Introduction to AAOIFI standards

Practical insights into Financial Accounting Standard (FAS) 4, 7, 10, 28 and 32 and the corresponding Shari’ah Standards (SS)

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بسم الله الرحمن الرحيم

Workshop agenda

Session 1: - equity-based contracts

- FAS 4 “Musharaka Financing” and SS 12 “Sharikah (Musharakah) Sharikah (Musharakah) and Modern Corporations and Modern Corporations”

Session 2: - trade-based contracts

- FAS 28 FAS 28 “Murabaha and Other Deferred Payment Sale” and SS 8 “Murabahah”
- FAS 7 and SS 10 “Salam and Parallel Salam”;
- FAS 10 and SS 11 “Istisna and Parallel Istisna”

Session 3: rental-based contracts

- FAS 32 “Ijarah” and SS 9 “Ijarah and Ijarah Muntahia Bittamleek”

Session 1

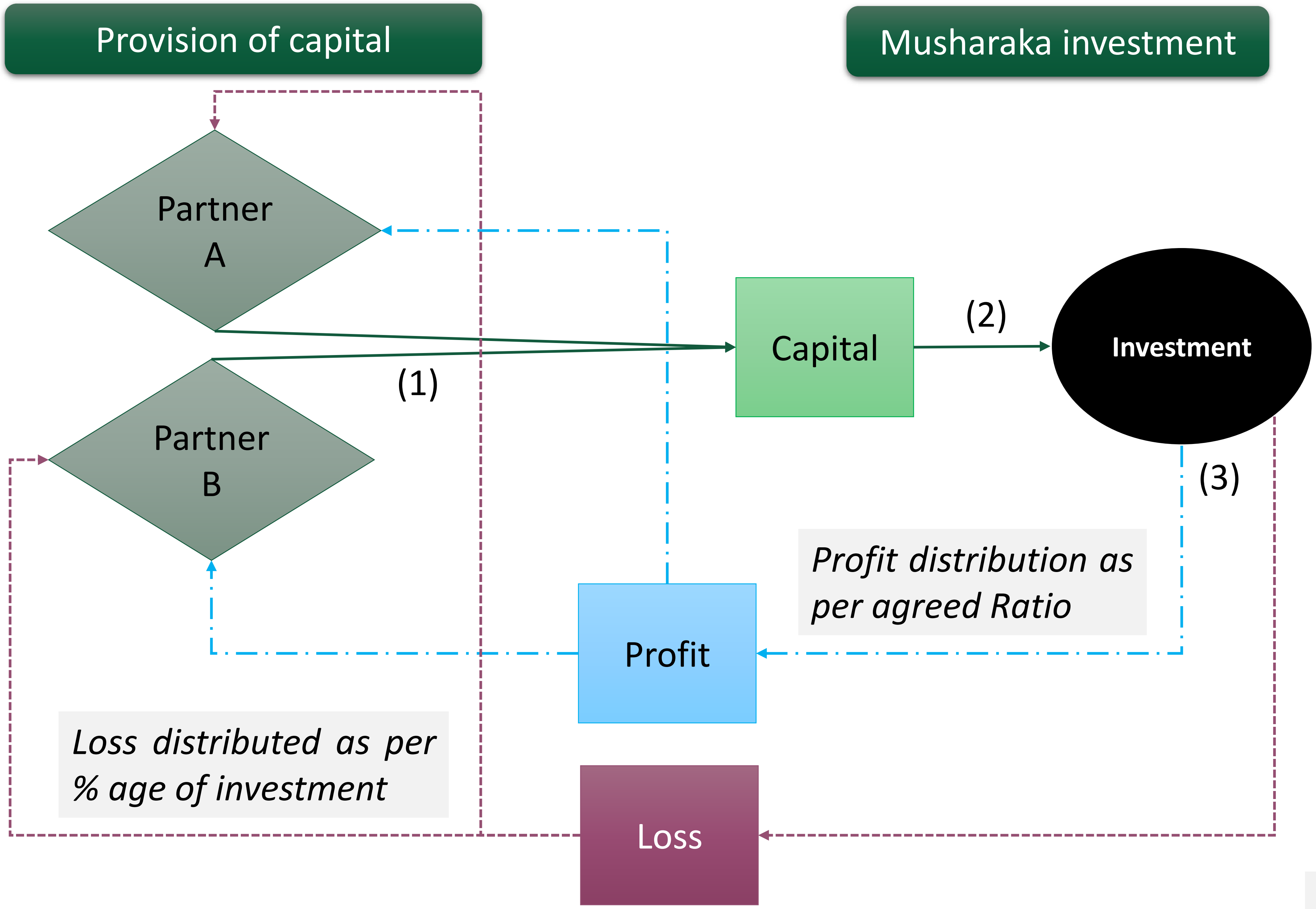
Equity-based contracts

1.1

FAS 4 “Musharaka Financing”
SS 12 “Sharikah (Musharakah) Sharikah (Musharakah) and Modern Corporations and Modern Corporations”

Musharaka – definition and process flow

"A form of partnership between the IFI 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."



FAS 4 “Musharaka Financing”

Initial recognition

- Initial Musharaka capital is recognised when it is paid to the partner or placed under his disposition. IFI’s share in Musharaka capital is presented in the books of IFI under Musharaka financing.
- When Musharaka capital is provided in cash it is measured by the amount paid or amount placed under disposition of the partner.
- When capital is provided in the form of non-monetary assets or trading asset in the form of tangible or non-tangible asset such as inventories or trademarks, these are measured at fair value of the asset and if the valuation of the assets results in a difference between fair value and book value, such difference shall be recognised as profit or loss to the Islamic bank itself.

Recording of Musharaka in books of IFI
Dr. Musharaka financing (SFP)
Cr. Cash/ Bank (SFP)

FAS 4 “Musharaka Financing” (contd.)

Subsequent measurement

- At the historical cost at the end of the financial period.
- Diminishing Musharaka is also measured at historical cost after deducting share of transferred units to customer. Such sale is made on fair value and the difference between historical cost and fair value is recorded as profit or loss in the income statement of the IFI.

Diminishing Musharaka – sale of units
Dr. Cash/ Bank (SFP)
Cr. Diminishing Mushraka (SFP)
Cr. Profit on DM [FV – BV] (IS)

FAS 4 "Musharaka Financing" (contd.)

Recognition of profits and losses

- Profit or losses in respect of short-term Musharaka financing which commences and ends during the same financial period is recognised when the tenure of Musharaka contract ends i.e. at the time of liquidation.
- In the case of a constant Musharaka that continues for more than one financial period, the IFI's share of profits for any period, resulting from partial or final settlement between the IFI and the partner, shall be recognised in its accounts for that period to the extent that the profits are being distributed (based on the pre-agreed profit distribution formula); the IFI's share of losses for any period shall be recognised in its accounts for that period to the extent that such losses are being deducted from its share of the Musharaka capital.

Accounting for Musharaka profits
Dr. Cash/ Bank (SFP)
Cr. Profit from Musharaka financing (IS)

Accounting for Musharaka losses
Dr. Loss from Musharaka financing (IS)
Cr. Musharakah financing (SFP)

- **Presentation and disclosures**

Notes to financial statements shall disclose provision for decline in value of Musharaka assets and provision for loss of capital in Musharaka financing transactions.

Musharaka Accounting – Case Study

On 1st Jan 20X1, Noon IFI entered into a constant Musharaka with a customer by investing USD 1,000,000 in a bottled water manufacturing company whereas the customer invested USD 500,000.

The partners agreed to share the profit in the ratio of 50% for the IFI and 50% for the customer. The venture earned/ incurred profits/ losses as follows;

31 December 20X1	USD 10,000
31 December 20X2	(USD 20,000)

The Musharakah was terminated on 31st Dec, 20X2 following loss.

Provide Accounting Entries to be recorded by Noon IFI for:

1. **Musharakah Financing**
2. **Profit on Musharakah**
3. **Loss on Musharakah, and**
4. **Final Settlement/ Termination**

Musharaka Accounting – Case Study solution

1.Recording of Musharaka in books of Noon IFI	USD
Musharaka financing (SFP)	1,000,000
Cash/ Bank (SFP)	1,000,000

2. Musharaka profits 31 December 20X1	USD
Cash/ Bank (SFP)	5,000
Profit from Musharaka financing (IS)	5,000

3. Musharaka losses 31 December 20X2	USD
Loss from Musharaka financing (IS)	13,333
Musharaka financing (SFP)	13,333

4. Musharaka termination 31 December 20X2	USD
Musharaka Receivable (SFP)	986,667
Musharaka financing (SFP)	986,667

Session 2

Trade / Sale based contracts

Commonly practiced sales-based contracts

Sale-based contracts

- Murabaha
- Salam and parallel Salam
- Istisna and parallel Istisna
- Tawarruq

Key similarities in sales-based contracts

1	**Shari’ah compliant**	All transactions are Shari’ah compliant and offer different avenues for carrying out sales transactions, catering to the specific needs of clients.
2	**Asset-based contracts**	They are sales contracts with the primary goal of acquiring assets.
3	**Defined terms and conditions**	Every type of sale-based contract includes its own specific and well-defined terms and conditions.
4	**Risk sharing**	Each type of sale-based contract involves a degree of risk sharing between the seller and buyer.
5	**Structured payments**	Each type of sale-based contract has its own specific structure for payment, i.e., on spot, in advance, by instalment, etc,.

2.1

FAS 28 “Murabaha and Other Deferred Payment Sale”
SS 8 “Murabahah”

Murabaha summarised process flow and accounting treatment

- According to Shari'ah, Murabaha is principally a trade- based transaction i.e. a sale transaction (cost plus profit sale).

Advance to supplier / agent	Recorded as interest free advance in other assets
Acquisition of Murabaha asset	Recorded as inventory
Sale of Murabaha asset	Revenue and receivable recognized Profit deferred
Amortisation of deferred profit	Profit amortized over the period
Recovery	Amount received adjusted against gross receivable

Important definitions

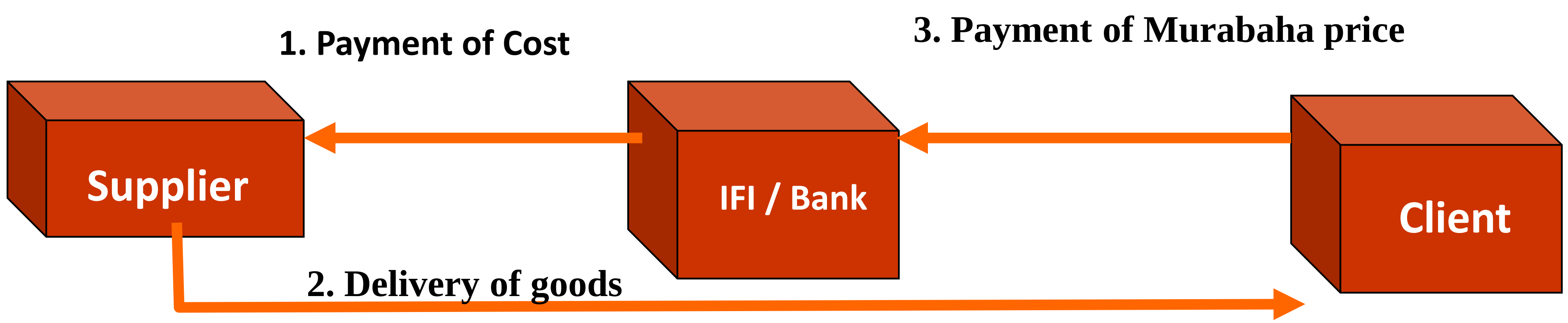
Murabaha	Sale of goods with an agreed upon profit mark-up on the cost. This could be on a spot basis or deferred payment basis
Deferred payment sale	Sales transaction in which the payment of sales consideration is deferred over a fixed credit term, in installments or on a lump sum basis
Murabaha to purchase orderer	Sale and purchase transaction where the purchaser makes an order and confirmed his order with a promise (Wa'ad) to purchase the specified subject matter from the intended seller on agreed Murabaha terms
Arboun	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 in promise to purchase by the buyer
Hamish Jiddiyyah	Amount deposited as a security against fulfillment of a contract, or promise, or completion of a transaction by one of the parties to other

Hamish Jiddiyyah and Arboun

- Collateral
  - Hamish Jiddiyyah (promise stage)
    - Binding Contract
      - Recovery to the extent of loss
    - Non-binding contract
      - Return the entire amount irrespective of loss
  - Arboun (at the time of Murabaha conclusion)
    - Customer proceed with sale
      - Will be adjusted as sales proceed
    - Customer does not proceed with sale
      - IFI has right to retain the entire amount

Murabaha – Key features

Underlying principle	Cost plus sales
Tenure	Short term - upto 1 year
Rate	Fixed
Prepayment Discount	No
Rescheduling of Price	No
Uses	Purchase of Raw material/ Fixed asset/ Consumer Items



AAOIFI Shari’ah compliance – SS 8 Murabaha

- IFI must ensure that the party from whom the item is bought is a third party other than customer.
- It is permissible for the IFI, in the case of a binding promise by the customer, to take a sum of money as Hamish Jiddiyyah (security deposit). In the case of the customer’s breach of his binding promise, the Institution is not permitted to retain Hamish Jiddiyyah as such. Only actual loss suffered in sale to third party may be recovered.
- The original principle is that the IFI itself purchases the item directly from the supplier. However, it is permissible for the IFI to authorize customer as an agent.
- The IFI shall not sell any item before it acquires such item. It is obligatory that the IFI’s actual or constructive possession of the item be ascertained before its sale.
- It is an obligation that both the price of the item and the IFI’s profit be fixed and known to both parties at the initiation of the Sale Contract.
- It is permissible to agree on the payment of the price of the item either by short or long term installments, and the selling price of the asset becomes a debt that the customer is obligated to pay at the time agreed upon.

AAOIFI Shari’ah compliance – SS 8 Murabaha (contd.)

- It is permissible for the IFI to stipulate to the customer that installments may become due before their originally agreed due dates in case of the customer’s refusal or delay in paying any installment without any valid reason.
- The IFI should ask the customer to provide permissible security in the contract of Murabaha.
- It is not permissible to stipulate that the ownership of the item will not be transferred to the customer until the full payment of the selling price.
- It is not permissible to extend the date of payment of the debt in exchange for an additional payment in case of rescheduling, irrespectively of whether the debtor is solvent or insolvent.
- When there is default in payment by the customer, it is not permissible for the IFI to impose any additional payment on the customer.
- It is permissible for the IFI to give up part of the selling price if the customer pays early, provided this was not part of the contractual agreement.

Risk profile of Murabaha

RISK	MITIGANTS
Agency Risk	Direct payment to the supplier/vendor and proper pre-inspection
Ownership transfer/Asset Risk	Takaful of goods during transit and induce customers to submit declaration immediately after the purchase of goods
Repayment/ Default Risk	Obtain sufficient collateral and adopt staggered payments
Price Risk	Secure the collateral upon executing the promise to purchase with the customer

Risk profile of Murabaha (contd.)

RISK	MITIGANTS
Profitability Risk	A charity may be imposed to discourage a delay in payment of Murabaha price
Legal Risk	To secure the position, the bank shall ensure that the promise to purchase is properly documented and it is legally enforceable
Shariah Compliance Risk	Ensure that the relevant staff have appropriate training and have proper knowledge of Shari'ah principles as well
Product Risk	Ensure Offer and Acceptance on time to book profit

How to structure Murabaha based solution?

Information Needed:

- Nature of goods
- Payment Terms with supplier
- Timing of payment to supplier
- Timing of receipt of goods
- In-transit risk
- Nature of evidence of purchase
- Inventory holding period
- Storage mechanism
- Goods Identification method
- Timing of offer and acceptance

Initial recognition and subsequent measurement

Initially recognised at '*Cost*' which shall include all costs incurred in bringing the inventory to its present location & condition (taxes, transportation and handling, Takaful costs, agent's fee) net of trade discounts and rebates.

Purchase of Inventory	
Murabaha Inventory (SFP)	Dr.
Cash/ Accounts Payable (SFP)	Cr.

Subsequently, inventories shall be measured at '*lower of cost and net realisable value (NRV)*'.

If NRV falls below Cost of Inventory	
Loss for Decline in NRV (IS)	Dr.
Murabaha Inventory (SFP)	Cr.

estimated selling price in the ordinary course of business less the estimated costs of completion and the estimated costs necessary to make the sale

Initial recognition and subsequent measurement (contd.)

Binding promise from customer to purchase inventory

The seller shall carry inventories at cost irrespective of fluctuations in fair value of inventories.

Binding promise from customer to purchase inventory is not available

Adjustment in carrying value to write-down to net realizable value (if lower than cost).

If NRV falls below cost of inventory	
Loss for Decline in NRV (IS)	Dr.
Murabaha Inventory (SFP)	Cr.

Treatment of trade discounts

The cost of the relevant goods shall be reduced by the amount of the discount.

Initial recognition and subsequent measurement (contd.)

Initial recognition

The seller shall recognise receivables and revenue in its financial statements, when the inventory is sold under Murabaha or deferred payment sale contract at an amount equal to the face value (gross amount or invoice value)

Recording of receivables at the time of sale	
Murabaha Receivable (SFP)	Dr.
Murabaha Sales (IS)	Cr.

Subsequent measurement

Subsequent to initial recognition, gross receivables shall be carried at their outstanding amount less any allowance for credit losses.

Inventories
Receivables
Revenue and Profits
Hamish Jiddiyyah & Arboun

Revenue and profit recognition

- ## Revenue and cost of sales

Revenue shall be recognised at the time Inventory is sold under "Murabaha or Deferred Payment Sale Contract" and cost of sales in the period in which the related revenue is recognised.

Recording of revenue and cost of sales
Dr. Murabaha receivable [cost + deferred profit] (SFP)
Cr. Murabaha revenue (IS)
Dr. Murabaha cost of sales (IS)
Cr. Murabaha asset (SFP)

- ## Profit deferment

The profit arising from the transaction i.e. the difference between revenue and cost of sales recognised, shall be deferred through a deferred profit account – to be presented as contra of respective receivables account.

Recording of profit
Dr. Murabaha revenue (IS)
Cr. Murabaha cost of sale (IS)
Cr. Deferred profit (contra asset)

Hamish Jiddiyyah and Arboun

- The initial deposit or advance payment, paid by the buyer shall be recognised as a liability of the seller.
- Once the Murabaha or deferred payment sale transaction is consummated:
  - ✓ Hamish Jiddiyyah, being in the nature of a security deposit, shall continue to be presented as a liability and shall not be set-off against the receivables.
  - ✓ Arboun, being in the nature of an advance payment, shall be netted off against the receivables.

Receipt of Hamish Jiddiyyah/ Arboun	
Cash Deposit (SFP)	Dr.
Hamish Jiddiyyah / Arboun (SFP)	Cr.

Adjusting Murabaha receivable with Arboun when sale is executed	
Arboun (SFP)	Dr.
Murabaha receivable (SFP)	Cr.

Presentation and disclosure (illustration)

4. RECEIVABLES

	2023 US$ '000	2022 US$ '000
Sales (Murabaha) receivables (note 4.1)	10,211,340	10,610,013
Ijarah receivables (note 4.2)	160,765	136,924
Salam receivables (note 4.3)	315,780	283,574
Istisna'a receivables (note 4.4)	139,682	150,365
Allowance for credit losses	(757,447)	(743,303)
	10,070,120	10,437,573

4 .1 Sales (Murabaha) receivables

	2023			2022		
	Self financed US$ '000	Jointly financed US$ '000	Total US$ '000	Self financed US$ '000	Jointly financed US$ '000	Total US$ '000
Commodity murabaha	10,135	319,734	329,869	23,679	314,383	338,062
Other murabaha	1,081,623	9,913,066	10,994,689	954,173	10,246,009	11,200,182
Gross sales (murabaha) receivables	1,091,758	10,232,800	11,324,558	977,852	10,560,392	11,538,244
Deferred profits (note 4.1(a))	(93,798)	(1,019,420)	(1,113,218)	(86,767)	(841,464)	(928,231)
	997,960	9,213,380	10,211,340	891,085	9,718,928	10,610,013
Allowance for credit losses (note 22)	(310,526)	(360,050)	(670,576)	(263,339)	(398,762)	(662,101)
Net sales (murabaha) receivables	687,434	8,853,330	9,540,764	627,746	9,320,166	9,947,912

	2023 US$ '000	2022 US$ '000
Non-performing	360,872	381,464

Presentation and disclosure (illustration) (contd.)

4. RECEIVABLES (continued)

4.1(a) Murabaha deferred profit movement

	2023 US$ '000	2022 US$ '000
Deferred profit at the beginning of the year	928,231	1,106,458
Murabaha sales during the year	2,769,309	2,793,595
Murabaha cost of sales	(1,979,339)	(2,279,654)
	1,718,201	1,620,399
Deferred profit collected during the year	(404,227)	(488,655)
Deferred profit settled during the year	(15,162)	(15,947)
Deferred profit waived during the period	(529)	(5,033)
FX translation	(185,065)	(182,533)
Deferred profit at the end of the year	1,113,218	928,231

4.2 Ijarah receivables

	2023			2022		
	Self financed US$ '000	Jointly financed US$ '000	Total US$ '000	Self financed US$ '000	Jointly financed US$ '000	Total US$ '000
Gross ijarah receivables	3,085	157,680	160,765	3,657	133,267	136,924
Allowance for credit losses (note 22)	(83)	(56,774)	(56,857)	(179)	(46,424)	(46,603)
Net ijarah receivables	3,002	100,906	103,908	3,478	86,843	90,321

	2023 US$ '000	2022 US$ '000
Non-performing	123,977	110,053

Key considerations for Murabaha

1 - Buy back arrangement

- Bai’ Al Inah (sale and buy back) is not permitted.
- Purchase from third party (not from customer or relater party of the customer)

2 - Rollover

- Refinance the commodity of earlier Murabaha contract with same customer is not permitted.
- Roll over of existing Murabaha

3 - Rebate on early payments

- Majority of Muslim jurist consider it un-Islamic
- IFI can give rebate, without stipulating in the contract, but it should not be regular practice

Key considerations for Murabaha

4 – Late payment charges

- No additional price for default or delay in payment
- Undertaking from customer to pay penalty that will be given to charity and will not be taken as income of IFI.
- SSB will supervise the Charity fund maintained by the IFI.

5 – Transaction sequence

- Breaking the sequence of Murabaha transaction may lead to void the transaction.

6 – Transfers of risk and reward (ownership)

- Before conclusion of Murabaha, IFI is responsible for all risks and rewards

7- Specification of subject matter

- Specification of subject matter is a must and selling without specifying the goods will render Murabaha void.

Murabaha Accounting – Case Study

Ghurair Corporation is the largest producer of Palm Oil in Saudi Arabia.

It approached an Islamic Financial Institution (IFI) to finance an Oil Seed flanker machine on the basis of Murabaha on 1st February, 2024 with a deferred repayment arrangement.

The machine was purchased for SR 150,000 by the IFI on 1st March, 2024. The IFI also incurred SR 15,000 for transportation, takaful and other expenses to bring the asset to the present condition and location.

The machine was sold onwards on the same date on a credit period of 5 Months. The selling price was agreed at SR 175,000 which Ghurair Corporation agreed to repay on 31st July, 2024.

Provide Murabaha Accounting Entries to be recorded by Islamic Financial Institution (seller) for:

1. **Purchase of Oil Seed Flanker Machine**
2. **Sale under Deferred Payment Murabaha Contract**
3. **Recording of Deferred Murabaha Profit**
4. **Murabaha Profit Accruals at month end, and**
5. **Receipt of Cash Proceeds**

Murabaha Accounting – Case Study - Solution

1 - Purchase of Machinery by the IFI	SR
Murabaha Inventory (SFP)	165,000
Cash/ Accounts Payable (SFP)	165,000

2 - Recording of Murabaha Sales and Cost of Sales	SR
Murabaha Receivable [Cost + Deferred Profit] (SFP)	175,000
Murabaha Sales / Revenue (IS)	175,000
Murabaha Cost of Sales (IS)	165,000
Murabaha Inventory/Asset (SFP)	165,000

3 - Recording of Deferred Murabaha Profit	SR
Murabaha /Sales Revenue (IS)	175,000
Murabaha Cost of Sale (IS)	165,000
Deferred Profit (SFP)	10,000

Murabaha Accounting – Case Study - Solution

4 - Recording of Murabaha Profit (Monthly)	**SR**
Deferred Profit (SFP)	2,000
Murabaha income (IS)	2,000

5 – Receipt of installment (Monthly)	**SR**
Cash/Bank (SFP)	35,000
Murabaha Receivables (SFP)	35,000

Murabaha Accounting – Concept Checker 1

Murabaha is a kind of sale in which:

01	The seller discloses the Total Sale price to the buyer
02	The seller discloses the Cost and Profit Markup
03	Both of above.
04	None of above

Murabaha Accounting – Concept Checker 2

Ibrahim & Co. purchased a Farming Machine at a cost price of 10,000 USD. It had to pay Taxes for import of machinery amounting to USD 700, Transportation & Handling cost of USD 1,000 and USD 300 as Takaful premium. It also got a Trade discount of USD 100.

The asset shall initially be recognized at:

01	USD 10,000
02	USD 12,000
03	USD 11,900.
04	USD 10,700

Murabaha Accounting – Concept Checker 3

Which of the following statement(s) are correct under FAS. (28):

01	Inventories shall subsequently be measured at lower of Cost & NRV
02	The cost of the relevant goods shall be reduced by the amount of the discount.
03	Both of above.
04	None of above

Murabaha Accounting – Concept Checker 4

Which of the following statement(s) are incorrect under FAS. (28):

01	Profit shall be recognized when payment is received
02	The seller shall recognize receivables and revenue in its financial statements, when the inventory is sold not when payment is received.
03	Deferred profit shall be presented as part of respective receivables account
04	Only (1) & (3)

Murabaha Accounting – Concept Checker 5

The treatment of initial deposit or advance payment, paid by the buyer, under FAS. (28) is as follows:

01	It is treated as a Liability by the seller
02	Hamish Jiddiyah shall not be set of against Murabaha Receivables
03	Urbun shall be netted off against Murabaha Receivables
04	All of above are true.

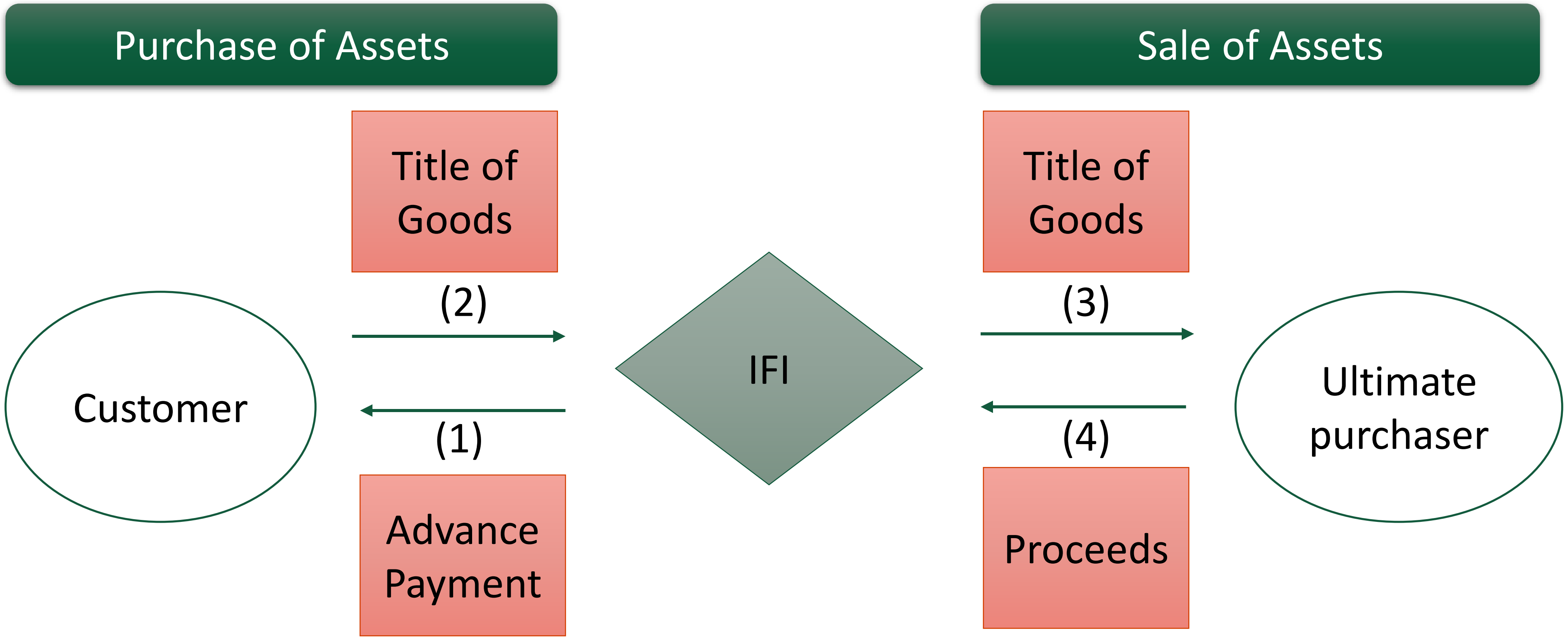
2.2

FAS 7 & SS 10 “Salam and Parallel Salam”

Salam - definition and process flow

Salam is defined as: "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."

FAS 7 "Salam and Parallel Salam"



Important definitions

Salam/Salaf		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
Parallel Salam		A Salam contract whereby Al-Muslam Ileihi **(Seller)** depends, for executing his obligation, on receiving what is due to him –in his capacity as Al-Muslam **(Purchaser)** – from a sale in a previous Salam contract, without making the execution of second Salam contract dependent on the execution of the first one.
Others	**Al-Muslam Ileihi**	The seller
	Al-Muslam	The purchaser
	Al-Muslam Fihi	The commodity to be delivered
	Ra's Al-Mal	Capital (cost) paid (in cash, kind or benefit) in a Salam contract; i.e., price

Difference between Salam and Istisna'a

Parameter	Salam	Istisna'a
Payment terms	Price must be paid in advance	Price may be paid in advance, in installment or can be deferred.
Subject matter	❑ Should be homogeneous ❑ The subject matter generally does not require manufacturing	❑ Not necessarily be homogeneous commodity ❑ The subject matter of Istisna'a invariably needs manufacturing
Cancellation	Salam contract can not be cancelled unilaterally	Istisna'a contract can be cancelled before the manufacturer starts the work

Brief summary of Salam accounting

- Advance payment
  - No revenue recognised
- Once the goods are delivered
  - Inventory is recorded at cost
  - No revenue recognised
- Once the goods are sold
  - Cash
    - Recognise full revenue
  - Credit
    - Recognise revenue and defer the profit related to future periods

Salam financing / capital
Receipt of goods
Sale of Salam inventory
Parallel Salam

Initial recognition & subsequent measurement

Initial recognition & subsequent measurement

- Salam capital (cash or in kind) paid to the supplier is initially recognized at the amount paid to the seller / supplier.

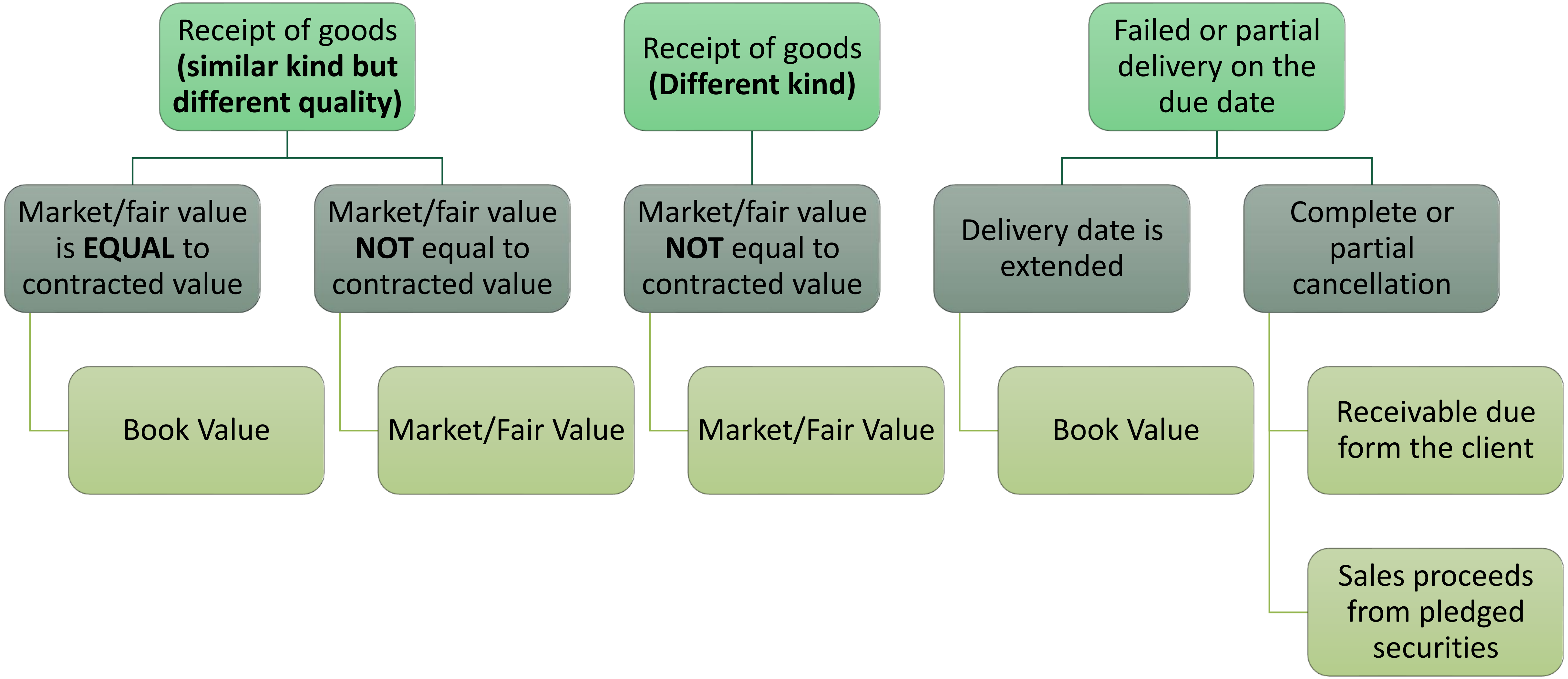
Disbursement of Salam Capital	
Salam Financing (SFP)	Dr.
Bank/ Cash/ *Asset or Usufruct/ Liability (SFP)	Cr.

* The asset/benefit provide shall be measured at the agreed fair value

- Salam financing is subsequently measured at historical cost unless there is a probability that the supplier will not deliver goods of the same quality and quantity in full or in part in which case a provision shall be created.

Provision in respect of Salam Financing	
Provision against Salam Financing (IS)	Dr.
Provision against Salam Financing (SFP)	Cr.

Conditions of receipt of goods and treatment



Receipt of goods and treatment

Receipt of goods / commodity (Al Muslam Fihi)

- If goods received are of the agreed quantity but of different quality and the market value or fair value of such goods is equal to the market/fair value of Salam contract, the goods will be recorded and measured at <u>book value</u>.

Receipt of similar kind of goods but different quality	
Salam Inventory (SFP)	Dr.
Salam Financing (SFP)	Cr.

- In case the value of such goods is below the contracted amount at the time of delivery, the price has to be lowered to reflect the <u>market/fair value.</u>

Impairment of inventory in case value declines below market value	
Salam inventory (SFP)	Dr.
Loss on Salam Financing (IS)	Dr.
Salam Financing (SFP)	Cr.

Salam financing / capital

Receipt of goods

Sale of Salam inventory

Parallel Salam

Failure to receive goods

Failure to receive goods

- If a Salam contract is partially or fully cancelled due to failure to receive goods and the seller does not repay the Salam financing, it shall be recorded as receivable due from seller.

Partial or full cancellation	
Account Receivable (SFP)	Dr.
Salam Financing (SFP)	Cr.

- If there are securities pledged against the goods, sale of such securities are adjusted against capital receivable from the seller. If the proceeds are more than the Salam capital the remaining is credited to the seller.

Adjustment of proceeds from sale of securities (sales proceeds < salam financing)	
Cash/ Bank (sale of securities) (SFP)	Dr.
Receivable (SFP)	Dr.
Salam Financing (SFP)	Cr.

Adjustment of proceeds from sale of securities (sales proceeds > salam financing)	
Cash/ Bank (sale of securities) (SFP)	Dr.
Salam Financing (SFP)	Cr.
Customer account (SFP)	Cr.

Subsequent measurement at year end

Subsequent measurement of salam goods at the end of financial period

- Recorded at lower of historical cost and cash equivalent value.
- If the cash equivalent value of such goods is below the historical cost, the difference is charged to income statement.

Cash Equivalent Value less than Historical Cost	
Impairment/ Loss on Salam (IS)	Dr.
Salam Inventory (SFP)	Cr.

Sale of Salam goods

- Sale is recorded through the income statement and the income is then taken as net balance of sale and cost of sale

Sale through normal sale contract	
Cash/ Bank/ Receivables (SFP)	Dr.
Cost of Sale (IS)	Dr.
Sale of Salam Goods (IS)	Cr.
Salam Inventory (SFP)	Cr.

Salam financing / capital
Receipt of goods
Sale of Salam inventory
Parallel Salam

Parallel Salam

- Parallel Salam transactions are presented as a liability under the heading of 'Parallel Salam' in the financial statements when the amount is received by the IFI.

Advance against Parallel Salam	
Bank/ Cash (SFP)	Dr.
Parallel Salam (SFP)	Cr.

- When the commodity acquired through Salam is delivered by the IFI to the next buyer (under Parallel Salam), the difference between the amount paid by the IFI for the goods and the amount received from the buyer will be recognized as a profit or loss.

Sale of Commodity on Parallel Salam	
Parallel Salam (SFP)	Dr.
Loss on Parallel Salam (IS) *[OR Depending upon proceeds* Cr. Gain on Parallel Salam (IS)]	Dr.
Salam Inventory (SFP)	Cr.

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Presentation and disclosure (illustration)

4.3 Salam receivables

	2023			2022		
	Self financed US$ '000	Jointly financed US$ '000	Total US$ '000	Self financed US$ '000	Jointly financed US$ '000	Total US$ '000
Gross salam receivables	-	315,780	315,780	-	283,574	283,574
Allowance for credit losses (note 22)	-	(14,316)	(14,316)	-	(17,361)	(17,361)
Net salam receivables	-	301,464	301,464	-	266,213	266,213

	2023 US$ '000	2022 US$ '000
Non-performing	22,998	24,543

Source Al Baraka Group Annual Report 2023

Salam Accounting – Case Study

Hilal Islamic Bank is a renowned Shari'ah Compliant Financial Institution with its head quarters based in Riyadh, Kingdom of Saudi Arabia.

On 1st Feb, 2024, the bank entered into Salam Contract with Golden Barley Company to purchase 50,000 Metric Tons of Barley at an agreed price of USD 100,000 to be delivered on 15th May, 2024.

Subsequently, on 2nd Feb, 2024, the bank signed Parallel Salam contract with Silver Barley & Co. to supply 50,000 Metric Tons of Barley (Salam Goods) at a price of USD 105,000.

Golden Barley delivered the Salam Goods to Hilal Islamic Bank as per agreed date. Under Parallel Salam, the goods were sold to Silver Barley & Co. on 20th May, 2024.

Provide accounting entries for:

1. **Recording of Salam Transaction with Golden Barley Company.**
2. **Recording of Parallel Salam Transaction with Silver Barley & Co.**
3. **Receipt of Salam Goods under first Salam.**
4. **Sale of Goods under Parallel Salam.**

Salam Accounting – Case Study - Solution

1. Recording of Salam Transaction	USD
Salam Financing (SFP)	100,000
Cash / Bank (SFP)	100,000

2 - Recording of Parallel Salam Transaction	USD
Cash / Bank (SFP)	105,000
Parallel Salam (SFP)	105,000

3 – Receipt of Goods Under Salam	USD
Salam Inventory (SFP)	100,000
Salam Financing (SFP)	100,000

4 – Sale of Goods Under Parallel Salam	USD
Parallel Salam (SFP)	105,000
Salam Inventory (SFP)	100,000
Gain on Parallel Salam	5,000

Salam Accounting – Concept Checker 1

The seller in a Salam contract may not deliver the quality agreed under Salam contract. In this case, which of the following is true:

01	The buyer will create Provision against Salam Financing only if it is probable that the seller shall not deliver the goods of same quality or quantity
02	If the goods received are of the agreed quantity but of different quality and the market value or fair value of such goods is equal to the value of Salam contract, the goods will be recorded and measured at book value
03	If a Salam contract is partially or fully cancelled due to failure to receive goods and the seller does not repay the Salam financing, it shall be recorded as receivable due from seller
04	All of above.

Salam Accounting – Concept Checker 2

Subsequent Measurement of Salam Goods at the end of Financial Period shall be as follows:

01	Recorded at lower of historical cost and cash equivalent value
02	If the cash equivalent value of such goods is below the historical cost, the difference is charged to income statement
03	Both of above statements are correct.
04	None of above statements are correct

Salam Accounting – Concept Checker 3

Mr. Wan entered into a Salam contract with Hilal Islamic Bank on 11th June 2018 to deliver him 1,800 tons of A grade Wheat @ USD 800 per ton on 30th September 2018. After signing the Salam contract, Hilal Islamic Bank contracted a vender to deliver the same wheat at USD 700 per ton on 29th September 2018.

The amount of profit recognized by Hilal Islamic Bank under second contract shall be:

01	USD 180,000.
02	USD 150,000
03	USD 100,000
04	None of above

Salam Accounting – Concept Checker 4

An Islamic Bank may enter into a Parallel Salam contract with a Third party. Which of the following regarding Parallel Salam is true:

01	Parallel Salam Transaction is presented as an Asset in the FS of seller
02	Parallel Salam Transaction is presented as a Liability in the FS of seller
03	Under Parallel Salam, an IFI may contract to sell an item not yet owned by it
04	Both (2) and (3).

Salam Accounting – Concept Checker 5

The buyer in Salam may ask the seller to provide securities which the buyer may sell in case of seller's failure to deliver Salam Goods;

01	If the proceeds are more than the Salam capital the remaining is credited to the seller
02	If the proceeds are more than the Salam capital the buyer may keep any excess amount.
03	Sale of pledged securities are adjusted against capital receivable from seller
04	Both (1) & (3) are correct.

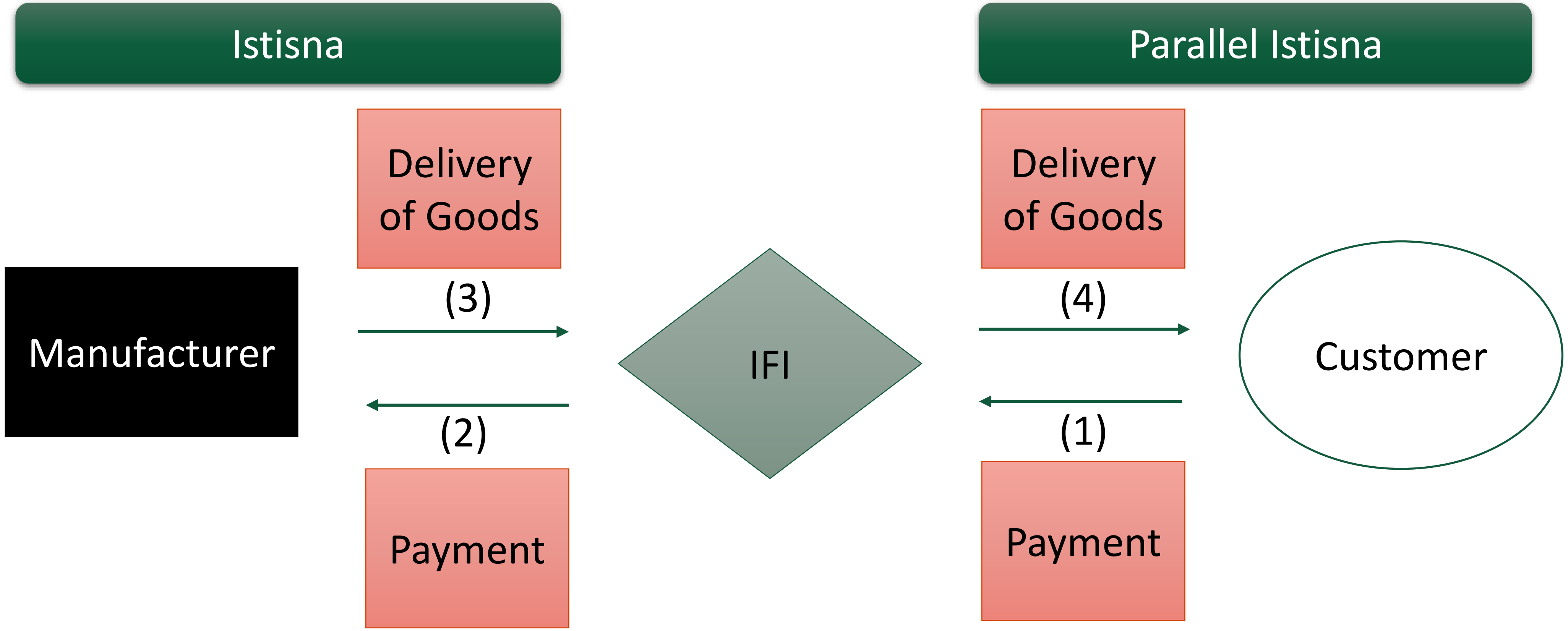
2.3

FAS 10 & SS 11“Istisna’a and Paralell Istisna’a”

Istisna'a - definition and process flow

"Istisna'a is defined as: "a sale contract whereby the seller undertakes to manufacture the Istisna Goods for buyer according to the specifications prescribed in the contract, in exchange for an agreed price.

- FAS 10 "Istisna'a and Parallel Istisna'a"



Important definitions

Istisna'a	Istisna'a is a **sale contract** between **Al-Mustasni' (the buyer)** and **Al-Sani' (the seller)**, whereby Al Sani' based on an order from Al-Mustasni', undertakes to have manufactured or otherwise acquired **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 in advance, 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.

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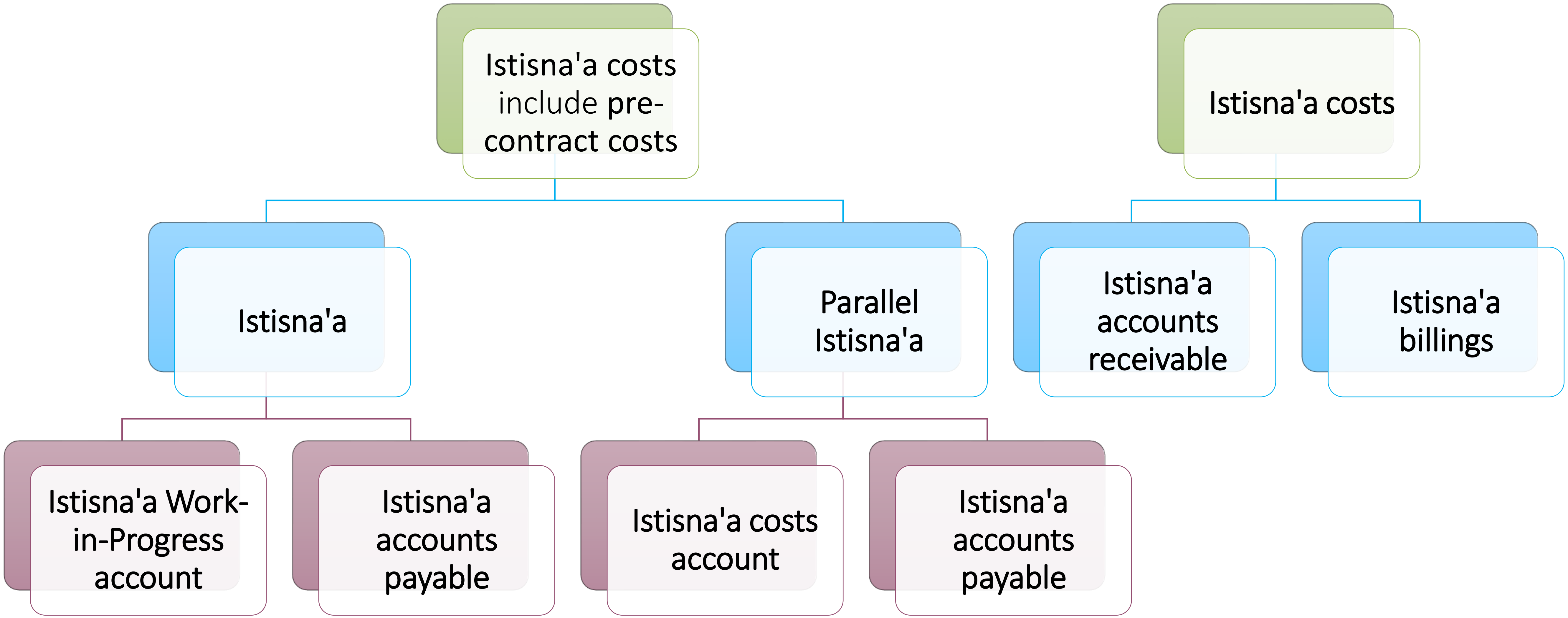
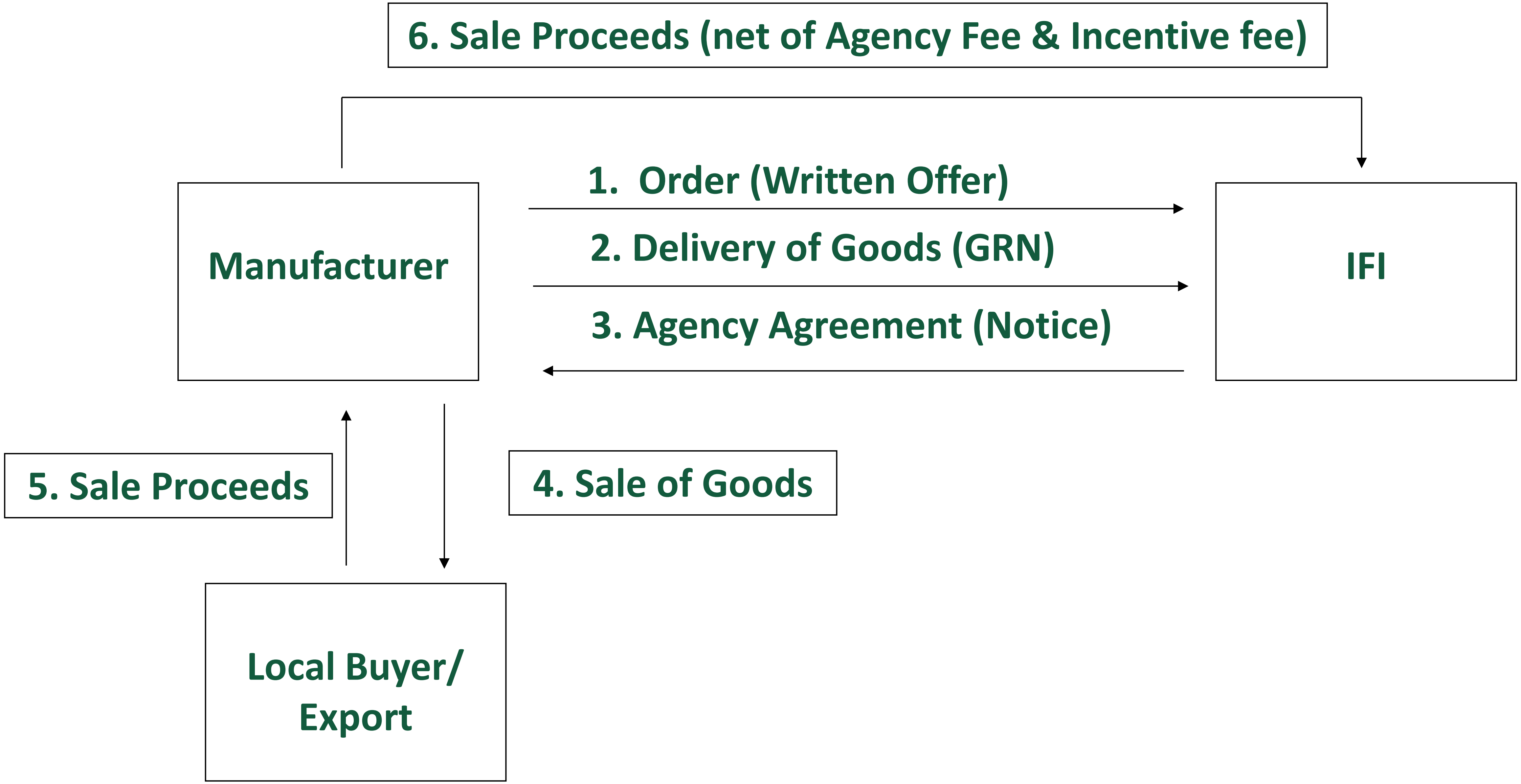
Recognition of Istisna'a costs and billings



Istisna – Key features



AAOFI Shari’ah compliance – SS 11 Istisna

- It is an order to manufacturer to manufacture a specific commodity for the purchaser
- Manufacturer uses his own material
- Quality & quantity should be agreed in absolute terms
- Purchase price should be fixed with mutual consent
- Upon delivery of the specified items (Constructive possession through physical inspection), IFI can appoint the Customer as its agent to sell the goods to its buyers.

AAOFI Shari’ah compliance – SS 11 Istisna (contd.)

- It is permissible that the bank and a customer conclude an Istisna’a contract before the bank assumes title to the subject-matter to be sold to the customer or to the materials from which the subject-matter will be produced (manufactured or constructed).
- A contract of Istisna’a is binding on the contracting parties provided that certain conditions are fulfilled, which include specification of the type, kind, quality and quantity of the subject-matter to be produced. Moreover, the price of the subject-matter must be known and, if necessary, the delivery date must be determined.
- It is not permitted for the manufacturer to stipulate in the contract of Istisna’a that he is not liable for defects.
- It is not permissible that the subject-matter of an Istisna’a contract be an existing and identified capital asset.

AAOFI Shari’ah compliance – SS 11 Istisna (contd.)

- The price of an Istisna’a contract may be deferred or paid in instalments within a certain period of time, or if delivery of the subject-matter is to be made in stages a portion of the price may be paid immediately while the balance is paid by instalments according to the stages of delivery.
- If the condition of the subject-matter does not conform to the contractual specifications at the date of delivery, the Mustasni’ has the right to reject the subject-matter or to accept it in its present condition.
- The delivery of the subject-matter may take place through constructive possession, by enabling the Mustasni’ to take control over the subject-matter after the production process is completed.

Risk Profile of Istisna

RISK	MITIGANTS
Delivery Risk	Istisna price can be reduced as per a mutually agreed formula to penalize the manufacturer
Default Risk	The banks must obtain sufficient collaterals
Non-performance	The bank can terminate the Istisna agreement and demand the price back from the manufacturer
Quality Risk	Khiyar-e-Aib may be exercised and Sub-contractors may be penalized

How to structure Istisna based solution?

Information Needed:

- Nature of goods
- Manufacturing period
- Goods Identification method
- Point of Risk transfer
- Method of taking delivery
- Storage mechanism
- Sale of Istisna goods in the market
- Evidence of Sale
- Payment Terms with Ultimate Buyer

Accounting treatment – Istisna'a costs

Istisna'a costs consist of:

a. **Direct costs**, in particular costs of producing Al-Masnoo'; and

b. **Indirect costs** relating to the contract as allocated on an objective basis.

c. **General and administrative expenses, selling expenses, research and development costs** shall not be included in an Istisna'a contract costs.

Recording pre-contract costs	
Deferred Cost (SFP)	Dr.
Bank/ Account Payable/ Cash (SFP)	Cr.
Upon Agreement	
Istisna'a WIP (SFP)	Dr.
Deferred Cost (SFP)	Cr.
Recording contract costs after contract initiation	
Istisna'a WIP (SFP)	Dr.
Bank/ Cash (SFP)	Cr.

Costs and billing

Revenue and profits

Accounting treatment – Istisna’a billings

This amount is booked as a receivable from buyer together and a liability is recorded under the name ‘Istisna'a billing’.

Amount Billed to Buyer (Al-Mustasni)	
Istisna'a Account Receivable (SFP)	Dr.
Istisna'a Billing [Contra Asset] (SFP)	Cr.

Upon Receipt of Billing	
Cash/ Bank (SFP)	Dr.
Istisna'a Account Receivable (SFP)	Cr.

At the end of the contract the amount of **Istisna'a billing account** shall be off-set against **Istisna'a work in progress account** and presented on the appropriate side of the Islamic bank’s statement of financial position.

Selection of method of recognition

Istisna'a revenue is the total price agreed between the Islamic Bank as 'Al-Sani' and the ultimate client as 'Al-Mustasni', including the Islamic Bank's profits margin on the contract.

Istisna'a revenue and associated profit margin are recognized in the Islamic banks financial statements according to either the **percentage of completion or the completed contract methods** as set up below:

Percentage of completion and estimated expected cost to complete the contract can be measured with reasonable accuracy

YES → Percentage of Completion Method

NO → Completed Contract Method

Revenue and profits – explanation

Istisna’a Revenue

Istisna’a Revenue is a part of contract price commensurate with the work performed during each period in which the contract is being executed shall be recognized as revenue for that period.

$$\text{Istisna'a Revenue} = \frac{\text{Accumulated Cost To Date}}{\text{Total Expected Contract Cost}} \times \text{Contract Price}$$

Istisna’a Profit for the Accounting Period

The portion of the Istisna’a profit margin recognized during the financial period (Istisna’a profit margin being the difference between the cash price of Al- Masnoo to the ultimate purchaser and the Islamic banks estimated total Istisna’a costs) shall be added to the Istisna’a work in progress account. Thus, at any point in time, the balance of the Istisna’a work in progress account will include the amount of profit recognized to date subject to deduction of any anticipated contract losses

$$\text{Profit} = \frac{\text{Accumulated Cost To Date}}{\text{Total Expected Contract Cost}} \times (\text{Contract Price} - \text{Total Expected Contract Cost})$$

Revenue and profits – recognition

Percentage of completion method – entry at the end of period	
Istisna’a WIP [with profit recognized] (SFP)	Dr.
Cost of Istisna’a Revenue (SFP)	Dr.
Istisna’a Revenue (IS)	Cr.

Completed contract method, on the other hand, recognizes Istisna’a cost and revenue only in the financial period in which the contract is completed. The work in progress account will only carry the accumulated costs, without any profit being recognized

Istisna'a Accounting – Case Study

Ehsan Islamic Bank entered into a two year Istisna contract to construct an airport terminal commencing January 2023. Material and Wages cost of USD 800,000 (on 31 December, 2023) were estimated at the time of concluding the contract.

Sales price of USD 1 million was agreed between IFI and final purchaser. Construction was completed at end of year 2024. Handover to final purchaser and 100% billings were also made at end of year 2024.

The following is the payment schedule that was agreed with the client:

Year % of total price

- 2023 - 0 %
- 2024 - 0 %
- 2025 - 70%
- 2026 - 30%

The IFI recognizes revenue based on the percentage of completion method.

Prepare all necessary journal entries for the years 2013 to 2016 to record the above transactions in the books of Ehsan Islamic.

Istisna'a Accounting – Case Study - Solution

1. Year 2023	USD
Istisna'a Work-in-progress (SFP)	800,000
Cash / Accounts Payable (SFP)	800,000

2. Year 2024	USD
Istisna'a Receivable (SFP)	1,000,000
Istisna'a Work-in-progress (SFP)	800,000
Deferred Profit (SFP)	200,000

Istisna’a Accounting – Case Study - Solution

3. Year 2025	**USD**	
Cash [1,000,000 @ 70%] (SFP)	700,000	
Istisna’a Receivable (SFP)		700,000
Deferred Profit [200,000 @ 70%](SFP)	140,000	
Income on Istisna’a (IS)		140,000
4. Year 2026	**USD**	
Cash [1,000,000 @ 30%] (SFP)	300,000	
Istisna’a Receivable (SFP)		300,000
Deferred Profit [200,000 @ 30%](SFP)	60,000	
Income on Istisna’a (IS)		60,000

Istisna'a Accounting – Concept Checker 1

Which of the following costs shall be included in Istisna Contract costs

01	Administrative Expenses
02	Selling Expenses
03	Research and Development costs
04	None of above.

Istisna'a Accounting – Concept Checker 2

Which of the following statements are true:

01	Istisna Billing is booked as a receivable from buyer together and a liability is recorded under the name 'Istisna' billing
02	Upon receipt of billing, Istisna account Receivable is credited against receipt of cash
03	Under completed contract method, the seller in Istisna does not recognize Istisna cost and revenue in the financial period in which the contract is completed
04	Only (1) & (2) above.

Istisna'a Accounting – Concept Checker 3

Receipt of Al-Masnoo shall be recorded at:

01	Fair Value
02	Historic Cost.
03	Market Value less cost to Sale
04	None of above

Istisna'a Accounting – Concept Checker 4

Which of the following statement is incorrect:

01	The buyer in Istisna can make payment in Advance
02	The buyer in Istisna can make payment in Installments
03	The buyer in Istisna can make payment at the time of delivery only and only if there is no parallel Istisna arrangement.
04	None of above

Istisna'a Accounting – Concept Checker 5

Which of the following statement(s) are incorrect:

01	Percentage of Completion method for Istisna Revenue Recognition shall be used if Percentage of completion and estimated expected cost to complete the contract can be measured with reasonable accuracy
02	Completed contract method for Istisna Revenue Recognition shall not be used if Percentage of completion and estimated expected cost to complete the contract can be measured with reasonable accuracy
03	The seller has the choice to use whatever method he deems appropriate for Istisna Profit Recognition.
04	None of above

Session 3

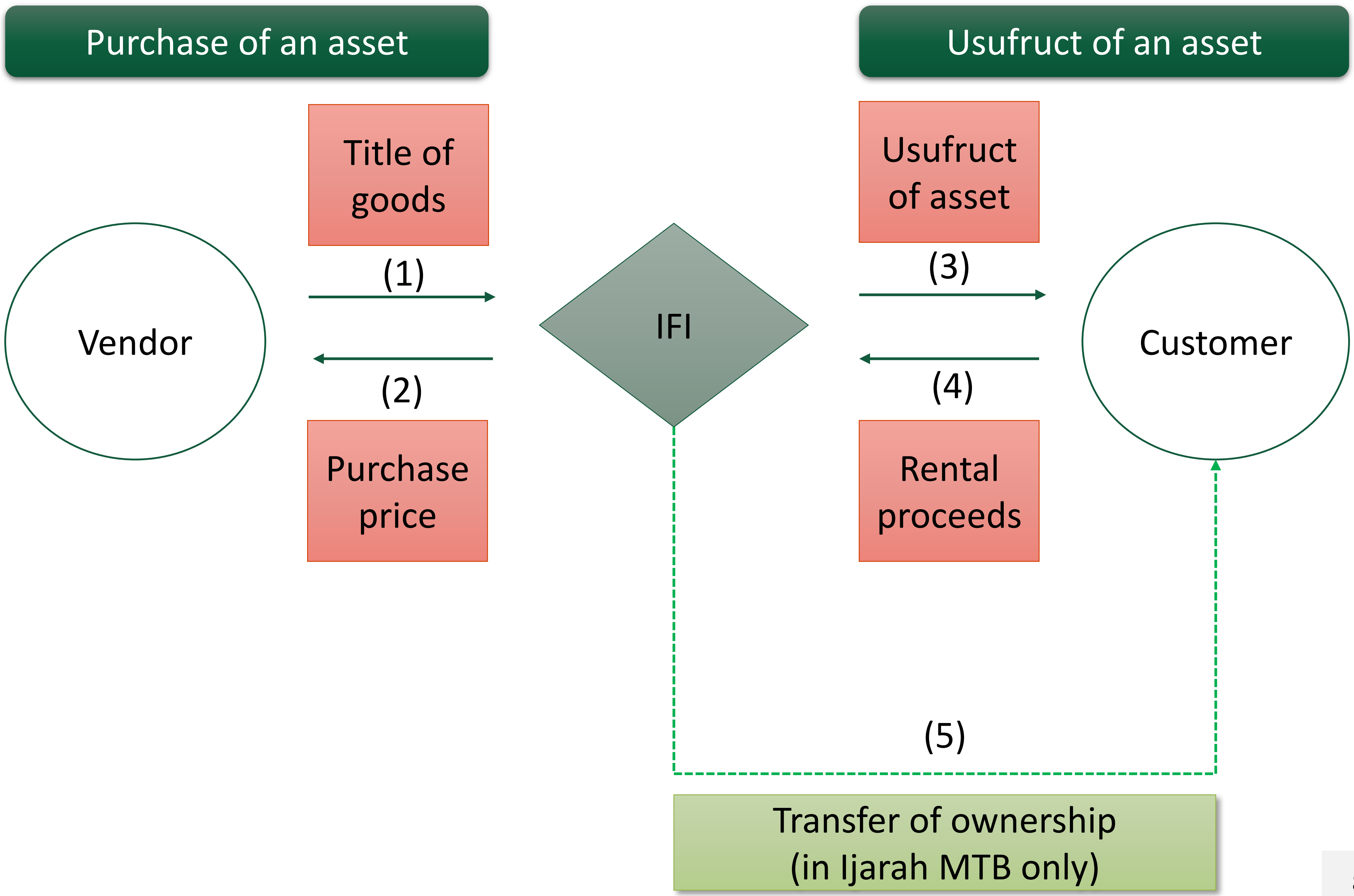
Rent based contracts

3.1

FAS 32 “Ijarah”
SS 9 “Ijarah and Ijarah Muntahia Bittamleek”

Ijarah - definition and process flow

- "The term Ijarah means leasing of property pursuant to a contract under which a specified permissible benefit in the form of a usufruct is obtained for a specified period in return of a specified consideration."
    - AAOIFI Shari'ah Standard # 09 Ijarah and Ijarah Muntahia Bittamleek



Classification of Ijarah: FAS No. 32

Operating Ijarah

- is an Ijarah that is not accompanied with an option of transfer of ownership of the underlying asset to the lessee

Ijarah Muntahia Bittamleek (Ijarah MBT)

- is a hybrid Ijarah arrangement which, in addition to the Ijarah contract, includes a promise resulting in transfer of the ownership of the underlying asset to the lessee, either after the end of the term of the Ijarah period or by stages during the term of the contract. Such transfer of the ownership is executed through a sale or a gift, or a series of sales transactions – independent of Ijarah contract;

Diminishing Musharaka (Shirkat-ul-Milk) Ijarah

- is a hybrid Ijarah product similar to 'Ijarah Muntahia Bittamleek through gradual transfer' comprising of:
  - a co-ownership in which two parties share the ownership of a tangible asset in an agreed proportion (without intention to engage in common business with respect to such asset); and
  - a promise under which one of the co-owners undertakes to buy in periodic installments the proportionate share of the other co-owner until the ownership / title to such tangible asset is completely transferred to the purchasing co-owner (whereby each transaction takes place as a sale); and
  - a separate Ijarah contract, whereby one co-owner (lessor) rents out its proportionate share in the asset to the other co-owner (lessee);

Ref.: FAS 32: Para 4(f, n, v)c

- Classification of Ijarah
  - Operating Ijarah
  - Ijarah Muntahia Bittamleek
    - Expected transfer of ownership after the end of the Ijarah term
      - Through a sale
      - Through a gift
    - Gradual transfer of ownership during the Ijarah term
      - This includes "Diminishing Musharaka Ijarah"

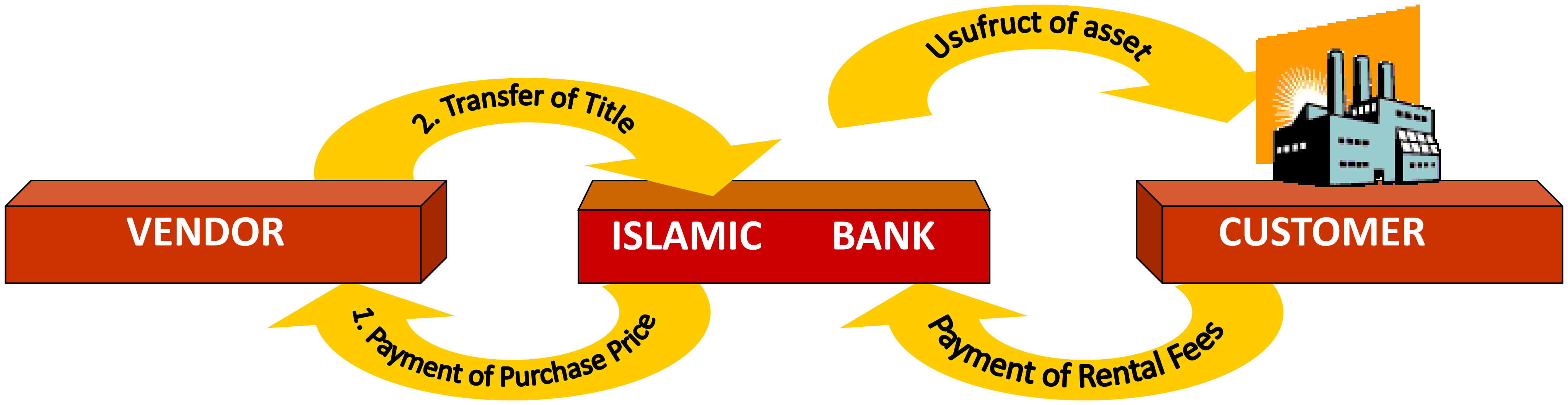
Ref.: FAS 32: Para 12

Classification of Ijarah: SS No. 9

- Classification of Ijarah
  - Ijarah
  - Ijarah Muntahia Bittamleek
    - Expected transfer of ownership through sale
      - For a token or other consideration
      - By accelerating the payment of the remaining amount of rental
      - By paying the market value of the leased property
    - Expected transfer of ownership through gift
      - For no contingent condition
      - Contingent upon the payment of the remaining instalments

Ijarah

Tenure	Long Term
Rate	Fixed / Variable
Early Termination	Yes
Uses	Fixed Assets Financing like plant, machinery, generators, equipments, cars, trucks etc.



AAOFI Shari’ah compliance – SS 9 Ijarah

- The lease contract is a binding contract which neither party may terminate or alter without the other’s consent.
- The duration of an Ijarah contract must be specified in the contract. The period of Ijarah should commence on the date of execution of the contract.
- The leased asset must be capable of being used while preserving the asset, and the benefit from an Ijarah must be permissible by Shari’ah.
- The lessee must use the leased asset in a suitable manner or in conformity with common practice, and comply with conditions which are acceptable in Shari’ah.
- If the benefit from the leased asset is impaired wholly or partially as a result of the lessee’s misconduct, while the property remains under lease, the lessee is obliged to restore or repair the usufruct, and rent for the time during which the benefit is lost is not to be waived
- The lessor may not stipulate that the lessee will undertake the major maintenance of the asset that is required to keep it in the condition necessary to provide the contractual benefits under the lease.

AAOFI Shari’ah compliance – SS 9 Ijarah (contd.)

- No increase in the rental due may be stipulated by the lessor in case of delay in payment by the lessee.
- In case of total destruction of the leased asset, the Ijarah contract is terminated.
- It is permissible to terminate the lease contract by mutual consent, but it is not permissible for one party to terminate it except in case of force majeure or if there is a defect in the leased asset that materially impairs its use.
- The lessor may stipulate that the Ijarah contract be terminated if the lessee does not pay the rent or fails to pay it on time.
- An Ijarah contract does not terminate with the death of either party thereto.

Risk Profile of Ijarah

RISK	MITIGANTS
Repayment/Default Risk	Risk mitigated by the market value of Ijarah asset which may be repossessed and collateralized
Price Risk	Ensure that the promise to Ijarah is properly documented and is legally enforceable
Residual value Risk	Mitigated by the market value of the Ijarah asset, which is repossessed
Early Termination Risk	Mitigated by taking a profit on Sale in case of early termination

How to structure Ijarah based solution?

Information Needed:

- Ijarah Asset must be clearly defined
- Ijarah period must be mentioned
- Major ownership related expenses are borne by the Lessor
- Rental must be defined in the Lease contract and can be linked to a known benchmark with floor and cap
- Operations related expense to be borne by Lessee
- Ijarah asset must be in a useable condition

Ijarah – lessor's accounting

Advance to vendor
Dr. Advance against Ijarah (SFP)
Cr. Cash/ Bank (SFP)

Receipt of advance rentals
Dr. Cash/ Bank (SFP)
Cr. Obligation against advance rentals (SFP)

Recognition of Underlying Asset
Dr. Ijarah asset (SFP)
Cr. Advance against Ijarah (SFP)

Ijarah asset shall be initially recognized at cost.

Cost - Cost includes all types of taxes (other than those subsequently recovered), transportation and handling costs including related Takaful cost and all other costs directly attributable to bring the underlying asset to its present location and condition capacity of agent and any fee paid to the agent. Trade discounts, rebates and similar items should be deducted from the costs.

Ijarah – lessor’s accounting

- **Subsequent measurement**

  Subsequent to initial recognition, the underlying assets shall be measured at cost less accumulated depreciation less accumulated impairment, if any.

- **Depreciation**

  Straight line or another method that more appropriately reflects the expected pattern of economic benefits.

  Depreciable amount shall represent the cost of the underlying asset less residual value.

Depreciation of Ijarah asset
Dr. Depreciation expense (IS)
Cr. Ijarah Asset – accumulated depreciation (SFP)

- **Impairment**

  An underlying asset shall be subject to the impairment requirements of FAS 30 “Impairment, Credit Losses and Onerous Commitments”.

Ijarah – lessor's accounting (contd.)

- Ijarah revenue

Accrual basis, applying, either straight-line basis (preferred method) or another systematic basis (if representative of the pattern in which benefit from the use of the underlying asset is diminished).

1) *Effective rate of return method*

Gross Ijarah revenue is allocated to income statement over the term of Ijarah.

Accrual of Ijarah rental
Dr. Ijarah rental receivable (SFP)
Cr. Rental revenue (IS)

Receipt of Rental
Dr. Cash (SFP)
Cr. Ijarah rental receivable (SFP)

Ijarah Costs

Recognised as expense.

a) Depreciation
b) Amortisation of initial direct cost
c) Major Repairs/ maintenance, Takaful & Taxes etc.

2) *Systematic method for Ijarah MBT through gradual transfer*

Recognise Ijarah revenue in the financial period in which it is due, on accrual basis.

Operating Ijarah – lessee's accounting

Initial recognition

a) Advance rentals

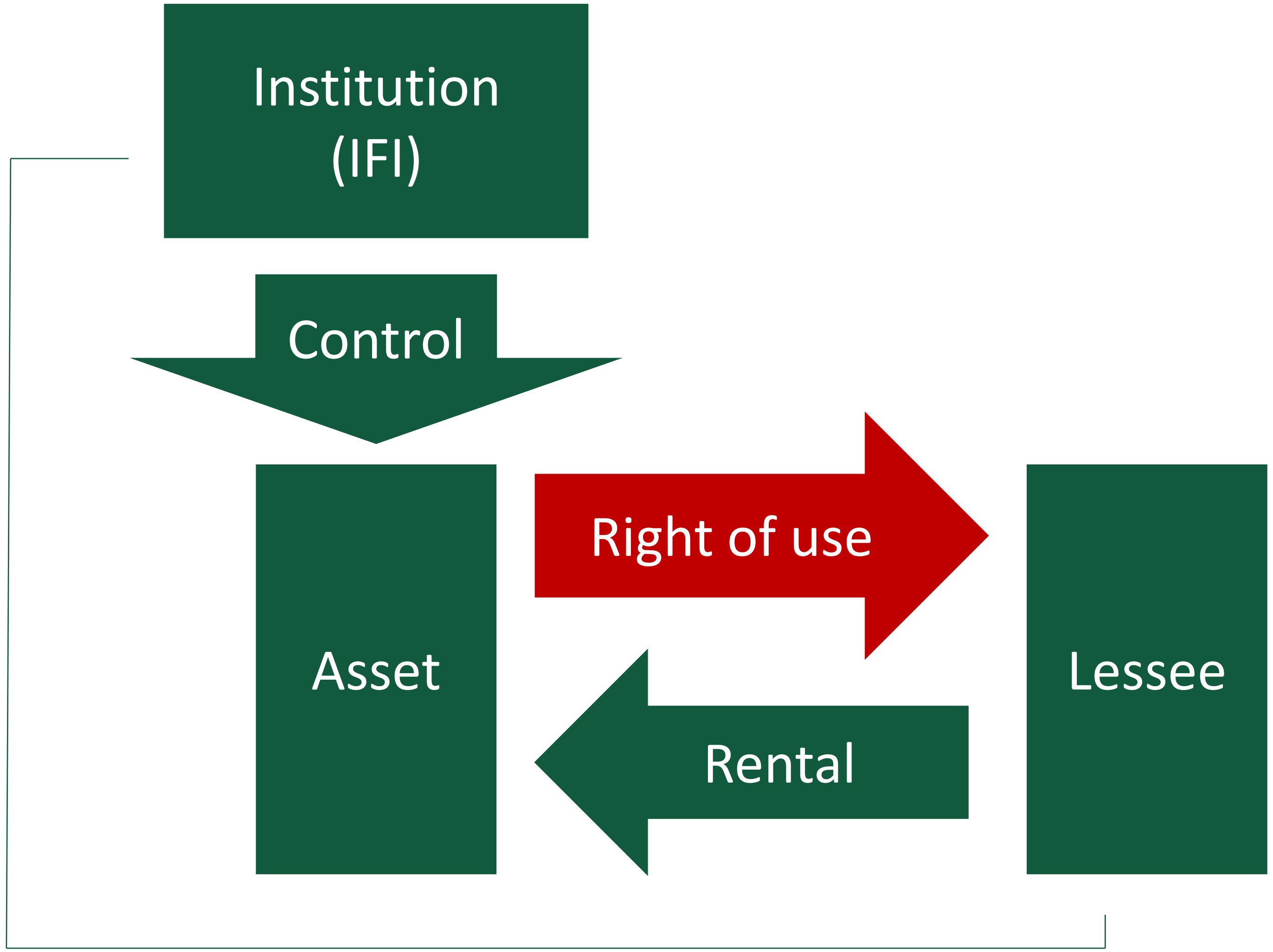
- Accounted for and presented as 'advance Ijarah rentals paid'.
- Once the Ijarah term is commenced, and the gross Ijarah liability and net Ijarah liability are determined, such advance rentals shall be netted-off with the gross Ijarah liability.

Advance rentals paid
Dr. Advance against Ijarah (SFP)
Cr. Cash/ Bank (SFP)
Treatment of advance rentals upon commencement of Ijarah
Dr. Gross Ijarah liability (SFP)
Cr. Advance against Ijarah (SFP)

Initial recognition
Dr. Right-of-use (SFP)
Dr. Deferred Ijarah cost (SFP)
Cr. Ijarah Liability (SFP)

Right-of-use asset

- **Right-of-use asset (usufruct asset)** is an "intangible" asset that represents a lessee's legally enforceable right-of-use (or **control of usufruct**) of an underlying asset (normally being a tangible asset) for the Ijarah term, and includes a 'combined asset' for the purpose of application of this standard;



Illustrative example 1

- **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 × Ijarah term

= 33,000 × 10 = USD 330,000

Deferred Ijarah cost = Gross Ijarah Liability – Prime Cost

= 330,000 – 305,000 = USD 25,000

		Dr.	*Cr.*
Jun 23	Right-of-use Asset (Asset)	305,000	
	Deferred *Ijarah* Cost (Asset)	25,000	
	Gross *Ijarah* Liability (Liability)		330,000

(To record the right-of-use asset and gross Ijarah liability for the aircraft)

Amortisation of Right-to-Use Asset: Example 2

- Cost incurred by the lessor in procuring the Ijarah asset: CU120,000
- Ijarah rental payable by the lessee: CU30,000 p.a.
- The lessor promised to transfer ownership of the asset to the lessee at the end of the Ijarah term as a gift
- Estimated residual value of the asset at the end of the Ijarah term: CU20,000
- Ijarah term: 5 years

Accordingly:

Item	Details	Amount
Prime cost	Cost of the underlying asset – Terminal value of the underlying asset	CU120,000 – CU0 = CU120,000
Cost of right-to-use asset	Prime cost + Initial direct costs + Dismantling or decommissioning costs	CU120,000 + CU0 + CU0 = CU120,000
Gross Ijarah liability	The gross amount of total Ijarah rentals payable for the Ijarah term	CU30,000 x 5 = CU150,000
Residual value	Estimated residual value at the end of the lease term - Promised purchase price (if any)	CU20,000 – CU0 = CU20,000
Amortisable amount	Cost – Residual value	CU120,000 – CU20,000 = CU100,000
Amortisation of right-of-use asset	Amortisable amount ÷ Useful economic life	CU100,000 ÷ 5 = CU20,000
Deferred Ijarah cost	Gross Ijarah liability – ‘Prime cost’ of right-of-use asset	CU150,000 – CU120,000 = CU30,000
Amortisation of deferred Ijarah cost	Straight line basis	CU30,000 ÷ 5 = CU6,000

Ijarah Accounting – Concept Checker 1

Under Operating Ijarah, the Lessor shall recognize the asset initially at:

01	Market Value
02	Cost including Transportation and Takaful cost.
03	Cost excluding Transportation and Takaful cost
04	None of above

Ijarah Accounting – Concept Checker 2

Under Operating Ijarah, the Lessee shall:

01	Treat advance rentals paid as an asset
02	Net off the Advance rentals with the gross Ijarah liability after commencement of Ijarah
03	Recognize Ijarah Liability at Gross Amount of Total Ijarah Rentals Payable for the Ijarah term
04	All of above.

Ijarah Accounting – Concept Checker 3

The lessee in Operating Ijarah, recognizes the ‘ right-of-use’ initially at Cost. Which of the following shall be included in computation of cost:

01	Prime cost
02	Initial Direct Cost
03	Dismantling Cost
04	All of above.

Ijarah Accounting – Concept Checker 4

In case of an Ijarah MBT, the transfer of asset's ownership may take place through:

01	Contract of sale – after the end of the Ijarah term
02	Contract of gift – after the end of the Ijarah term
03	Contracts of sale of proportionate ownership (generally in form of ownership units) – during the Ijarah term
04	All of above.

Ijarah Accounting – Concept Checker 5

Which of the following statement is incorrect:

01	Advance Ijarah Rental received is presented as an 'Asset' by the Lessor.
02	Advance Ijarah Rental received is presented as a 'Liability' by the Lessor
03	Right-of-use of an asset is recognized as an asset by the Lessee in Operating Lease
04	Net Ijarah cost is presented in the lessee's income statement

و الحمدلله في الأولى والآخرة

Contact us

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