk of obsolescence. These assets must therefore be recorded at their revised value to ensure they are not overstated and that users of the financial statements are able to make a fair assessment of the future cash flows expected to arise from those assets.

In AAOIFI's **FAS 30 Impairment, Credit Losses, and Onerous Contracts** assets have been classified into three main categories. For each category, a different approach is taken to determine the reduction in their carrying value as and when required. The classifications are (Figure 12.1):

- 1 Receivables and off-balance sheet exposures which are subject to credit risks. The credit loss approach is applied on these assets.
- 2 Other financing and investment assets which are subject to risks other than credit risks (excluding inventories). The impairment approach is applied on these assets.
- 3 Inventories. The **net realisable value (NRV)** approach is applied to inventories.

Box 12.1 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) If a manufacturing company designates the plant for sale, then the plant would classify as the inventory of the company.

- 2) If the market value of inventory falls below the book value of inventory, then no adjustment is needed for the inventory goods.
- 3) Credit losses represent the receivables that a bank is unlikely to recover from its customers.
- 4) NRV approach is used for fixed assets.
- 5) For receivables and off-balance sheet exposures, we apply the credit loss approach.

Solution

- 1) False. Inventories include only the assets that a firm designates for sale in the normal course of the business.
- 2) False. If the market value of inventory falls below the book value of inventory, then an adjustment is needed for the inventory goods.
- 3) True.
- 4) False. NRV approach is used for the inventories.
- 5) True.

12.1.1 Credit Losses

Expected credit losses (ECL) represent the receivables that a bank is unlikely to recover from its customers. All IFIs provide multiple financing services. For example, an IFI may provide financing on a *Murabaha* contract in which the customer agrees to pay back at a later date on spot or instalment terms. The IFI records such amounts as financial assets on its balance sheet. If a customer does not pay back on time or is expected to **default** on the agreed payments, the IFI creates an allowance account to record the credit losses. The **allowance for credit losses** is also created for off-balance sheet exposures including guarantees and letters of credit. Off-balance sheet exposures refer to any instruments of a bank that classify as assets or liabilities but are not shown on the face of the balance sheet.

FAS 30 defines two types of ECL – **lifetime expected credit losses** and **12-month expected credit losses**. Lifetime ECLs are possible defaults which may arise during the life of the assets whilst 12-month ECLs are those which may occur within 12 months of the reporting date.

12.1.2 Impairment

An asset should not be shown in the statement of financial position at an amount which exceeds the benefit which the entity is likely to obtain from it (whether by using it and generating cashflows over its life or by disposing of it). An **impairment loss** is the amount by which the carrying value of the

asset exceeds its recoverable amount. It shows a permanent decrease in the value of fixed or intangible assets due to an unusual event.

12.1.3 *Inventory*

Inventories are the physical assets that a firm designates for sale in the normal course of the business. For a manufacturing company, inventories fall into three categories – raw material, work in process, and finished goods. However, for an IFI, which often acts as a merchandiser, there is only one inventory account in the balance sheet, which would contain different assets that are purchased under different contracts like *Murabaha* or *Salam*. For many companies, and IFIs are no exception, inventories represent a large portion of assets, and the companies want to plan and control their inventories effectively to execute their sales efficiently. To control the inventory effectively, it is essential to value the inventory correctly.

However, in some cases, the value of inventory may decline below its original cost. For example, an IFI may purchase some computers under a *Murabaha* contract for a customer. At the time of execution, the customer may back out of the deal, and the computers would remain with the IFI. As technological assets, the computers would become obsolete over time, and the **fair value** of those computers would decrease significantly below their historical cost. In case of a decline in the value of inventory, the IFI needs an adjustment to the original value to show the true and fair value of the inventory.

12.2 AAOIFI Accounting Treatment

FAS 30 sets the accounting and reporting framework for impairment, credit losses, and **onerous contracts** for an IFI. The main objective of this standard is to set a framework that provides a true and fair assessment of the amount, timing, and risk of cash flows which can be generated from the firm's assets. FAS 30, along with FAS 35 "Risk Reserves", supersede the previous standard on **provisions**, FAS 11 "Provisions and Reserves". FAS 30 applies to all types of investments, Islamic financing contracts, and other assets of an IFI. This standard is also applicable to the assets that are recognised in various stages of Islamic finance transactions. For example, in the case of an *Istisna'a* transaction, the asset is recognised over the period of the contract. Moreover, the standard also deals with the off-balance sheet exposures of the firm and the onerous contracts that will be defined later in this chapter. However, FAS 30 does not apply to the assets that come under the umbrella of a restricted portfolio. Assets in a restricted portfolio may be classified as off-balance sheet *Sukuk* or investment accounts that are managed by the IFI. Under special conditions, FAS 30 should be applied to the assets in the restricted portfolio too, if the firm faces a risk of significant losses from such assets in any way. In

this section, we will discuss the accounting treatment for the three methods: NRV, credit losses, and impairment.

12.3 Assets and Exposures

12.3.1 *Accounting Using the Credit Losses Approach*

The IFIs test for a “significant increase” in the credit risk to determine the amount of credit loss at the end of each reporting period. To determine if the credit risk has significantly increased or not, the firms compare the expected **default risk** of the receivables at the reporting date with the default risk of the same receivables determined at the time of initial recognition. Default risk refers to the uncertainty that the firm will not be able to recover its receivables.

There are various methods to determine the default risk, but FAS 30 requires the firm to use a method that complies with the credit risk practices of the management. It is common to believe that a **receivable** or exposure is considered default if the payment or consideration is 90 days past due. The aforementioned definition of default risk must be used by the management unless they can demonstrate a better way of defining default risk for their IFI. Now coming back to our discussion of credit risk, if the default risk at the reporting date is significantly higher than that at the time of initial recognition, the firms can assert that credit risk has increased significantly and vice versa. To quantify the credit risk, FAS 30 provides a rebuttable presumption (true unless proved otherwise) that if the receivables are 30 days past due, then it means that the credit risk of such receivables and exposures has been increased significantly. However, if the management has supporting evidence to show that the credit risk has not increased significantly even though the payments are 30 days past due, then the rebuttable presumption does not apply to such receivables.

Normally, the firms compare default risk at the reporting date with that at the time of initial recognition (historical data) to determine the significance of credit risk. It is because using historical data is simple and cost-effective. However, FAS 30 encourages the management to follow a future-looking approach if the forecasting can be done cost-effectively and with reasonable effort.

12.3.1.1 *Measurement of Credit Losses*

An IFI needs to consider the following elements to determine the amount of credit loss:

- 1 The total amount of receivable or exposure at risk;
- 2 Weightage of risk and the probability of different outcomes to arrive at an expected figure for credit loss;
- 3 Any change in the credit loss of a receivable due to a decline in credit rating or other industry factors;
- 4 The presence of credit enhancement contracts or other collaterals that may minimise the amount of credit loss for a receivable.

An IFI is required to develop and use a consistent approach to measure the credit loss on the receivables. The method used for measurement must:

- 1 Evaluate a range of potential outcomes to determine the probability-weighted credit loss amount. It is not necessary or even possible to evaluate every possible outcome. Instead, the management needs to identify only the potential risk or uncertainty of the credit loss. Every identifiable risk outcome must be incorporated even if there are low chances of occurrence for that outcome.
- 2 Apply the **effective rate of return** to show the maturity period and income allocation of the receivables. The maximum period to consider for calculation is the contractual period, including any extension options.
- 3 Incorporate historical, current, and expected future information in a way that the amount of credit loss is determined without incurring undue expenses and efforts.

It is also important to note that the prudence concept does not apply to the calculation of credit loss allowance, that is, overestimating the allowance for credit losses is not a good accounting approach. Instead, the firms use the best estimation technique that utilises the aforementioned points.

FAS 30 divides the receivables into the following three categories to determine the credit losses (Figure 12.2):

- 1 **Stage-1 receivables:** These are the receivables that do not meet the criteria of 30 days payment delay at the time of reporting period. For stage-1 receivables, the expected credit loss (ECL) must be calculated for the next 12 months period as a collective value for the allowance. The ECL for such receivables may be determined using customer-specific factors.

Box 12.2 Illustration 12.1 Allowance for Expected Credit Losses

In Jul 2022, Harmony Islamic Bank booked receivables of SAR 4,000 from Tahir Mills Limited, which were to be received in four equal instalments. The first payment was due by Dec 15, 2022. By the end of Dec 2022, Harmony Islamic Bank had not received the payment from Tahir Mills. Harmony Bank categorised the receivables as stage-1 receivables and determined the ECL to be 10% of the first payment.

Requirement: State the amount of ECL to be recorded and the accounting treatment.

Solution:

Value of one payment = $\text{USD } 4,000/4 = \text{USD } 1,000$

- 2 **Stage-2 receivables:** These receivables have crossed the 30 days payment delay time but have not reached 90 days delay for the payment. Moreover, if the credit rating of the debtor declines, or there is any other event that may negatively affect the risk of payment, the receivable from such customers may also be classified as stage-2 receivables even if they have not crossed 30 days delay in payment yet. For stage-2 receivables, the ECL is determined considering the expected lifetime losses on the receivables. The allowance may be calculated as a collective figure or depending on customer-specific factors.

Box 12.3 Illustration 12.2 Allowance for Expected Credit Losses

Continuing from the Illustration 12.1

Assume that Tahir Mills Limited has still not made any payment to Harmony Islamic Bank by Jan 31, 2023.

Requirement: What will be the impact on the financial statement of the bank?

Solution:

Harmony Bank would categorise the receivables as stage-2 receivables and determine the ECL to be 40% of the total value of the receivable, that is, $\text{USD } 4,000 \times 40\% = \text{USD } 1,600$ (assuming the bank's policy is to provide 40% of the stage-2 receivables).

- 3 **Stage-3 receivables:** The receivables that have 90 or more days of delay in payments are categorised as stage-3 receivables. Like stage-2 receivables, stage-3 receivables may also comprise the receivables that do not have a delay in payment but have deteriorated credit ratings. The ECL is calculated for stage-3 receivables by estimating the life-long-expected losses on the receivables. Unlike stage 1 and stage 2, ECL cannot be calculated for stage-3 receivables as a cumulative figure. Instead, the firm needs to calculate ECL for these receivables for the specific assets or the customers.

Box 12.4 Illustration 12.3 Allowance for Expected Credit Losses

(Continuing from the Illustrations 12.1 and 12.2)

Assume that Tahir Mills still has not made any payment to the Harmony Islamic Bank till Mar 31, 2023.

Requirement: What will be the impact on the financial statement of the bank?

Solution:

Harmony Islamic Bank would categorise the receivables as stage-3 receivables and determine the ECL to be 70% of the total value of the receivable, that is, $\text{USD } 4,000 \times 70\% = \text{USD } 2,800$ (assuming the bank's policy is to provide 70% of the stage-II receivables).

Note: The provision should be specific and based on individual cases.

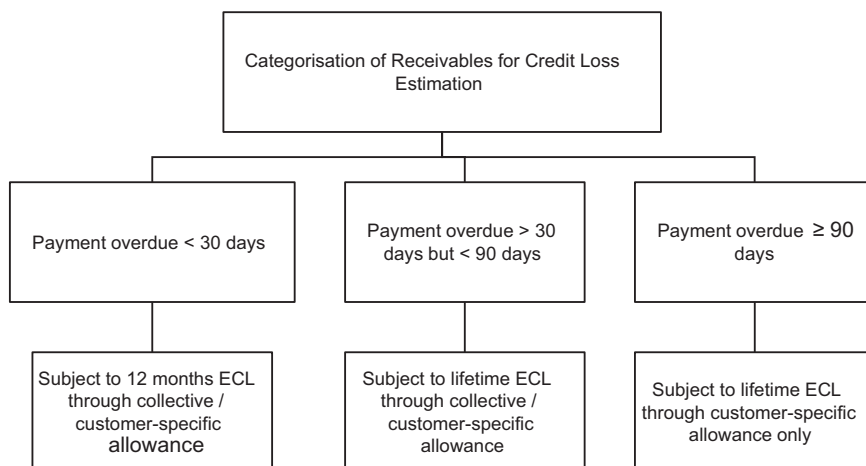


Figure 12.2 Categorisation of Receivables for Credit Loss Estimation

Source: Diagram by the authors.

Box 12.5 Practical Insight: Al Rayan Bank of the UK

In 2020, Al Rayan Bank, a UK-based Islamic bank, reported a £1.5 million impairment charge in part due to the economic uncertainty caused by the Covid-19 pandemic. The bank reported that the impairment charge was related to its retail and corporate portfolios and reflected the expected credit losses arising from potential loan defaults (Al Rayan Bank, 2020).

12.3.1.2 Recording Credit Loss

The expected credit loss is recorded as an expense to the income statement and an allowance account is created (a contra-asset account) which reduces the carrying value of the relevant assets.

Box 12.6 Illustration 12.4 Allowance for Expected Credit Losses

In Jul 2022, Harmony Islamic Bank booked receivables of SAR 4,000 from Tahir Mills Limited, which were to be received in four equal instalments. The first payment was due by Dec 15, 2022. By the end of Dec 2022, Harmony Islamic Bank had not received the payment from Tahir Mills. Harmony Bank categorised the receivables as stage-1 receivables and determined the ECL to be 10% of the first payment.

Requirement: State the amount of ECL to be recorded and the accounting treatment.

Solution:

Value of one payment = USD 4,000/4 = USD 1,000

Amount of ECL to be recorded = 10% of USD 1,000 = USD 100

		Dr.	Cr.
Dec 31	Credit Loss (Expense)	100	
	Allowance for ECL (Liability)		100
	<i>(To record an allowance for expected credit losses)</i>		

12.3.2 Accounting Using the Impairment Approach

Financial and investment assets which are subject to the **impairment** approach are those which are exposed to risks other than credit risk (excluding inventories). Impairment is accounted for if the **carrying value** of the asset exceeds its **recoverable amount** (Figure 12.3).

Carrying value is the net book value of the asset. For a fixed asset, the carrying value would simply be the gross value of the asset, less the accumulated depreciation. In other words, carrying value represents the value that can be generated from the asset.

The recoverable amount of an asset is the higher of its **value in use** (the value that can be generated by using the asset) and fair value less **cost of disposal** (the benefit that can be obtained by selling the asset). Since a firm can benefit from an asset only by using or selling it, the recoverable amount shows the maximum benefit that can be obtained from an asset. The carrying value of the asset at the reporting date is compared with the value that can be generated by using or selling the asset to arrive at the true and fair carrying value of the asset. If the carrying value exceeds the recoverable amount, this implies that the carrying value cannot be recovered by either using or selling the asset, and hence a write down is required.

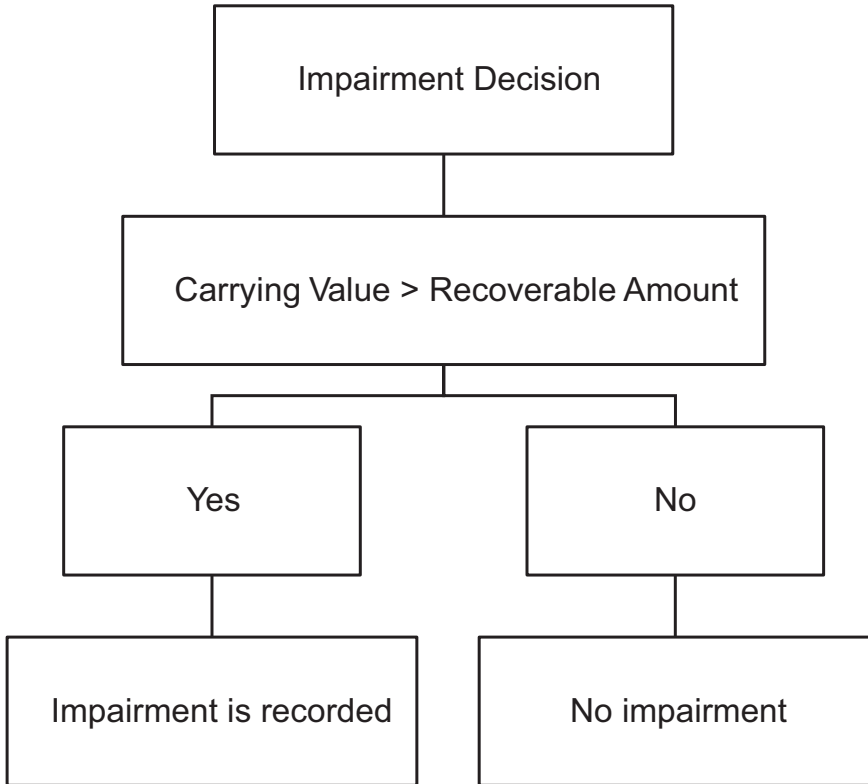


Figure 12.3 The Impairment Decision

Source: Diagram by the authors

Value in use is computed as the present value of all the expected cash flows from the use and future sale of the asset. Future cash flows refer to the net cash inflows that the firm will receive by continuing the use of the asset. Moreover, the cash flows must be reasonably attributed to the specific asset. The following points must be considered while estimating the value in use of an asset:

- The estimate of future cash flows must incorporate different scenarios for changing amounts and timing of the cash flows to arrive at the expected cash flow for each period.
- The effective rate of return used to determine the present value must include all the possible risk factors, including firm-specific, country, currency, industry risk, and so on.
- Any market-related risk must be considered while determining the value in use. For example, the market conditions and the expectations of the market participants should be incorporated into the model.

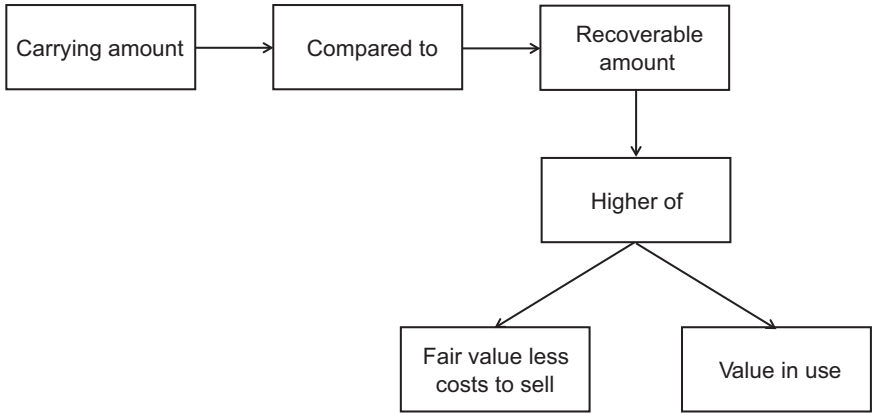


Figure 12.4 The Impairment Approach

Source: Diagram by the authors.

Fair value less cost of disposal is the amount that the firm can get by selling the asset after deducting any costs that may be incurred while making the sale. The term “fair value” refers to the assumptions that the buyers will use to price the asset. For example, Seasons Foods has machinery whose fair value is determined to be USD 5,000. The firm estimates the commission fee on selling would be USD 300. So, the fair value less the cost of disposal would be $\text{USD } 5,000 - \text{USD } 300 = \text{USD } 4,700$.

So, an impairment should be recorded if a machine whose carrying value at the reporting date is USD 50,000, whereas its recoverable amount is lower, say USD 45,000. Since the carrying value exceeds the recoverable amount by USD 5,000, an impairment of USD 5,000 should be recorded.

Figure 12.4 summarises the complete impairment approach that we have discussed till now.

If an institution determines that an impairment is to be recorded for a particular asset and determines the impairment value, a debit is made to the Impairment Loss account (an expense account) and Accumulated Depreciation is credited. This reduces the carrying value of the asset to reflect the recoverable amount of the asset.

Box 12.7 Illustration 12.5 Recording a Loss on an Asset Due to Impairment

Hayak Pharma Corporation tests its machine for impairment at the end of the financial year 2023. The carrying value of the machine is USD 2,500. The firm estimates its value in use to be USD 2,300 and the fair value to be USD 2,450. The firm will have to pay USD 75 to an agent to sell the machine.

Requirement: Given this information, answer the following questions:

- a) What is the recoverable amount for the machine?
- b) Should Hayak Pharma Corporation record impairment on the machine? If yes, suggest the accounting treatment.

Solution:

- a) The recoverable amount is the higher of value in use and fair value less the cost to sell. So the recoverable amount would be:

Value in use = USD 2,300

Fair value less cost of disposal = USD 2,450 – USD 75 = USD 2,375

Recoverable amount = Fair value less cost of disposal = USD 2,375

- b) Since the recoverable amount is less than the carrying value, the impairment would be charged.

Impairment value = Carrying amount – Recoverable amount

Impairment value = USD 2,500 – USD 2,375 = USD 125

The accounting entries would be as follows:

		Dr.	Cr.
Dec 31	Impairment Loss – Machine (Expense)	125	
	Accumulated Depreciation – Machine (Contra-Asset)		125
	<i>(To record the loss on the machine due to impairment)</i>		

Box 12.9 Concept Check

Identify which of the following five statements are true or false. If a statement is false, indicate why this statement is false.

- 1) If the NRV of inventory falls below the cost, we record the asset at its net realisable value.
- 2) If the customer has made a binding promise to buy a certain asset and the NRV of the asset falls below its historical price, the IFI will continue to recognise the asset at its NRV.
- 3) We apply the prudence concept for the calculation of credit loss allowance, that is, overestimating the allowance for credit losses is a good accounting approach.
- 4) For stage-2 receivables, the ECL is determined considering the expected lifetime losses on the receivables.

5) If the carrying value of the asset is greater than its recoverable amount, impairment is recorded.

Solution:

- 1) True.
- 2) False. If the customer has made a binding promise, the IFI will continue to recognise the asset at its historical cost.
- 3) False. We should not apply the prudence concept for the calculation of credit loss allowance as it is not a good accounting practice.
- 4) True.
- 5) True.

12.3.3 Accounting Using NRV Approach

A significant number of Islamic finance contracts made by an IFI have a trading structure in which the IFI is required to take ownership of inventory for a short period of time before it is sold to the customer and ownership is transferred. For example, in a *Murabaha* contract involving the sale of inventory, the IFI will acquire the inventory and record it as an asset before selling it to the customer. Similarly, in other contracts, such as *Salam* or *Istisna’a*, it might be necessary for the IFI to record inventory in its books of accounts. If the IFI holds any inventory at its reporting date, FAS 30 requires the IFI to value the inventory using the net realisable value (NRV) approach.

12.3.3.1 NRV Approach

NRV is the estimated selling price of the inventory, less any costs incurred for the completion of the asset or for the sale of the asset.

Box 12.10 Illustration 12.6 Calculating Net Realisable Value

Assume that Al-Noor Bank purchased a car on Dec 21, 2023, under a *Murabaha* contract to sell to its customers. The purchase price of the car was USD 10,000. The bank estimates that the market price of the car at the year-end would be USD 9,500, and the bank would have to give USD 500 to agents to make the sale.

Requirement: Calculate the NRV of the car.

Solution: The NRV of the car would be USD 9,000, as shown:

Expected Sale Price of the Car	USD 9,500
Less: Agent Fee	USD 500
NRV of Car	USD 9,000

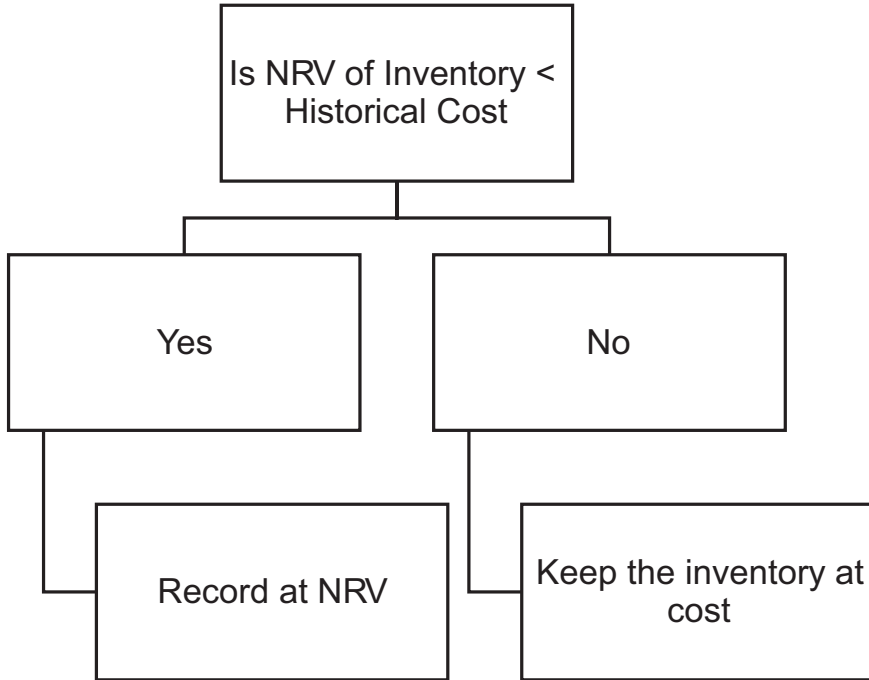


Figure 12.5 NRV approach

Source: Diagram by the authors.

According to the NRV approach, we compare the cost of the inventory with its NRV. If the cost of the asset is less than the NRV, then inventory continues to be recorded at cost. On the other hand, if the NRV of the inventory falls below the cost, then a write-down is required to reduce the carrying value to reflect the NRV. This approach is often referred to as LCNRV (Lower of cost and NRV) rule and ensures that the inventory value is not overstated. Figure 12.5 summarises the NRV approach for inventory.

12.3.3.2 Binding and Non-Binding Promise

In some cases, the customer makes a binding **promise** to buy the asset under a contract. The promise is said to be binding if the customer has a legal obligation to fulfil the promise. If the customer has made a binding promise to buy a certain asset, and the NRV of the asset falls below its historical cost, the IFI will continue to recognise the asset at its historical cost instead of its NRV. This is because the customer is legally bound to bear all the risks associated with the asset. On the other hand, if no binding promise is made by the customer to buy the asset, and the NRV of the asset becomes less than its cost, the IFI is required to restate the inventory asset at its NRV (Figure 12.6).

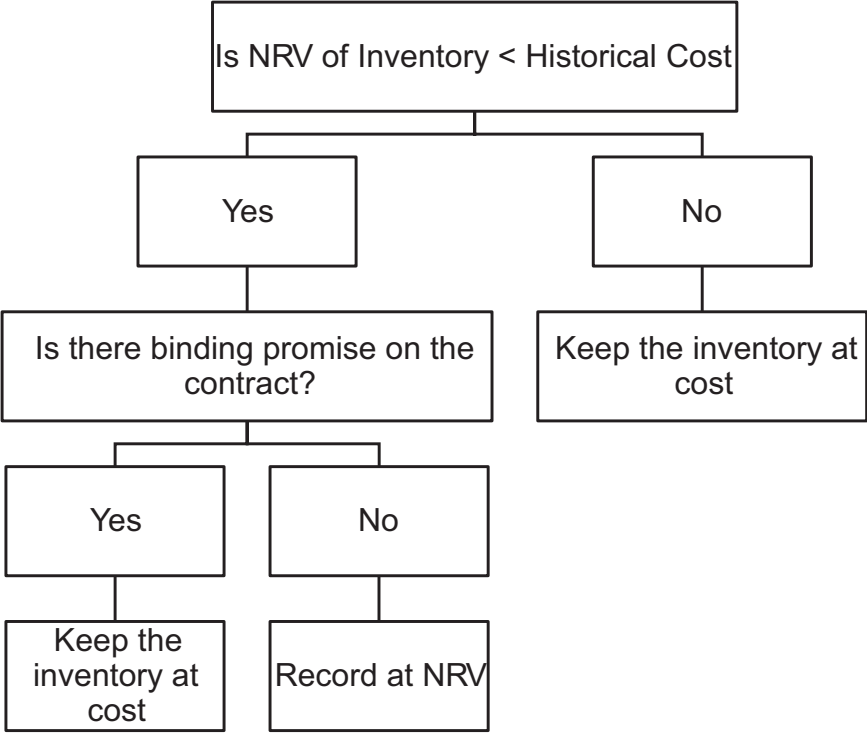


Figure 12.6 Inventory Assessment

Source: Diagram by the authors.

If the firm decides to restate the inventory at its NRV, the firm reduces the value of the inventory and records a loss in the income statement, as shown in the following illustration.

Box 12.11 Illustration 12.7 Recording Loss on Inventory

In Nov 2023, Al-Noor Bank purchased a car for USD 10,000 to sell to Mr Ali under a *Mudaraba* contract. Mr Ali made a non-binding promise to buy the car from the bank in January 2024. At the end of the reporting period, Al-Noor Bank management found that the NRV of the car was USD 8,000.

Requirement: Write the accounting treatment to record this event.

Solution:

Since the NRV is less than the cost of the car, we will value the car at its NRV according to the NRV approach. The resulting loss according to the NRV approach is $10,000 - 8,000 = 2,000$. The accounting entries would be:

		Dr.	Cr.
Date	Loss on Inventory (Expense)	2,000	
	Inventory (Asset)		2,000
	<i>(To record loss on inventory)</i>		

12.4 Onerous Contracts

12.4.1 Provision for Onerous Contracts or Commitments

An onerous contract or commitment is one in which “the unavoidable costs of meeting the obligations under the contract or commitment, respectively, exceed the economic benefits expected to be received under it” (FAS 30, para 6n). The entity involved in such a contract will incur a net loss. It is important to note that the nature of the onerous contract is binding, due to which losses are unavoidable for the party entering the contract. A contract may be onerous at the very start, or it may become onerous due to changes in circumstances.

To understand onerous contracts better, let us assume that an IFI makes a binding agreement to buy an asset for USD 400 at some future date. At the time of acquisition, the fair value of the asset decreased to USD 300. Now, if the firm fulfils the contract, the firm will pay USD 400 but will receive an asset of the value of USD 300, causing a net loss of USD 100 for the firm. Nonetheless, the firm will have to meet the contract’s obligations since it was a binding agreement.

In some cases, a firm makes an onerous contract to buy an asset and then makes a parallel contract with another creditworthy (third) party to sell that same asset at a price equal to or greater than the expected cost of acquiring the asset. If the third party makes a binding promise to buy the asset from the firm, then such a contract would not be considered onerous.

FAS 30 requires that firms create a provision to cover the expected losses from an onerous contract. The provision will be made on the date at which a contract becomes onerous. To record the provision, a loss is recorded in the current reporting period by debiting the income statement and crediting

a provision account. In some cases, there may be some collateral associated with an onerous contract which can be sold to cover the loss. If collateral is present, the amount of the provision must be calculated by considering the value of the collateral as well as any expected legal and selling costs that may be incurred.

Box 12.12 Illustration 12.8 Provision for Onerous Contracts

On Jul 25, 2023, Islamia Bank made a binding contract to buy a car for USD 10,000 from the manufacturer and deliver it to a customer under an *Ijarah* contract. The customer backed out of the deal and did not execute the *Ijarah* contract. The bank decided to sell the car in the market. The bank estimated the market price of the car to be USD 9,000. What would be the accounting entry to record such a transaction?

Solution:

Islamia bank has made a binding contract with the manufacturer, and the cost to purchase the car is USD 10,000, whereas the benefit from the purchase is only USD 9,000. Therefore, it is an onerous contract, and the loss on this onerous contract is USD 1,000. The bank will record a provision to account for this expected loss as follows:

		Dr.	Cr.
Date	Loss on Onerous Contracts (Expense)	1,000	
	Provision for Onerous Contracts (Contra-Asset)		1,000
	<i>(To record the provision for onerous contracts)</i>		

Box 12.8 Practical Insight: Onerous Contracts in IFIs

Onerous contracts are a common issue in IFIs, particularly in the context of long-term financing facilities. Applicable from January 2020, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) issued a new *Shariah* standard on the treatment of onerous contracts in IFIs. The standard provides guidance on how to identify and account for onerous contracts in a *Shariah*-compliant manner and requires IFIs to disclose information on the impact of onerous contracts on their financial statements.

Box 12.13 Concept Check

Identify which of the following three statements are true or false. If a statement is false, indicate why this statement is false.

- 1) An onerous contract refers to an agreement in which the costs to fulfil the agreement exceed the benefits derived from the agreement in return.
- 2) FAS 30 requires the firms to create a credit loss allowance to record the expected losses on the onerous contract.
- 3) An onerous contract provides net profit or benefit to the firm on the contract.
- 4) If a third party makes a binding promise to buy the asset from the firm, then such a contract would be considered onerous.
- 5) In some cases, there may be some collateral associated with an onerous contract which can be sold to cover the loss.

Solution:

- 1) True.
- 2) True. FAS 30 requires the firms to create a provision account to record the expected losses on the onerous contract.
- 3) False. An onerous contract provides a net loss to the firm on the contract.
- 4) False. If a third party makes a binding promise to buy the asset from the firm, then such a contract would not be considered onerous.
- 5) True.

12.5 Presentation and Disclosure

12.5.1 Presentation

In this section, we will discuss the presentation of credit losses, impairment, and onerous contracts on the financial statements. The net realisable approach has no carrying forward account, and the adjustment is made directly to the inventories; therefore, we do not present any account related to the NRV approach on the financial statements.

- The allowance for credit losses is presented below the respective asset as a contra-asset account. It shows a cumulative balance, and the allowances of credit losses are shown separately depending upon their stages which were discussed earlier. Furthermore, the assets which are subject to credit losses must be presented separately from the assets which do not have any credit loss allowance.

- The cumulative balance for impairment is shown below each respective asset, just like the allowance for credit losses. Moreover, the assets which have impairment are shown separately from those which do not have an impairment.
- Provisions related to the onerous contracts and other off-balance sheet exposures must be shown as provisions on the liabilities side of the balance sheet. The provisions are included in the total liabilities of the firm.

12.5.2 *Disclosure*

An IFI should follow all the disclosure requirements mentioned in FAS 1, “General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions”, related to the impairments, credit losses, and provisions. In addition, an IFI must also follow the following disclosure requirements:

- An IFI must disclose the breakdown of the NRV approach if applied to the inventories. The category of inventory to which the NRV approach is applied must be listed separately, and the amount deducted because of NRV being less than the carrying amount of inventory must also be disclosed for each category of inventory.
- The accounting approach and the estimation techniques for the credit allowances, impairment, and provisions must be disclosed thoroughly.
- If the firm keeps some additional allowances or provisions to fulfil the regulatory requirements, then such allowances and provisions must be disclosed separately from the principal allowance and provision amounts (which are determined under the scope of FAS 30).
- The firm also needs to disclose the estimated amount and nature of securities (assets) to which the adjustments were made to determine the allowance and provision amounts. Furthermore, the accounting policy and methodology applied for these securities must also be disclosed in the notes to the financial statement.

Box 12.8 Practical Insight: Abu Dhabi Islamic Bank Rebound

Despite the challenging global economic conditions, ADIB, the leading Islamic bank in the UAE, achieved significant success in 2022. The bank experienced a remarkable capital gain of 33% while major indices such as the S&P 500 and MSCI World Bank showed negative returns. ADIB stands out by reporting a substantial 53% decrease in impairments compared to the previous year, thanks to the strong UAE and Gulf markets (Gulf News, 2023).

Box 12.14 Concept Check

Identify which of the following three statements are true or false. If a statement is false, indicate why this statement is false.

- 1) The allowance for credit losses is presented below the respective asset as a liability account.
- 2) Provisions related to the onerous contracts must be shown as provisions on the liabilities side but not included in the calculation of the long-term liabilities of the firm.
- 3) The accounting approach and the estimation techniques for the credit allowances, impairment, and provisions must be disclosed thoroughly.
- 4) If an IFI keeps some additional allowances or provisions to fulfil the regulatory requirements, then such allowances and provisions must be disclosed separately from the principal allowance and provision amounts.
- 5) IFIs need to disclose the estimated amount and nature of securities (assets) to which the adjustments were made to determine the allowance and provision amounts.

Solution

- 1) False. The allowance for credit losses is presented as a contra-asset account.
- 2) False. The provisions are included in the total liabilities of the firm.
- 3) False.
- 4) True.
- 5) True.

12.6 IFRS Perspective

Under IFRS, the accounting treatment for credit losses, impairments, and onerous contracts is similar to that discussed under the AAOIFI Framework but is covered under different standards.

12.6.1 Credit Losses

Impairment losses relating to financial assets are covered under **IFRS 9 Financial Instruments**.

Recall from earlier chapters that a financial instrument is a contract giving rise to a financial asset of one entity and a financial liability of another. Financial assets are a contractual right to receive cash or another financial

asset from an entity and include (amongst other items) loans, advances, and trade receivables.

Under IFRS 9, financial assets are classified into two types – those measured at amortised cost and those measured at fair value. For those classified under the latter category, any gains or losses might be measured in the income statement (FVTPL) or in the statement of other comprehensive income (FVTOCI). These classifications are based on the business model test and the contractual cashflow characteristics test (which have been discussed in detail earlier). Trade receivables which do not have a significant financing component are however measured at their transaction price (i.e., the fair value).

Expected Credit Loss Model (General Approach)

If a financial asset is considered to be impaired, this will have implications for the carrying value of the asset as well as future expected cash flows to be generated from the asset. IFRS 9 requires the use of the Expected Credit Loss (ECL) Model to determine the allowance for credit losses. **Credit losses** are defined as the difference between the present value of all contractual cash flows and the present value of all expected future cash flows of a financial asset (the “cash shortfall”). Therefore, just changing the timing of the cash-flows will impact the amount of credit loss and hence the impairment loss. So, for example, if a receivable is expected to be fully recovered, but the date of receipt is delayed, then this will still result in an impairment loss.

The ECL method is a forward-looking approach to recording the potential credit losses on financial assets. In other words, IFRS 9 does not require a loss to have already been incurred. Instead, future expected losses must be estimated by the entity and incorporated in the loss allowance calculation together with any losses already incurred. It is a prudent approach to the calculation of past and potential future losses requiring the early recognition of the impairment of an asset. In fact, the ECL model requires that ECLs are recorded immediately upon recognition of the asset (they might be zero at this stage) and thereafter at each reporting period. A three-stage model is used for recognising impairment loss using the application of the ECL approach. The stages represent the deteriorating credit risk of the assets as we move from stage 1 to stage 3.

Two types of credit losses are classified in the standard – **lifetime ECL** and **12-month ECL**. These are defined here:

- **Lifetime ECL:** The expected credit losses that result from all default events on the financial instrument that are possible over the life of the financial instrument.
- **12-month ECL:** The expected credit losses that result from those default events on the financial instrument that are possible within 12 months of the reporting date (this is effectively a portion of the lifetime ECL).

12.6.1.1 Computation of ECL

The computation of the ECL requires a number of estimates. The basic formula is $ECL = EAD \times PD \times LGD \times D$. Each of these terms is explained here:

EAD = Estimate of the total exposure at a default date

PD = Estimate of the **probability of default** within a given time frame

LGD = Estimate of the loss arising on default (often expressed as a percentage of EAD)

D = Discount rate applied to compute the present value of the expected loss

STAGE 1 PERFORMING FINANCIAL ASSETS

At this stage, the financial asset is healthy and is expected to perform in accordance with its contractual obligations. There is no indication of increased credit risk. The asset will fall into this category as soon as it is acquired by the entity. Upon acquisition of the financial asset, a 12-month ECL is recognised in the profit and loss account and a provision is established (which may be zero). As far as the accrual of interest revenue is concerned, for assets at stage 1, this is to be calculated using the effective rate applied on the gross value of the asset (prior to the deduction of any ECL).

STAGE 2 FINANCIAL ASSETS WITH SIGNIFICANTLY INCREASED CREDIT RISK

An asset is considered to be in this stage if there has been a significant increase in its credit risk. At the reporting date, a provision for full lifetime ECL will be made; however, interest revenue will continue to be calculated on gross carrying value (as in stage 1).

Assessing the changes in the credit risk of a financial asset requires reliable information as well as judgement. There is no prescribed method of doing so; however, a number of indicators have been given in the standard which might be used to evaluate possible changes. The list is non-exhaustive and includes the following (as well as other possible factors):

- An actual or expected significant change in the financial instrument's external credit rating
- An actual or expected internal credit rating downgrade for the borrower
- An actual or expected adverse change in the economic, business, or financial conditions which are likely to cause a significant change in the borrower's ability to meet its debt obligations
- An actual or expected significant change in the operating results of the borrower which is likely to cause a significant change in the borrower's ability to meet its debt obligations

STAGE 3 CREDIT-IMPAIRED FINANCIAL ASSETS

If the credit risk increases so significantly that the asset is considered to be credit-impaired, that is, some default events have already occurred, then a provision for the lifetime ECL will be made, and interest revenue is calculated on the basis of the amortised cost of the asset (gross carrying value less provision).

12.6.1.2 Simplified Approach

The ECL model is quite a cumbersome one since many different estimates and probabilities must be calculated to compute the impairment loss. The model is mainly applicable to banks and financial institutions. Other entities extending normal trade credit to their customers (containing no significant financing component) are allowed to adopt a “simple model” in which they do not have to move from stage 1 to stage 3 but rather may simply estimate the lifetime ECL at the outset. This is likely to be applicable to short-term trade receivables. Companies normally adopt an ageing approach by creating a provision-matrix in which the probability of default for each age debtor is estimated. This is used to determine the impairment provision for the entire life of the asset.

12.6.2 Impairments and NRV

IAS 36 Impairment of Assets sets out the provisions relating to the impairment of an asset. Some assets, such as inventories (IAS 2) and financial assets (IFRS 9), are not included within the ambit of IAS 36. IAS 36 requires that an asset is not carried at an amount greater than its recoverable amount (the higher of the value in use and the fair value less costs of disposal). These terms are defined as follows:

Fair value less costs of disposal: To determine fair value, IFRS 13 Fair Value Measurement is relevant and sets out detailed provisions. Costs to sell include any legal expenses, taxes, or expenses incurred in getting the asset ready for sale.

Value-in-use: The present value of all future cashflows expected to be generated from an asset or cash-generating unit.

IAS 36 requires entities to assess annually whether there is any **indication of impairment** of an asset. If there is, then an impairment test must be conducted. **Indication of impairment** could include internal and external factors such as:

- Decline in market value
- Negative changes in technology, markets, economy, legislation
- Increases in market interest rates
- Obsolescence, physical damage, or wear and tear
- Lower economic performance than expected

Note that IAS 36 requires certain assets to undergo an annual impairment test regardless of any impairment indication. These are:

- Intangibles with an indefinite useful life
- Intangibles not yet available for use
- Goodwill acquired as a result of a business combination

NRV rules for inventory under IFRS are covered under **IAS 2 Inventories**. The LCNRV rule applies to inventories as defined under FAS 30 and discussed earlier in this chapter.

12.6.3 Onerous Contracts

The definition of an onerous contract is given under **IAS 37 Provisions, Contingent Liabilities and Contingent Assets** and is identical to that used by AAOIFI in FAS 30. The accounting treatment is also similar since IFRS also requires the creation of a provision for the expected loss as soon as a contract becomes onerous. IAS 37 further defines *unavoidable costs* as the “lower of the cost of fulfilling the contract and any compensation or penalties arising from failure to fulfil it”. FAS 30 does not define this term. There is, however, some ambiguity in terms of what should be considered the costs of fulfilling a contract. IAS 37 does not specify whether these should include incremental costs of the contract only or whether these may also include allocated costs (e.g. costs which may be shared with other contracts).

Concept Check

Identify which of the following three statements are true or false. If a statement is false, indicate why this statement is false.

- 1) Under IFRS, the accounting treatment for credit losses, impairments, and onerous contracts is covered under a single accounting standard.
- 2) IFRS uses the Expected Credit Loss (ECL) model to record potential credit losses on receivables and financial assets.
- 3) The ECL model is a 2-stage model which is to be applied on the recognition date and thereafter at each reporting date.
- 4) IAS 36 is not applicable to inventories or financial assets.
- 5) IAS 36 requires an annual impairment test for all assets.

Solution

- 1) False. Each of these asset value adjustments is covered under separate accounting standards. Credit losses are discussed in IFRS 9,

impairments are covered in IAS 36, and NRV rules (for inventory) are given in IAS 2.

- 2) True.
- 3) True.
- 4) True.
- 5) False. IAS 36 requires an impairment test only where there is an indication of impairment (either internal or external). In some cases, for example, for certain intangibles and goodwill annual impairments testing is required.

12.7 Chapter Summary

- An IFI is required to assess the value of its Islamic financing, investment, and other assets to check if the value of these assets exceeds the recoverable amount and adjust it accordingly. The IFI should also review its contracts or commitments where the unavoidable cost of meeting the obligation exceeds the economic benefits under the contract and provide for the expected losses. (LO 1)
- The principles for accounting and reporting impairments and credit losses are categorised into three groups. For receivables and off-balance sheet exposures which are subject to credit risks, the credit loss approach is applied. For other financing and investment assets which are subject to risks other than credit risks (excluding inventories), the impairment approach is applied to these assets. For inventories, the net realisable value (NRV) approach is applied. (LO 2)
- The principle for accounting and reporting onerous contracts is to create a provision on the account reflecting the expected loss arising from such contracts or commitments. (LO 2)
- An IFI should reassess its estimation at every reporting date. (LO 2)
- The impairment loss, credit loss, and the provision for onerous contracts are recorded in the respective year as an expense. (LO 3)
- Under IFRS, the accounting treatment for credit losses, impairment, and provisions against onerous contracts is almost the same as we discussed under the AAOIFI framework. To determine the allowance for credit losses, the IFRS 9 “Financial Instruments” uses the Expected Credit Loss (ECL) Model, which is a forward-looking approach to recording the potential credit losses on the receivables and financial assets using a three-stage model. (LO 4)

12.8 Key Terms and Definitions

- **Allowance for credit losses:** The allowance for credit losses on financial assets and the provision for expected credit losses on financing commitments and financial guarantee contracts. The allowance for credit losses

includes both the incurred credit losses and the expected future credit losses.

- **Carrying amount/carrying value:** The amount at which an asset is recognised after deducting any accumulated depreciation (amortisation) and accumulated impairment losses thereon.
- **Cost of disposal:** Incremental costs directly attributable to the disposal of an asset, excluding finance costs and income tax expense.
- **Default risk:** The uncertainty that the firm will not be able to recover its receivables.
- **Effective rate of return:** A method of allocating income from an asset or venture uniformly and equitably over the contractual (or expected) period of expected benefit from the asset or continuity of venture. This method allocates the cash flows from the asset or venture through a uniform rate of return, including all cash flows considering all contractual terms (or best expectations) and excluding expected future losses. Any fee or points paid or received, the transaction costs, premiums, or discounts are included in the cash flows insofar as these are part of the base contract or are ancillary costs.
- **Fair value:** The price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date.
- **Impairment loss:** The amount by which the carrying amount of an asset exceeds its recoverable amount.
- **Inventory:** In relation to this standard, an asset held for sale in the ordinary course of business or in the process of production for such sale.
- **Lifetime expected credit losses:** The expected credit losses that result from all possible default events over the expected life of a receivable or irrevocable unutilised commitment component.
- **Net realisable value (NRV):** The estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale, considering the factors specific to the institution.
- **Onerous contract or commitment:** A contract or commitment, respectively, in which the unavoidable costs of meeting the obligations under the contract or commitment, respectively, exceed the economic benefits expected to be received under it.
- **Probability of default:** The likelihood of a default (i.e., inability to meet debt obligations – also see “default”) by a debtor over a particular time horizon.
- **Promise and bilateral promise:** A commitment assumed by one party (e.g., in *Murabaha*, the purchase order). The promise is understood to be religiously binding on the party who makes it unless a legitimate excuse under *Shariah* arises and prevents its fulfilment. Nevertheless, a promise is understood to be binding from the juristic perspective if it is pending on a cause, and the promisee has incurred costs by reason of the promise. A

bilateral promise is the exchange of two back-to-back promises between two parties, each promising to perform an act in the future relating to the same subject matter.

- **Provision:** A liability of uncertain timing or amount or both.
- **Receivable (*Dain*):** In relation to this standard, an amount of contractual right established because of a permissible exchange (commutative) contract representing only established and known amounts of cash flows.
- **Recoverable amount:** The recoverable amount of an asset is the higher of its value in use (the value that can be generated by using the asset) and fair value less cost of disposal (the benefit that can be obtained by selling the asset).
- **Value in use:** The net value of the future cash flows expected to be derived from the use of an asset or continuity of venture applying the effective rate of return method.
- **12-month expected credit losses:** The portion of lifetime expected credit losses that represent the expected credit losses that result from default events on a receivable that is possible within the 12 months after the reporting date.

12.9 Review Questions

- 1 Which approach is used for the revaluation of on-balance sheet receivables?
 - a) NRV approach
 - b) Provision accounts
 - c) Credit losses
 - d) None of the above
- 2 FAS 30 has classified the assets into three main categories for the purpose of revaluation. A different revaluation technique is applied to each category of assets.
 - a) Credit loss approach for other assets
 - b) Impairment approach for receivables and off-balance sheet exposures
 - c) NRV approach for inventories
 - d) NRV approach for other assets
- 3 TRK Pharma Co. estimated the net realisable value of its inventory stock to be USD 56,000. The inventory was initially recorded by the company at a cost of USD 60,000. What will be the loss or gain, if any, using the NRV approach?
 - a) USD 4,000 loss
 - b) USD 4,000 profit
 - c) No profit or loss would be incurred
 - d) None of the above

- 4 Which of the following will be used to determine the amount of credit losses?
- a) The total amount of receivable at risk
 - b) Any change in the credit loss of a receivable due to a decline of credit rating or other industry factors
 - c) Weightage of risk and the probability of different outcomes to arrive at the expected figure for credit loss
 - d) All of the above
- 5 Stage-2 receivables are those in which the payment is delayed by:
- a) Less than 30 days
 - b) More than 30 days but less than 90 days
 - c) More than 60 days
 - d) More than 90 days
- 6 In July 2023, JFI Islamic Bank booked receivables of USD 5,000 from Paragon Parks Limited which were to be received in five equal instalments. The first payment was due on Dec 15, 2023. By the end of Dec 2023, JFI Islamic Bank had not received the payment from Paragon Parks. JFI Islamic Bank categorised the receivables as stage-1 receivables and determined the ECL to be 15% of the first payment. What will be the amount of ECL to be recorded and the accounting treatment?
- a) Debit Credit Loss (Expense) 1,000, Credit Allowance for ECL (Liability) 1,000
 - b) Debit Credit Loss (Expense) 150, Credit Allowance for ECL (Liability) 150
 - c) Debit Allowance for ECL (Liability) 150, Credit Loss (Expense) 150
 - d) Debit Allowance for ECL (Liability) 150, Credit Loss (Expense) 150
- 7 If the carrying value of a fixed asset is USD 2,500, and its value in use is USD 2,200, which of the following is false? (Note: value-in-use is greater than its fair value less cost to sell)
- a) USD 2,200 is the recoverable amount of the asset.
 - b) Impairment of USD 300 would be charged.
 - c) A loss of USD 300 would be charged in the next accounting period.
 - d) The recoverable amount is less than the carrying value of the asset.
- 8 Which component is not present on the balance sheet?
- a) Net realisable value
 - b) Allowance for credit losses
 - c) Cumulative impairment
 - d) Provision accounts
- 9 GRE Tire Corporation tests its machine for impairment at the end of the financial year 2023. The carrying value of the machine is USD 3,000.

The firm estimates its value in use to be USD 2,800 and the fair value to be USD 2,250. The firm will have to pay USD 80 to an agent to sell the machine. What is the recoverable amount for the machine?

- a) USD 2,800
 - b) USD 2,250
 - c) USD 2,170
 - d) USD 200
- 10 Which of the following is the correct accounting treatment to record the provision for onerous contracts?
- a) Debit Provision for Onerous Contracts (Contra-Asset), Credit Provision for Onerous Contracts (Contra-Asset)
 - b) Debit Loss on Onerous Contracts (Expense), Credit Provision for Onerous Contracts (Contra-Asset)
 - c) Debit Provision for Onerous Contracts (Contra-Asset), Credit Onerous liability (Liability)
 - d) Debit Onerous liability (Liability), Credit Provision for Onerous Contracts (Contra-Asset)

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Answers

Chapter 1	1 c, 2 b, 3 b, 4 d, 5 c, 6 d, 7 a, 8 d, 9 b, 10 c
Chapter 2	1 b, 2 d, 3 c, 4 c, 5 c, 6 b, 7 a, 8 d, 9 c, 10 a
Chapter 3	1 a, 2 d, 3 a, 4 c, 5 a, 6 d, 7 a, 8 c, 9 a, 10 a
Chapter 4	1 d, 2 a, 3 c, 4 b, 5 d, 6 c, 7 c, 8 d, 9 c, 10 b
Chapter 5	1 a, 2 b, 3 d, 4 c, 5 c, 6 c, 7 d, 8 a, 9 d, 10 c
Chapter 6	1 c, 2 d, 3 a, 4 d, 5 b, 6 b, 7 c, 8 c, 9 a, 10 d
Chapter 7	1 b, 2 a, 3 a, 4 b, 5 a, 6 d, 7 a, 8 c, 9 b, 10 c
Chapter 8	1 b, 2 d, 3 a, 4 a, 5 c, 6 a, 7 b, 8 b, 9 b, 10 a
Chapter 9	1 d, 2 a, 3 b, 4 a, 5 b, 6 a, 7 b, 8 b, 9 b, 10 d
Chapter 10	1 c, 2 d, 3 d, 4 c, 5 a, 6 c, 7 a, 8 c, 9 d, 10 c
Chapter 11	1 c, 2 d, 3 c, 4 a, 5 b, 6 c, 7 c, 8 d, 9 b, 10 c
Chapter 12	1 c, 2 c, 3 a, 4 d, 5 b, 6 b, 7 c, 8 c, 9 a, 10 b

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