

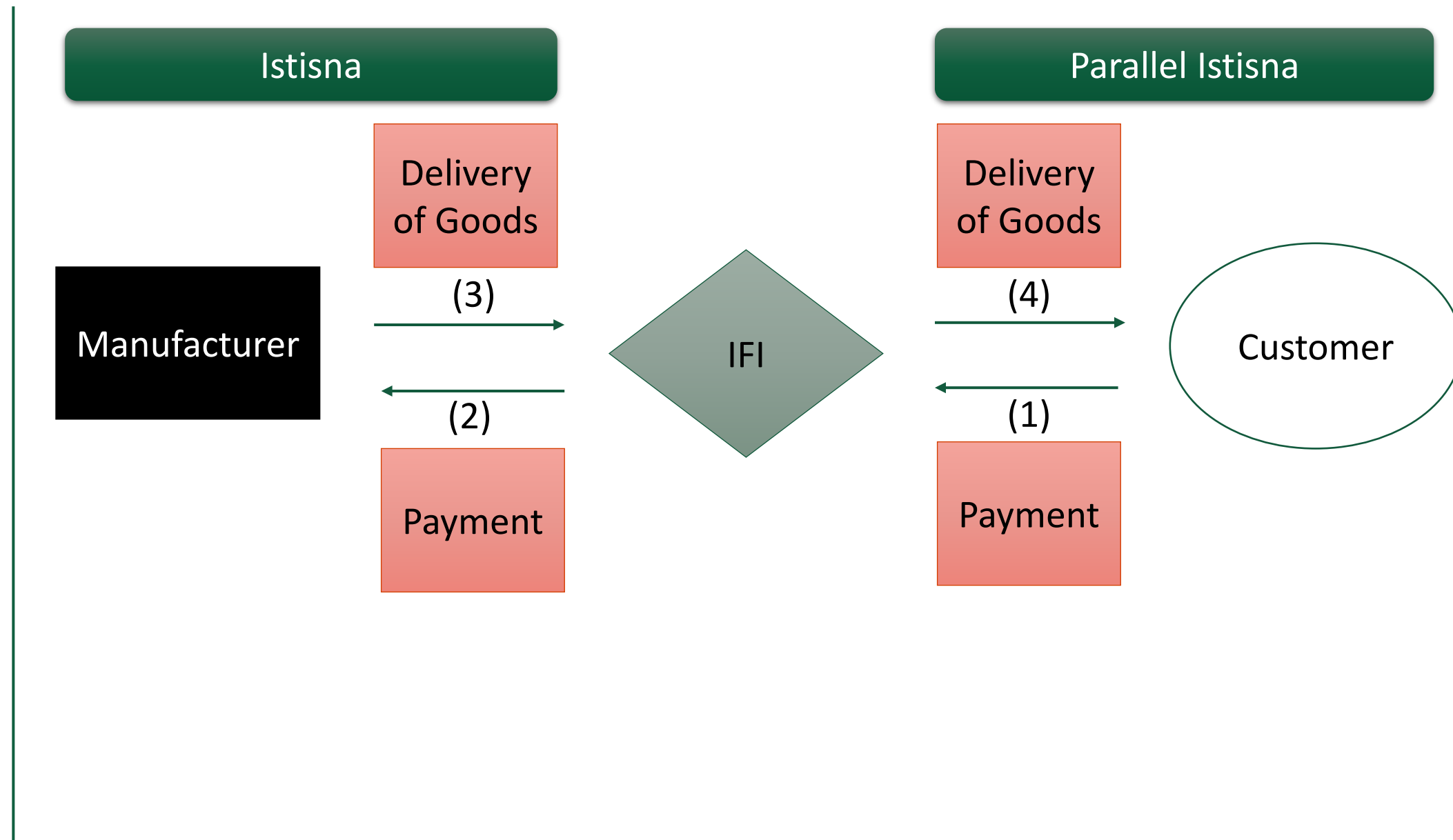
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FAS 10 & SS 11 “Istisna’a and Paralell Istisna’a”



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

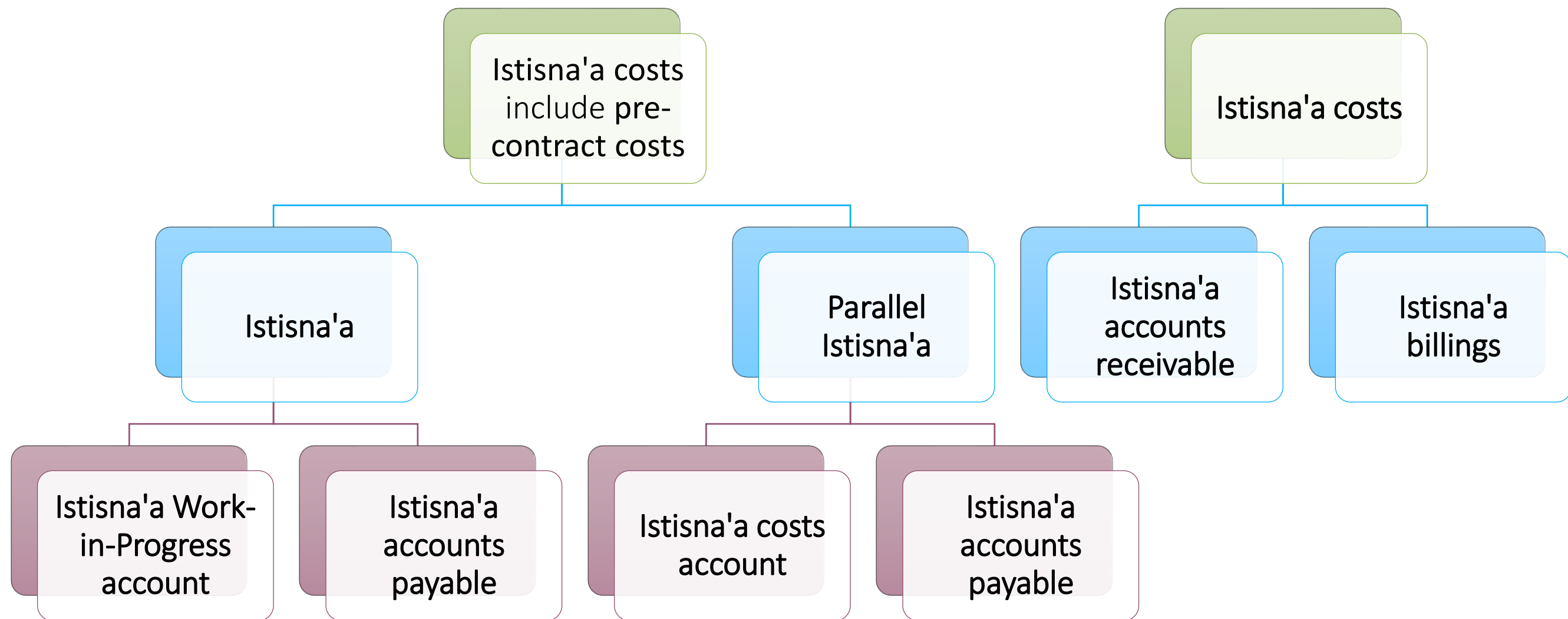
Istisna'a

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.

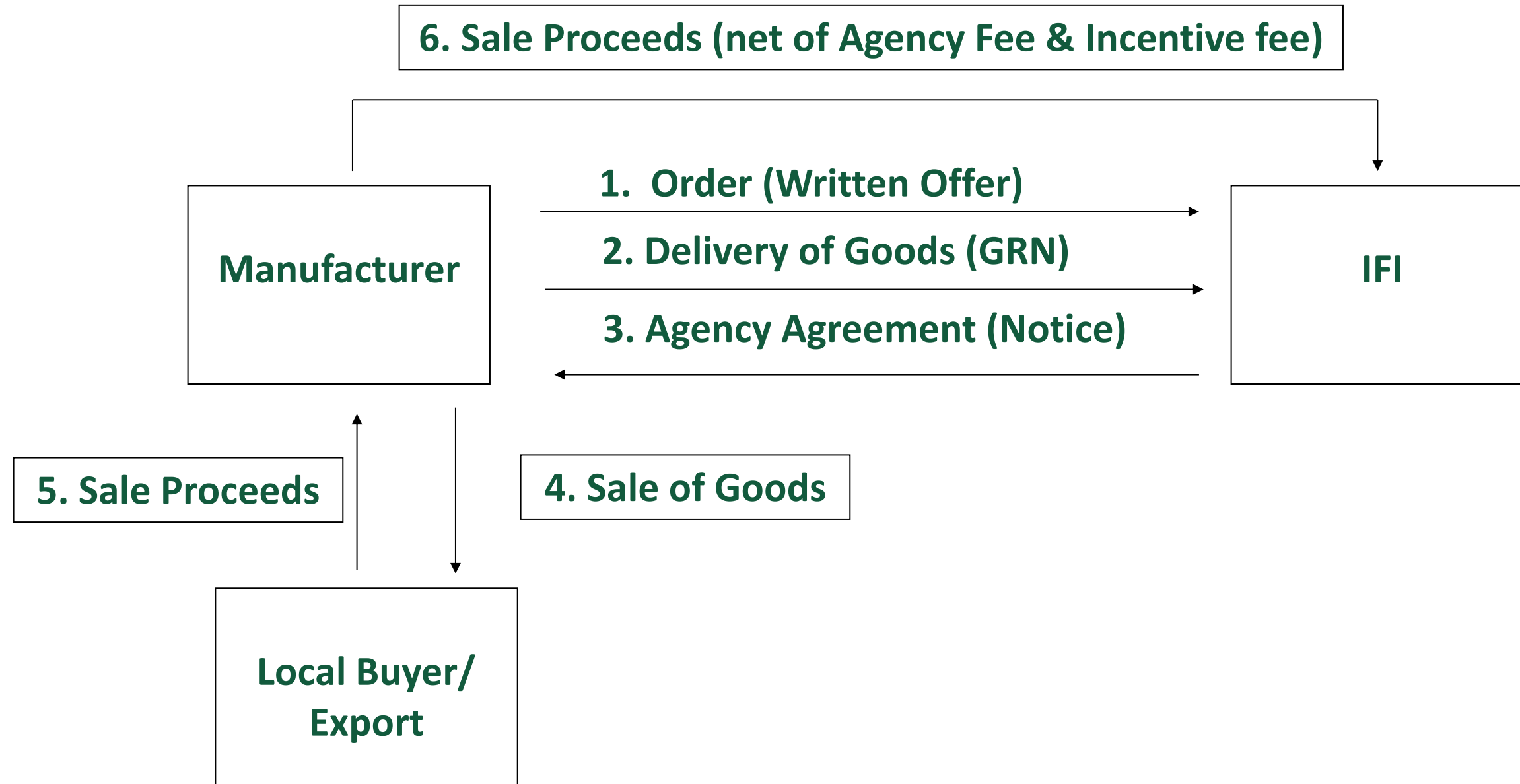
Parallel Istisna'a

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.

Recognition of Istisna'a costs and billings



Istisna – Key features



AAOIFI 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.

AAOIFI 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

<u>RISK</u>	<u>MITIGANTS</u>
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.

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.

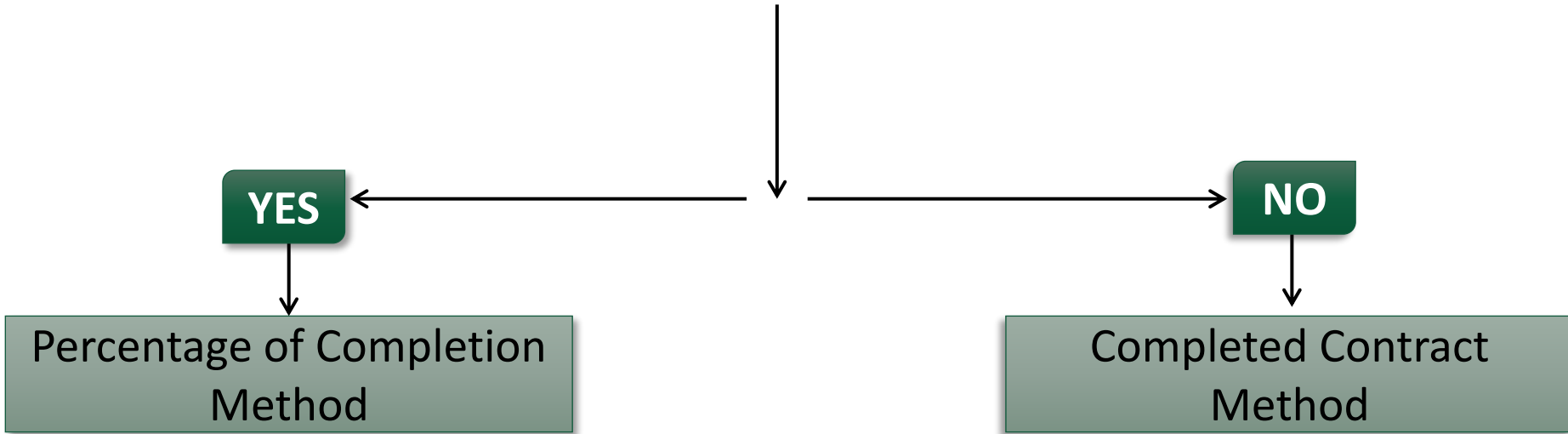
At the end of the contract the amount of **Istisna'a billing account** shall be off-set against **Istisna'a work in progress account** and presented on the appropriate side of the Islamic bank’s statement of financial position.

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



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.

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

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