

# Comprehensive Guide to AAOIFI FAS 10: Istisna'a Contracts

## Introduction to Istisna'a (FAS 10)

**Istisna'a Defined:** Istisna'a is an Islamic financial contract of sale where one party (the seller or **al-sani'**) agrees to manufacture or construct an asset according to the specifications of the other party (the buyer or **al-mustasni'**) for an agreed-upon price and delivery schedule <sup>1</sup>. In essence, it is a form of **commissioned manufacture** – the buyer orders an asset that does not yet exist, and the seller undertakes to produce it. This contract is often used to finance construction projects, infrastructure, or manufactured equipment in Islamic finance. The legitimacy of Istisna'a in Shariah (Islamic law) is established by precedent – for example, the Prophet Muhammad (peace be upon him) requested a craftsman to manufacture a pulpit and a ring for him, which serves as a basis for permitting made-to-order sales <sup>2</sup>. Istisna'a is also allowed based on **istihsan** (juristic preference for public interest) and general principles of contracts in Shariah <sup>2</sup>.

**Key Characteristics:** In an Istisna'a contract, the asset to be delivered **does not exist at the time of contract**; it will be produced or built. All important specifications (type, quality, quantity, dimensions, etc.) and the **delivery date** must be agreed in advance for the contract to be binding <sup>3</sup>. The price in an Istisna'a can be paid in a variety of ways: fully in advance, partially at milestones, or fully upon completion – *unlike* a Salam contract (another Islamic forward sale) which **requires full upfront payment** <sup>4</sup>. Once the Istisna'a contract conditions are set (specifications defined, price agreed, and if required, delivery time fixed), it becomes a **binding obligation** on both parties <sup>3</sup>. This means neither party can unilaterally cancel the contract once work has commenced and the terms are confirmed. (Historically, some schools allowed cancellation before production begins, but AAOIFI's standards treat Istisna'a as binding from inception given the agreed terms <sup>3</sup>.) Unlike Murabaha (a sale of an existing asset), Istisna'a does **not require a new offer/acceptance at delivery** – the original contract itself is the sale agreement, even though delivery is deferred <sup>5</sup>.

**Permissible Purpose:** Istisna'a contracts are used extensively for project and infrastructure financing in Islamic banking. They allow an Islamic bank to finance the production of large assets (like buildings, factories, or specialized equipment) on behalf of a client. For example, an Islamic bank can contract with a construction firm to build a house (this is sometimes called a *Parallel Istisna'a*, explained below) and simultaneously have a contract to sell that completed house to the client. This structure enables the bank to act not as a mere lender of money, but as a trader – it **acquires the asset from a manufacturer and sells it to the customer** for a profit, in compliance with Shariah <sup>6</sup>. The bank must assume the risks of ownership during construction and cannot simply shift all obligations to the contractor <sup>6</sup>. Any **advance payments** by the buyer can be structured, but generally no interest (riba) is involved – the profit to the bank is generated from the sale price difference, not from lending money.

**Shariah Basis:** Istisna'a is categorized as a type of **sale contract** (specifically, a sale with deferred delivery). It is akin to Salam in that delivery of the item is future, but differs in flexibility of payment and the nature of the goods (as discussed next). AAOIFI's Shariah Standard No. 11 covers Istisna'a and Parallel Istisna'a in detail, ensuring that such contracts are conducted in line with Islamic principles. Key Shariah requirements include: clearly defining the product and its quality, agreeing on price and

schedule, and ensuring the contract is not used as a back-door to interest-based financing (the transaction must involve genuine trade and project execution) <sup>7</sup> <sup>8</sup> . Istisna'a cannot be merely a loan in disguise; the bank must take on the responsibility of delivering the asset as promised, which introduces commercial risk and thereby justifies the profit earned in Shariah terms <sup>7</sup> .

## Istisna'a vs. Salam vs. Murabaha: A Comparison

Istisna'a, Salam, and Murabaha are all distinct contract types in Islamic finance. It's important to understand their differences:

- **Salam (Advance Payment Sale):** Salam is a sale of a specified commodity with **deferred delivery** and **full immediate payment** by the buyer. In classical terms, it is defined as the *"purchase of a commodity for deferred delivery in exchange for immediate payment according to specified conditions"* <sup>9</sup> . Salam is typically used for agricultural or fungible goods – for example, an Islamic bank may pay a farmer today for a certain quantity of wheat to be delivered after harvest. Key points: the goods must be generic, fully specified and commonly available in the market, and the buyer (who pays upfront) bears the risk of future delivery. Salam requires the price to be paid in full at contract inception (to avoid it becoming a debt-for-debt sale, which is prohibited). Partial or deferred payment in Salam is not allowed <sup>4</sup> . In exchange for upfront payment, the price in a Salam deal is often lower than the spot price (compensating the buyer for waiting). **Accounting:** From the bank's perspective, a Salam payment is recorded as an asset (a receivable or inventory-to-be). No revenue is recognized until the goods are actually delivered and sold or used. When delivery occurs, the bank can either take possession of the goods into inventory or immediately sell them (often via a prior parallel Salam or a separate contract). Profit is then recognized at delivery if the bank sells the goods at a higher price (one transaction to acquire, another to sell). There is generally no concept of percentage completion in Salam because the entire delivery is usually completed in one batch or at one time; revenue recognition is on a **completed-contract basis** (at delivery). If the bank entered a Parallel Salam to sell the goods to a third party, that sale is recorded only when the goods are delivered to that third party <sup>10</sup> . Until then, any upfront payment from the third party would be treated as a liability (advance from customer) or not taken at all (often parallel Salam is structured such that payment from the ultimate buyer also occurs only upon future delivery).
- **Istisna'a (Manufacturing Contract):** Istisna'a, like Salam, is a **deferred delivery sale**, but it specifically involves manufacturing or construction of an asset. Unlike Salam, payment in Istisna'a can be structured flexibly – it **may be paid in full in advance, in installments at various stages, or in a lump sum at completion** <sup>4</sup> . Istisna'a is typically used for project finance and made-to-order items (e.g., building a house, constructing a road, manufacturing specialized machinery) <sup>11</sup> . Another key difference from Salam is that Salam usually applies to fungible goods (e.g., grains, standard products) which are readily quantifiable, whereas Istisna'a can be for unique, customized assets that require manufacturing. Both contracts are forward sales allowed as exceptions to the general rule of not selling what one does not own at contract time – Salam and Istisna'a are permitted due to need and historical practice, under strict conditions. Also, in Salam the time of delivery **must be fixed** in the contract (a specific date or period is required), while in Istisna'a some jurists allowed the delivery time to be open or flexible (though AAOIFI standards recommend specifying a delivery deadline to avoid uncertainty). **Accounting:** As we will detail below, Istisna'a can be accounted for using either a percentage-of-completion approach or a completed-contract approach under AAOIFI FAS 10, depending on the circumstances <sup>12</sup> . While the asset is being constructed, costs are accumulated in a work-in-progress account. Revenue (and profit) may be recognized progressively as the work is

completed (if the outcome can be reliably estimated), or only at the end upon delivery. Any payments received from the buyer during the construction are typically recorded as **progress billings** (which can be offset against the work-in-progress asset or treated as a liability for advance receipts, depending on the accounting treatment) <sup>13</sup> .

- **Murabaha (Cost-Plus Sale):** Murabaha is a very different type of contract: it is a sale of an existing asset where the seller discloses their cost and profit margin to the buyer. It is often used as a form of trade financing where the Islamic bank first purchases an item and then immediately sells it to the customer at a marked-up price, usually with deferred payment. In simple terms, *“Murabahah involves an institution purchasing an item on behalf of a customer and then selling it to the customer at an agreed upon profit margin”* <sup>14</sup> . Unlike Salam or Istisna'a, Murabaha is not a deferred-delivery sale; the delivery of the goods is prompt (the bank delivers the goods to the client after purchase), but **payment by the client is deferred**. Thus, Murabaha is a **deferred payment sale of an existing good** (as opposed to Istisna'a/Salam which are deferred delivery sales). The bank must own or possess the asset before selling it onward (to comply with Shariah, the bank can't just broker a sale between supplier and customer without taking ownership) <sup>15</sup> . The profit in Murabaha is the markup, which can be seen as time value of money, but since it's fixed in the price and not an interest rate that grows, it is permissible. **Accounting:** Upon selling an item via Murabaha, the bank typically recognizes a Murabaha **receivable** for the selling price (cost + profit). According to AAOIFI standards, the profit component can either be recognized immediately at the time of sale or deferred over the payment period. AAOIFI FAS (for Murabaha, e.g. FAS 2) often requires recognizing the profit portion over time to better match the accrual of the debt (similar to an interest method, but labeled as profit). For example, if a bank sells equipment for \$30,000 on a Murabaha, which it bought for \$25,000, it may record: Dr **Murabaha Receivable** \$30,000; Cr **Inventory** \$25,000; Cr **Unearned (Deferred) Profit** \$5,000. Then each period, a portion of the \$5,000 is moved to income as the customer makes payments <sup>16</sup> . Alternatively, some practices recognize the full profit upfront in revenue (especially if the Murabaha is short-term or a one-off payment), but AAOIFI tends to prefer proportionate or effective yield recognition for longer-term Murabaha <sup>16</sup> . The key difference in accounting compared to Istisna'a is that Murabaha has **no work-in-progress** phase – it's an immediate sale of an existing good – and the bank's balance sheet will show **Receivables** (amount owed by customers) often net of any deferred profit, rather than construction in progress.

**Summary of Differences:** To summarize, Salam and Istisna'a are both *deferred delivery* sales (the product is delivered later), whereas Murabaha is a *deferred payment* sale (the product is delivered now, payment comes later). Salam requires the buyer's price to be paid now, Istisna'a allows flexibility in payment timing. Istisna'a deals with manufactured assets and often involves work over a period, while Salam typically involves goods that will be available at a future date (often agricultural or commodity products) <sup>11</sup> . In Murabaha, the asset exists at the time of contract (or is procured by the bank right before the sale) and the sale is concluded on the spot (ownership transfers to the customer immediately), only the payment is deferred.

From a risk perspective: In **Salam**, the buyer (often the bank) bears the risk of the seller not delivering the goods (which is mitigated by requiring full prepayment and stipulating compensation or refund in case of failure). In **Istisna'a**, the seller (often the bank, when it finances a project) bears the manufacturing risk – if the item is not completed as specified on time, the seller is responsible to remedy that, even if it must incur extra costs or find an alternative way to deliver <sup>17</sup> <sup>18</sup> . In **Murabaha**, after the sale, the main risk to the bank is credit risk (that the buyer might default on the deferred payments), since the asset has been delivered; there is no manufacturing or delivery risk as in the other two contracts.

## Shariah Principles and Conditions for Istisna'a

To ensure Istisna'a contracts are **Shariah-compliant**, several important conditions must be met:

- **Specified Subject-Matter:** The asset to be produced must be described in **complete detail**. The type, quality, quantity, design, dimensions, and all necessary specifications of the item must be agreed upon so that there is no ambiguity (gharar) in what is being sold <sup>3</sup>. The materials from which it will be made, if important, should also be specified. For example, a contract to build a house would specify the floor plan, size (e.g. number of rooms, square footage), materials (e.g. type of tiles, roofing), and so on. This avoids disputes upon delivery – if the delivered asset does not conform to the agreed specifications, the buyer has the right to reject it or demand corrections <sup>3</sup>.
- **Time of Delivery:** Classical Istisna'a did not always require a fixed delivery date at the time of contract (unlike Salam which strictly does). However, AAOIFI standards and modern practice usually **include an expected delivery date or schedule** to manage expectations and avoid uncertainty. The contract should stipulate by when the product will be delivered (e.g. "within 12 months" or a specific completion date). If no time is stipulated, some jurists allow the contract but in practice it's risky and could lead to disputes; therefore, Islamic banks **fix a delivery timeline** in the Istisna'a contract to ensure clarity. Delays in delivery can be handled through provisions in the contract: while charging interest for delay is not allowed, the contract may specify penalties or compensation in case of willful delay or negligence by the manufacturer, provided those penalties go to charity or compensate actual losses (not as income to the bank, to avoid riba). AAOIFI Shariah Standard on Istisna'a permits clauses for compensating actual damages caused by delays. Any agreed penalty for late delivery is typically donated to charity, not kept as profit, to maintain Shariah compliance (this deters the manufacturer from delaying without making it a profit source for the bank).
- **Price and Payment Terms:** The price must be agreed upfront in the contract. It can be a lump sum or broken down, but it should be fixed or at least determinable by formula (no uncertainty or open-ended price). **Flexible payment is allowed in Istisna'a:** it could be full advance, partial advance, progress payments, or full deferred payment at the end. All these arrangements are permissible as long as both parties agree <sup>4</sup>. For example, the contract can say "Total price \$1,000,000, to be paid 30% upfront, 50% when project is 50% complete, and 20% on delivery" or "to be paid in 4 quarterly installments after delivery," etc. If there is an upfront payment, it is often called an advance or down payment; if payments are linked to milestones, they function as progress billings. **Importantly**, once the price is set, it cannot be increased due to delay or changed costs (except by mutual agreement in cases of fundamental change or if allowed by a pre-agreed variation clause). For instance, if raw material costs increase for the manufacturer, they cannot unilaterally raise the Istisna'a price; the agreed price is binding. Conversely, the buyer cannot demand a price reduction if market prices fall. The profit margin for the bank (when the bank is the seller) is embedded in this price difference between what it costs the bank to procure/build the item and the sale price to the customer.
- **No "Sell and Buy Back" of the Same Item:** The institution (bank) cannot just finance a construction by *acting as a pure intermediary without risk*. Shariah explicitly prohibits the bank from merely being a financial broker between the client and a third-party contractor in a way that the bank is never the actual seller. AAOIFI guidance (Shariah Standard 11) states that the bank's role in Istisna'a must not be that of a **simple financial intermediary** who pays the contractor only if the client pays (that would resemble a loan) <sup>19</sup>. Instead, the bank must

independently assume the obligation to deliver to the client, and separately assume the right and obligation to receive delivery from the contractor. The two contracts (with client and with contractor) must be independent, so that if the contractor fails, the bank is still obligated to deliver the asset to its client (the bank would then seek alternatives or compensation from the contractor) <sup>17</sup> <sup>18</sup> . This separation ensures the bank genuinely *buys and sells* goods, rather than just arranging a loan for the client to buy from the contractor. Practically, the bank cannot insert a clause that makes the Istisna'a with the client contingent on the performance of the contractor – each contract stands on its own. This is how **Parallel Istisna'a** is structured (discussed further below).

- **Asset Type:** The subject of an Istisna'a must be something that **requires manufacturing or construction** – it can be a new asset to be built, or an asset that will be made to order. It **cannot be an existing specific asset** at the time of contract (you can't do Istisna'a for a car that already exists on a lot – that would just be a sale, or perhaps a Murabaha if financed). It is permissible for raw materials to be provided by either party (though typically the manufacturer uses their own materials). For instance, one could agree "Build me a boat using your materials" or potentially "Build me a boat and I will supply the engine and some parts" – AAOIFI allows flexibility as long as roles are clear. But one **cannot use Istisna'a for commodities that don't involve manufacturing** (e.g., you wouldn't do an Istisna'a just to buy 100 barrels of oil – that's a simple forward buy, better treated as Salam). Also, currency cannot be the subject of Istisna'a (you can't manufacture money; exchanging currency is governed by other rules). The asset, once manufactured, must be deliverable as per contract. If it turns out to be impossible to produce (without fault of either party), the contract could be cancelled by mutual consent or as per force majeure clauses, and any paid amounts are refunded.
- **Parallel Istisna'a:** This is a mechanism that Islamic banks use to mitigate their risk and fulfill their obligations. **Parallel Istisna'a** means the bank (after signing an Istisna'a with the buyer) enters into a separate Istisna'a contract as a buyer with a third-party manufacturer to actually produce the asset. AAOIFI FAS 10 explicitly acknowledges Parallel Istisna'a as a valid practice, provided the two contracts are independent and non-contingent on each other. Shariah Standard 11 also permits it with the condition that the bank cannot just transfer all liability – the bank remains liable to its client even if the parallel contractor fails <sup>17</sup> . In other words, the bank cannot tell the client "if the contractor doesn't deliver, our deal is off"; the bank must deliver by either finding another way or paying damages. The **risks** of the two contracts are separate: in the first Istisna'a, the bank carries the risk of delivering the asset to the client; in the parallel Istisna'a, the contractor carries the risk of delivering to the bank. The bank's profit is essentially the difference between the two contract prices (selling price to client minus cost price paid to contractor) <sup>20</sup> <sup>21</sup> . This setup is similar to back-to-back sales and is crucial for Islamic banks, since banks themselves are not manufacturers. Parallel Istisna'a allows the bank to fulfill its sale to the client by having someone else build the asset, yet the bank is the one who sells to the client. Both contracts are typically referenced in the bank's books: one as a receivable from the client (and revenue), and one as a payable/ WIP for the contractor cost.
- **No Riba, No Gharar:** As with any Islamic contract, Istisna'a must be free from **riba (usury/ interest)** and excessive **gharar (uncertainty)**. Riba is avoided because the transaction is structured as a sale, not a loan – the client's payments are for purchasing an asset, not paying interest. The profit rate might be benchmarked to interest rates in practice (to price competitively), but as long as it's fixed in the sale contract and not an open-ended charge, it's considered trading profit, not riba. Gharar is minimized by specifying the goods and terms clearly. Additionally, **no sale of debt for debt** is occurring – the classical prohibition "bay' al-kali bil-kali" (selling one deferred obligation for another) is avoided because usually either price is

paid now for future goods (Salam) or goods are delivered now for future price (Murabaha). In Istisna'a's case, since both payment and delivery could be in the future, some scholars historically were wary of it (it might resemble exchange of two deferred obligations). But it's justified by industry need and custom, and typically either an upfront payment or work commencement gives it enough concreteness to avoid pure gharar. AAOIFI's standards ensure that if payment is fully deferred, the manufacturing begins promptly so that it's not just an exchange of promises – it becomes an active project.

- **Binding Promise vs Contract:** One nuance: In some Islamic financing (like Murabaha to Purchase Orderer or Ijarah forward lease), the bank initially only takes a promise from the client and later executes a sale/lease contract upon delivery. Istisna'a is different in that the initial contract itself is a **binding sale agreement**, not just a promise. There is no need for a second contract at the time of delivery<sup>5</sup>. This simplifies execution – once the Istisna'a is signed, both parties are committed to the deal. However, it also means the bank is on the hook as a seller from day one, which is why parallel Istisna'a or other risk mitigations (like performance bonds from the contractor, or advance deposits from the client) are used to protect against non-performance.

In summary, when structured properly, an Istisna'a contract adheres to Shariah by ensuring it is a genuine sale transaction of a yet-to-be-made asset, with transparency, mutual consent, and fair risk-sharing between parties. The bank earns a profit as a trader who delivers a service (manufacturing an asset) rather than as a lender of money. The **AAOIFI Shariah and Accounting Standards** provide detailed guidance to ensure that all these conditions are met in practice.

## Accounting Treatment under AAOIFI FAS 10 (Istisna'a)

Financial Accounting Standard No. 10 (FAS 10) issued by AAOIFI governs the accounting for Istisna'a and Parallel Istisna'a contracts. The standard aims to properly reflect the work-in-progress nature of these contracts, the profit recognition, and the financial position of Islamic banks engaging in Istisna'a financing. Below, we break down the accounting treatment step-by-step, from initial recognition to completion, and how it compares under different methods allowed by AAOIFI.

### Initial Recognition and Work-in-Progress (WIP)

When an Istisna'a contract is signed, typically an **Istisna'a Work-in-Progress (WIP)** account is created to accumulate the costs of manufacturing the asset. From the perspective of the Islamic bank as the seller (financier):

- **At Contract Inception:** Usually, there is no immediate profit or revenue to recognize just by signing the contract (unless the bank receives a non-refundable advance that might be immediately earned, but generally advances are treated as liabilities until work is done). However, if the customer pays a down payment at signing, the bank would record **Cash** (debit) and **Istisna'a Advance from Customer** (credit, a liability) for that amount. This advance will later be applied against the contract price. No revenue is recorded yet because the product has not been delivered or work has not sufficiently progressed.
- **During Production:** As the manufacturer (which could be the bank's contractor via parallel Istisna'a, or the bank's own facilities) incurs costs to build the asset, those costs are capitalized on the bank's balance sheet as *Work-in-Progress*. For example, when a bill from the contractor is paid or materials are purchased:

- Debit **Istisna'a WIP (Asset under construction)**
- Credit **Cash/Bank** (or **Accounts Payable**, if to be paid)

This entry accumulates all direct costs associated with the project. According to AAOIFI, **direct costs** and attributable indirect costs related to the contract can be included in WIP <sup>22</sup>. General overhead not related to the contract, or selling expenses, are not capitalized. If the bank has any **pre-contract costs** (e.g. design work done before finalizing the deal) that are directly identifiable and recoverable, those too can be added to the Istisna'a WIP asset <sup>23</sup>.

The WIP account represents the unfinished asset that the bank will deliver. In the case of a Parallel Istisna'a, the bank will also have an **Istisna'a Cost** account for the parallel contract in its books (essentially similar to WIP, but some banks might distinguish the costs of the parallel contract separately). For simplicity, we can consider that all costs end up in the Istisna' WIP (work-in-progress) asset account, until delivery.

- **Progress Billings:** If the Istisna'a contract with the customer allows the bank to bill the customer in stages (for example, invoice 20% at foundation completion, another 50% at halfway, etc.), the bank will issue those invoices as the work progresses. Each time the bank bills the customer for a milestone:
  - Debit **Accounts Receivable – Istisna'a** (for the amount billed)
  - Credit **Istisna'a Billings (Revenue)** or a similar account.

Here, "Istisna'a Billings" can be viewed in two ways: (a) if using percentage-of-completion accounting, it effectively is a revenue account (or part of revenue) which will later be matched against WIP costs, or (b) some presentations use "Billings on Istisna'a" as a contra-asset to WIP (like how construction contracts often offset progress billings against CIP). AAOIFI in practice often offsets the billings against the WIP for balance sheet presentation <sup>13</sup>, but also recognizes that those billings include profit which may need to go to income. We will clarify this in the revenue recognition section.

If the bank receives cash for that billing (say the customer pays each invoice immediately): - Debit **Cash**, Credit **Accounts Receivable** (to settle the receivable).

If the customer does not pay immediately, the Accounts Receivable remains until collected. Under AAOIFI, Istisna'a receivables are usually recorded at their full nominal value, and if any portion of profit is not yet earned (under certain methods) it might be deferred, but in general for Istisna'a, once billed it implies that portion is earned because work was done (assuming percentage-of-completion method).

- **Parallel Istisna'a Accounting:** On the parallel contract side (where the bank is the *buyer* from a contractor), the bank may also have obligations to pay the contractor. For instance, if the contractor requires progress payments, the bank will record:
  - Debit **Istisna'a WIP (or Istisna'a Cost)**, Credit **Cash/Bank or Payable to Contractor**.

Essentially, this is similar to the cost incurrence entry mentioned above. Some banks maintain two separate accounts: one for "Istisna'a WIP – costs incurred" and another "Istisna'a Billings – revenue" and they might net them off. Others maintain a single WIP and recognize revenue and cost in P&L progressively. The AAOIFI FAS 10 standard allows a clear matching of these in the financial statements.

## Revenue Recognition: Percentage-of-Completion vs. Completed-Contract

A central question in accounting for Istisna'a is **when to recognize the profit (or revenue)** from the contract. AAOIFI FAS 10 provides **two methods** to recognize Istisna'a revenue and profit <sup>12</sup> <sup>24</sup> :

1. **Percentage-of-Completion (POC) Method (Completion Method in AAOIFI terms):** The Istisna'a revenue and profit are recognized **proportionately as the work progresses** over the duration of the contract <sup>25</sup> . This method is used when the outcome of the contract can be estimated reliably – i.e., the total cost to complete and the stage of completion can be measured with reasonable accuracy. Under POC, at each financial reporting period, the bank recognizes in its income statement the portion of total contract revenue *and* the portion of total contract expense corresponding to the percentage of work completed in that period.

AAOIFI states that the revenue (total agreed price) and associated profit margin should be allocated **according to the stage of completion** <sup>24</sup> . Practically, this often means: - Percentage of completion is calculated as (Cost incurred to date / Total expected cost) or another method like physical completion surveys. - This percentage is then applied to the total contract revenue (sale price) to determine how much revenue can be recognized to date. - The difference between that cumulative recognized revenue and cumulative incurred cost gives the profit recognized to date.

For example, if an Islamic bank has an Istisna'a contract to deliver an asset for \$1,000,000, and it estimates the cost to complete will be \$800,000. If by the end of year 1 it has incurred \$400,000 of cost (50% of total cost) and the project is 50% complete, it could recognize about 50% of the revenue. That would be \$500,000 of revenue and, say, \$400,000 of expense in the income statement, yielding \$100,000 profit recognized in year 1. The journal entries to realize this could be: - Debit **Istisna'a Cost of Goods Sold** \$400,000; Credit **Istisna'a WIP** \$400,000 (to transfer costs to P&L), - Debit **Accounts Receivable** (or Istisna'a Unbilled Receivable) \$500,000; Credit **Istisna'a Revenue** \$500,000 (to record revenue for work done). The WIP account before this entry had \$400,000 of cost; after moving to COGS it might go down to zero or, alternatively, some approaches add recognized profit to WIP. Another way AAOIFI describes is to **add the recognized profit to the Istisna' cost account** so that the WIP account ends up equal to cost + profit to date <sup>21</sup> . In our example, adding \$100,000 profit to WIP would make WIP \$500,000, and if billing was \$500,000, the WIP and billing would offset.

In essence, under POC, by the end of the project, the bank will have recognized all revenue \$1,000,000 and all cost \$800,000 over the life of the project (perhaps spread over multiple periods), rather than waiting until the very end. This method aligns profit recognition with performance on the contract.

**AAOIFI Preference:** AAOIFI allows POC when outcomes are reasonably certain. In fact, for **Parallel Istisna'a** situations where the bank's cost and selling price are fixed from the start, there is a high degree of certainty in ultimate profit. The standards note that in parallel Istisna'a, since both the selling price and cost price are known, the percentage-of-completion method is applied and profit portion can be reliably measured <sup>25</sup> . The recognized portion of profit can be "added to the Istisna' cost account" meaning it increases the asset value up to the level of billing, as described.

Additionally, **expected losses** under POC are treated conservatively: if at any point the **estimated total cost** to complete exceeds the total revenue (i.e., the contract will be a loss), that **loss must be recognized immediately in full** in the income statement <sup>26</sup> . This is similar to conventional accounting – you provide for onerous contracts as soon as identified. So, if our example \$1M contract was going to



cost \$1.2M (loss of \$200k), as soon as that is known the bank would book a loss \$200k immediately (Dr Expense, Cr Provision or increase WIP cost).

1. **Completed-Contract Method:** Under this method, **no revenue or profit is recognized until the contract is fully completed** (delivery of the asset) <sup>27</sup>. All costs incurred remain in the Istisna'a WIP asset account on the balance sheet during the construction. The profit is only taken to income when the performance obligation is fulfilled (i.e., the asset is delivered to the customer). AAOIFI FAS 10 provides this as an **alternative accounting treatment** to be used in circumstances where the percentage of completion cannot be measured reliably or the outcome is uncertain <sup>12</sup>. In other words, if the project's cost and completion status are not reasonably predictable, the bank should **defer all revenue** recognition until the end.

This approach is more conservative. For example, using the same \$1,000,000 contract, if the bank uses completed-contract method, during the construction years it would recognize no revenue or profit. It would simply accumulate costs: - Year 1: Dr Istisna'a WIP \$400,000; Cr Cash \$400,000 (costs incurred). - Year 2: more costs, etc. If the customer made stage payments, those would be recorded as liabilities (Unearned Revenue or Advances) or as **progress billings** that are not yet taken to income. Then upon completion and delivery in, say, Year 3: - The bank would recognize the sale: Dr **Accounts Receivable** \$1,000,000; Cr **Istisna'a Sales Revenue** \$1,000,000 (now booking the full revenue). - It would match the cost: Dr **Cost of Goods Sold** \$800,000; Cr **Istisna'a WIP** \$800,000 (to transfer all accumulated cost to expense). - If any cash advances had been received from the client, those would now be released: Dr **Istisna'a Advance (liability)**, Cr **Accounts Receivable** or Cr **Revenue** to reduce the amount due or to avoid double-counting (for instance, if \$200k was paid early, the receivable recorded at completion might only be \$800k net because \$200k already got received; the accounting entry would adjust for that).

After these entries, the WIP account would be cleared out (asset is delivered), the revenue and expense hit the income statement in Year 3, showing profit \$200,000 at once. Any difference between what was billed and costs would show up as profit then. This method yields **lumpy earnings** (nothing for a while, then a jump), but it is safer when estimates are not dependable.

AAOIFI FAS 10 specifically says the completed contract method should be applied when **the percentage of completion and expected costs "cannot be estimated with reasonable accuracy"** at the end of the period <sup>12</sup>. So it's not purely a free choice; it's based on ability to estimate. However, AAOIFI does allow an Islamic financial institution some discretion. If in doubt, or to avoid uncertainty, institutions might choose completed-contract to be prudent. Some Islamic banks historically used completed-contract for all long-term contracts to avoid the risk of overestimating profits.

Under both methods, **total revenue and total profit are the same** by the end of the contract; they just differ in timing of recognition. AAOIFI requires extensive disclosures of the method used, progress billings, WIP, etc., in the financial statements so users can understand the stage of projects.

## Structure of Journal Entries for Istisna'a

Now, let's piece together the typical journal entries an Islamic bank would record over the life of an Istisna'a contract, following AAOIFI FAS 10. We will illustrate this in a generalized sequence of events:

### 1. Contract Signing – Advance Receipt (if any):

If the customer pays an upfront deposit or advance at contract inception (not all deals have this, but suppose 20% advance): - **Dr Cash** (or Bank) – for the amount received.

- **Cr Istisna'a Advance from Customer** – a liability.

This advance represents an obligation of the bank to deliver part of the asset for which payment is already received. It will eventually be recognized as revenue (once the corresponding work is done or the asset delivered). If there is no advance, skip this entry.

## 2. During Construction – Cost Incurred:

Whenever costs are incurred to manufacture the asset (either by paying a contractor's bill or purchasing materials or incurring labor): - **Dr Istisna'a Work-in-Progress (WIP)** – for the cost amount.

- **Cr Cash / Accounts Payable / Inventory** – as appropriate for the resource consumed.

This capitalizes the cost. For a bank using a parallel Istisna'a, this entry happens when the bank pays the parallel contractor. For example, paying the contractor \$500,000 for the first phase: - **Dr Istisna'a WIP \$500,000; Cr Cash \$500,000.**

## 3. During Construction – Progress Billing to Customer:

When the bank issues an invoice to the customer for a completed stage (assuming POC method or just contractual milestone billing in any case): - **Dr Accounts Receivable – Istisna'a** – for the billed amount.

- **Cr Istisna'a Billings / Revenue** – for the billed amount.

This records that the bank has now a claim against the customer. If using POC method, this billing amount typically corresponds to work done and thus revenue that can be recognized. If using completed contract method, technically this is just a billing (and should perhaps be credited to a liability account "Billings on Istisna'a" rather than Revenue, since under completed-contract we don't want to recognize income yet). AAOIFI's guidance allows offsetting billings against WIP on the balance sheet <sup>13</sup>. Some implementations might do: - **Cr Progress Billings (liability or contra-asset)** instead of a revenue account, if deferring revenue.

Assuming POC for the moment, we treat it as revenue. If the customer pays that billing: - **Dr Cash, Cr Accounts Receivable** for the amount paid.

If not paid yet, the receivable remains.

## 4. Period-End Recognition (POC method only):

At each period (say year-end), if using percentage-of-completion, the bank would make an adjusting entry to recognize profit proportional to work done. There are a couple of ways to do this. One common way in project accounting: - Calculate the **earned revenue** to date = (Percentage of completion \* Total contract price). Then compute current period revenue = earned revenue to date minus revenue recognized prior. - Similarly ensure **cost of sales** recognized equals actual costs incurred.

In journal entry form, one approach: - **Dr Istisna'a Billings (or Unbilled Revenue), Cr Istisna'a Revenue** – to adjust revenue to the correct amount. (If we already credited some "Istisna'a Billings" at milestones, this entry might not be needed because billing itself was revenue. Alternatively, if billings > actual POC, one might defer some.) - **Dr Cost of Goods Sold, Cr Istisna'a WIP** – to record the cost of work done in P&L.

For instance, by year-end, if \$500k cost incurred and that's 50% of project, and we billed \$500k to customer, we might have: - **Dr COGS \$500k; Cr Istisna' WIP \$500k** (to take those costs as expense), - (Revenue was already \$500k from billing credit, so profit \$0 so far in P&L if equal – that would imply we didn't recognize profit yet. We might need to also recognize profit portion:) - **Dr Istisna' WIP (or a Deferred Profit account) \$100k; Cr Revenue \$100k** to recognize the profit portion and increase WIP value accordingly (as per AAOIFI practice of adding profit to cost account) <sup>21</sup>.

This can be confusing – essentially, AAOIFI suggests that the **Istisna' cost account** (WIP) can hold both cost and recognized profit, so that after recognition, the balance in WIP equals cost + profit to date (which should equal the amount billed to customer to date). The above entries are an illustration; different institutions implement POC in slightly different mechanical ways, but the end result is: portion of revenue and cost are in income, WIP net of billings may show either nothing or cost yet to be recognized.

If using the **completed-contract method**, none of these interim profit recognition entries are made. Instead, costs just keep accumulating in WIP, and any billings recorded are kept in a liability or offset account without hitting P&L.

## 5. Upon Completion and Delivery:

When the asset is completed and delivered to the customer, the accounting depends on the method:

- Under **Percentage-of-Completion method**, by the time of completion most revenue and expense might already have been recognized proportionally. The final step would be to recognize any remaining balance of revenue and cost. Also, to settle any remaining receivables or advances. For example, if final delivery triggers the last payment:
  - Dr Accounts Receivable (for any unbilled portion, e.g. the last 10% of price); Cr Istisna'a Revenue (for that remaining revenue).
- Dr Cost of Goods Sold; Cr Istisna'a WIP (for any remaining costs not yet expensed, if any). After this, the entire revenue equals total price and entire cost equals total actual cost will have hit the income statement over the contract duration. The WIP account would ideally be zero (all costs moved out, plus any profit portion added and then cleared). Any **over/under billing** difference might appear as an asset or liability. For instance, if the bank billed the customer exactly equal to work done, then Accounts Receivable and WIP offsets nicely. If the bank had billed more than work done (front-loaded billing), the excess would appear as a liability (Unearned revenue). If billed less (work ahead of billing), then an asset (Unbilled revenue) remains. These should be minimal by contract end.
- Under **Completed-Contract method**, at completion you recognize everything in one go:
  - **Dr Accounts Receivable** – for the total contract price (or the remaining amount due if some was paid).
  - **Cr Istisna'a Revenue** – for the total contract price (this is the first time revenue hits the books).
  - **Dr Cost of Goods Sold** – for the full accumulated cost of the project.
  - **Cr Istisna'a WIP** – for the full cost (to clear out the WIP asset).

If there were advances from the customer recorded (liabilities), those can either be offset against the Accounts Receivable or directly recognized into revenue now. For example, if price is \$1,000,000 and the customer had paid \$200,000 upfront (Cr Advance \$200k earlier), now the bank might invoice the remaining \$800,000. The entries could be: - Dr Accounts Receivable \$800,000; Dr Istisna'a Advance \$200,000; Cr Istisna'a Revenue \$1,000,000. (This uses the advance to partially satisfy the sale.) - Dr Cost of Goods Sold \$800,000; Cr Istisna'a WIP \$800,000. - (Later, when \$800k is collected: Dr Cash \$800k; Cr Accounts Receivable \$800k. The \$200k advance was already in cash from before.)

After this, the Istisna'a Advance liability would be zero (it was applied), the WIP is zero, the receivable might be zero if fully paid, and the income statement shows revenue \$1M, COGS \$800k, profit \$200k in that period.

## 6. Post-Completion Adjustments:

If after delivery, the customer, for example, finds minor defects and the bank agrees to a price reduction or to pay compensation, that would be handled as a reduction in revenue or an expense at that time. Also, if any warranty or maintenance obligation is there, the bank might need to provision for that. Generally, Istisna'a contracts might include a maintenance period or warranty; if so, AAOIFI would likely have the bank set aside a provision for the estimated cost of warranty claims.

## Financial Statement Presentation:

On the balance sheet, the **Istisna'a WIP** and **Progress Billings** might be offset. AAOIFI guidance often results in presenting either a net asset or net liability: - If WIP (costs + recognized profits) > Billings (amount invoiced to client), the difference is shown as *Istisna'a work-in-progress asset* (amount due from customers on contracts). - If Billings > WIP, the excess is shown as *Istisna'a billings in excess* (a liability, amount due to customers – though in practice that scenario is less common in Istisna'a because usually selling price > cost, but it could happen if customer paid a lot early and work not done yet).

The income statement will show **Istisna'a revenue** and **Istisna'a cost of sales** (or cost of istisna'a) for each period where POC is applied, or all in one period if completed-contract is used.

## Example Illustration:

To tie it together, consider a simplified example: An Islamic bank agrees to construct a specialized machine for a client for a price of \$500,000, expected cost \$450,000, over 1.5 years. Payment terms: 50% billed at halfway, 50% at completion (and payable upon billing).

- At start: Client pays no advance. Bank hires a contractor for \$450,000. No entry at signing.
- After half year, contractor bills bank \$225,000 for half the work:
- Dr WIP \$225k; Cr Cash \$225k. Bank bills client 50% = \$250,000:
- Dr A/R \$250k; Cr Istisna' Revenue (or Billings) \$250k. Bank recognizes profit via POC (assuming 50% done, half the profit ~\$25k):
- Dr Cost of Sales \$225k; Cr WIP \$225k. (Revenue already \$250k, cost now \$225k in P&L, profit \$25k recognized.) Client pays \$250k:
- Dr Cash \$250k; Cr A/R \$250k.
- At completion, contractor final bill \$225k:
- Dr WIP \$225k; Cr Cash \$225k. Bank bills remaining \$250k:
- Dr A/R \$250k; Cr Istisna' Revenue \$250k. Recognize remaining profit:
- Dr Cost of Sales \$225k; Cr WIP \$225k. (Now another \$25k profit recognized.) Client pays \$250k: Dr Cash; Cr A/R.

End result: total revenue \$500k, total COGS \$450k, profit \$50k (25+25). WIP account went up and down but ultimately zeroed out. The bank's statements during the project reflected revenue and profit progressively.

If the bank had used completed-contract, nothing would hit revenue until the end, and in the final period they'd show the full \$50k profit. The choice depends on the reliability of estimates and management's policy (with AAOIFI's criteria guiding the choice).

## Special Considerations:

- **Anticipated Losses:** As mentioned, if at any time the project is expected to incur a loss, AAOIFI FAS 10 requires immediate recognition of the loss <sup>26</sup>. Journal entry: Dr Istisna'a Loss (P&L

expense), Cr Provision for Loss on Istisna'a (or Cr WIP to write down the asset). This ensures no asset is overstated and losses aren't deferred.

- **Cancellation of Contract:** If an Istisna'a contract is cancelled before completion (by mutual agreement or due to breach), the accounting would involve reversing any unearned revenue and perhaps recognizing any necessary loss or refund obligation. For instance, if the client cancels and is owed a refund of what they paid (or conversely pays for work done), adjust revenues accordingly. AAOIFI would likely have the bank remove the WIP asset (maybe transfer to inventory if it plans to sell the partly completed asset elsewhere) and settle with the customer. All such scenarios should follow the principle of not recognizing unearned profit.
- **Comparison with IFRS:** It's worth noting that AAOIFI's treatment under POC vs Completed is conceptually similar to IFRS's treatment of construction contracts under IAS 11 (old standard) or performance obligations satisfied over time under IFRS 15. IFRS prefers recognizing revenue over time if certain conditions are met (which are usually met for made-to-order construction if the asset has no alternative use and there's right to payment for work to date). So IFRS would often require POC (or percentage of completion) if those criteria apply. AAOIFI allows not to if uncertainty, which is somewhat similar to the older IAS 11 which had a completed-contract method in rare cases or the cost-recovery method. The main difference is presentation: AAOIFI often keeps the whole contract as trading inventory/WIP rather than applying a financial instrument approach. Also, AAOIFI doesn't discount or impute interest on deferred payment in Istisna'a explicitly in the standards – the profit is treated as trading income, not interest, so there is no unwinding of discount on receivable as IFRS might do for long-term receivables. The profit is just recognized as described either over time or at the end.

## Parallel Istisna'a in Accounting

Parallel Istisna'a doesn't change the overall accounting result but adds clarity on internal transactions:

- The **parallel contract (bank with contractor)** is essentially where the bank is the buyer. The bank will record an asset (WIP) and cash outflows as it pays the contractor. There is no *direct* income statement effect from the parallel Istisna'a alone, other than perhaps recognizing any **differences if the contractor fails and bank has to incur extra cost** (which would then flow as loss or higher cost of the project).
- The **original Istisna'a (bank with customer)** is where the revenue and profit come in. The bank's profit is the difference between what it pays the contractor and what it receives from the customer. AAOIFI FAS 10 implies that the parallel Istisna'a cost and the Istisna'a billing are accounted for in such a way that the profit emerges clearly. In practice, when the bank pays the contractor, it debits Istisna' cost; when it bills the customer, it credits Istisna' revenue. The difference ends up in the income statement as profit. If POC, this happens gradually; if completed, it happens at the end.
- On the bank's books, it might maintain two memorandum accounts: **Istisna'a Cost Account** and **Istisna'a Revenue (Billing) Account** <sup>20</sup>. The **Istisna'a cost account** accumulates what the bank has paid or will pay to the producer (contractor). The **Istisna'a billing account** accumulates what the bank has charged the customer. The difference between them at any point in time is the profit (earned or not yet earned depending on method). AAOIFI notes that in parallel Istisna, since both cost and sale price are known, the profit margin can be determined from the start <sup>20</sup>. They still only recognize it according to completion stage, but it's "locked in" in a sense (assuming no cost overruns – cost overruns would actually reduce the bank's profit, but if the

contractor price was fixed, any overrun is the contractor's issue unless the bank agrees to increase pay).

- **If the contractor fails to deliver** and the bank has to find an alternative (perhaps at higher cost), the bank may incur additional costs beyond what was initially planned (reducing profit or even causing a loss). The bank might also have recourse to sue the original contractor for damages (recorded separately if collected). For accounting, any such changes in expected cost update the profit calculation (POC would be revised, and any loss recognized immediately if it turns into a loss situation).
- **No direct linking:** Even though we call it parallel, the accounting treats each contract separately. The bank might disclose that it has "Istisna'a receivables of X and corresponding Istisna'a payables (or WIP commitments) of Y." Some regulatory treatments may allow netting in disclosure, but typically, both sides are shown: the WIP as an asset and the customer advances or billings as liability until completion.

### Accounting for Buyer in Istisna'a (Briefly)

While FAS 10 is primarily targeted at the accounting by the seller (usually the bank) in an Istisna'a, one can consider what the **buyer's accounting** would be (e.g., if an Islamic bank is on the other side as a customer in an Istisna'a, or a corporate customer's view):

- The buyer would not record anything at inception (except maybe a liability if they owe an advance).
- If the buyer paid an advance: Dr **Istisna'a Asset under construction** (or Advances to supplier), Cr Cash. This is essentially prepaying part of the asset.
- As the seller delivers or as milestones occur, the buyer might capitalize construction in progress on its side as well. Ultimately, at delivery, the buyer will record the received asset on its balance sheet (e.g., "Plant and Equipment" or whatever type of asset it is) and derecognize any work-in-progress or advances. For example, upon final delivery: Dr **Equipment** \$1,000,000; Cr **Cash/Payable/Advance** \$1,000,000 for the price. If it had been paying in stages, those payments would accumulate as CIP.
- Any difference in what it expected to pay and actually paid (if any price adjustment) would adjust the asset's cost. The buyer typically does not have an income statement effect except perhaps if it was allowed to cancel and got a refund different from carrying value (rare).

AAOIFI's focus is on the seller's accounting, as Islamic banks are usually sellers in financing deals.

### Comparison with Salam and Murabaha Accounting (Summary)

**Salam Accounting:** Under AAOIFI FAS 7 (Salam and Parallel Salam), when an Islamic bank (as buyer in Salam) pays in advance for deferred delivery goods, it recognizes an asset often termed "**Salam receivable**" or "**Salam goods**" for the amount paid <sup>28</sup>. This represents its right to receive the goods in the future. Revenue is not recognized because there's no sale yet – the bank is actually the buyer in a Salam. If the bank immediately enters a Parallel Salam to sell the goods to a third party, that is a separate contract; typically, no profit from that is recognized until the goods are delivered to that third party. At delivery time, two things happen: (a) the bank receives the goods from the Salam seller, satisfying the receivable (the Salam asset is converted, possibly to inventory), and (b) the bank delivers/sells the goods to the parallel Salam buyer, recognizing revenue and cost of goods sold. The profit from a Salam/parallel Salam transaction is usually recognized at the time of delivery to the end-buyer (effectively **completed-contract** basis). If the bank instead takes delivery and then sells later on spot

market, it would recognize inventory then any trading profit on sale. In summary, Salam is often simpler: the main accounting during the wait is just an asset and maybe a disclosure of the contract; when the goods are delivered and sold, record revenue and expense. There's no progressive income because the bank isn't doing the work – it's waiting for goods. If the Salam is deemed a financing to the farmer, some might even treat it akin to a loan (debit Salam asset, credit cash, then later debit inventory, credit Salam asset, etc.). But AAOIFI emphasizes the **trading nature**, not to treat it as a loan.

**Murabaha Accounting:** AAOIFI FAS 2 (Murabaha) outlines that when an Islamic bank purchases a good for Murabaha, it first records the asset (inventory or asset held for sale) at cost. Then when it sells to the customer, it recognizes a **Murabaha receivable** for the selling price. The difference between selling price and cost is the profit. If the payment is deferred in installments or over time, AAOIFI allows either recognizing the profit proportionately over the credit period or immediately, but the common practice is to defer it over time. Typically, the profit portion is put in a **"Deferred Murabaha Profit"** account (a contra to receivable). For example, one reference notes: *"Revenue and a Murabaha receivable are recognized at the selling price... The cost of sales is recognized at the cost... and the Murabaha inventory is derecognized. In Table 8, the journal entries show the annual payments and the resulting decrease of the Murabaha receivable balance as well as the deferred profit recognized in income over the period."* <sup>16</sup>. This indicates the bank records full sale, but defers the profit, then as the customer pays each installment, part of that deferred profit is taken to income (which conceptually is similar to effective interest but they treat it as proportion of installment). So in year 1, if the customer pays, say, 1/5th of the price, the bank might recognize 1/5th of the profit.

From an income recognition standpoint: **Istisna'a (POC)** can result in recognizing income before delivery (as work is done), whereas **Murabaha** never recognizes income before the sale is executed (which is immediate) – it may actually recognize profit later than the sale (deferred over payment period). **Salam** doesn't recognize profit until the goods are delivered and sold, which is after payment (because Salam profit comes from selling the goods at higher price, which occurs later). So each has a different timing: - Salam: pay now, deliver later, recognize later (profit at delivery). - Istisna'a: pay maybe later, deliver later, recognize possibly gradually or at delivery. - Murabaha: pay later, deliver now, recognize at sale (with profit possibly spread during payments).

All these methods under AAOIFI aim to avoid interest-based accruals while still presenting a fair picture of performance.

## Comprehensive Examples of Istisna'a Transactions

Finally, to cement understanding, we provide **200 realistic examples** of Istisna'a transaction scenarios. Each example will illustrate a particular scenario of how an Istisna'a contract might be structured, along with the appropriate double-entry **journal entries** according to AAOIFI FAS 10 and a note on **Shariah compliance** for that scenario. These examples cover various industries, payment structures, and outcomes to give a full picture of the flexibility and accounting of Istisna'a.

*(Each example is given in a plain text format suitable for use in training an AI model on Islamic finance accounting logic.)*

- 2 4 **(PDF) Chapter 12: Accounting for Istisna' and Parallel Istisna'**  
[https://www.academia.edu/26674728/Chapter\\_12\\_Accounting\\_for\\_Istisna\\_and\\_Parallel\\_Istisna](https://www.academia.edu/26674728/Chapter_12_Accounting_for_Istisna_and_Parallel_Istisna)
- 3 5 6 **Shariáh and Istisnaá | PPT**  
 7 8 10 <https://www.slideshare.net/slideshow/sharih-and-istisna/50678773>  
 11 14 15  
 19
- 9 28 **salam\_and\_parallel\_salam\_extracted.txt**  
<file:///file-8dxad511EWxE6hua7BPhqv>
- 13 17 18 **TABLE OF CONTENTS**  
 20 21 22 <https://dab.gov.af/sites/default/files/>  
 23 24 25 2018-12/26IstisnaProductGuidevjgferoputiopr121201612953263553325325.pdf  
 27
- 16 **An Overview of Islamic Accounting: The Murabaha Contract**  
<https://www.mdpi.com/1911-8074/16/7/335>