

Financial Accounting Standard No. (10)

Istisna'a and Parallel Istisna'a



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Preface

This standard aims at setting out accounting rules for recognizing, measuring and disclosing the transactions of Istisna'a and parallel Istisna'a that are carried out by Islamic banks and financial institutions.⁽¹⁾ Attached with the standard are details of the juristic bases for the accounting treatments.

Istisna'a contract is usually accompanied with a separate parallel contract, whereby an Islamic bank acts in the first contract as a seller (Al-Sani') of goods (Al-Masnoo', the subject-matter of the contract) to an ultimate buyer (Al-Mustasni') while in the parallel Istisna'a contract the Islamic bank acts as a buyer (Al-Mustasni') of Al-Masnoo' from another seller (Al-Sani').

(1) Referred to hereafter as Islamic bank or Islamic banks.

Statement of the Standard

1. Scope of the Standard

This standard addresses the accounting rules of Istisna'a and parallel Istisna'a contracts in the financial statements of Islamic banks relating to measuring and recognizing the costs and revenues from Istisna'a and parallel Istisna'a, the gains and losses accruing therefrom, and their presentation and disclosure in the financial statements of the Islamic bank.

Should the requirements of this standard contradict the Islamic bank's charter or the laws and regulations of the country in which it operates and the Islamic bank had to comply with such requirements, a disclosure should be made to the point of conflict. (para. 1)

2. Accounting Treatment by the Islamic Bank As Al-Sani' (A Seller)

2/1 Istisna'a costs

- a) Istisna'a costs consist of: (I) Direct costs, in particular costs of producing Al-Masnoo'; and (II) Indirect costs relating to the contract as allocated on an objective basis. General and administrative expenses, selling expenses, research and development costs shall not be included in an Istisna'a contract costs. (para. 2)
- b) Istisna'a costs incurred during a financial period, as well as pre-contract costs as described in (c) below, shall be recognized in an Istisna'a work-in-progress account, and reported under assets in the statement of financial position of the Islamic bank. (In case of parallel Istisna'a, this account shall be called Istisna'a costs account as stated in 2/2 a). Amounts billed to Al-Mustasni' will be debited to Istisna'a accounts receivable account and credited to an Istisna'a billings account. The balance of the latter account shall be offset against Istisna'a work-in-progress account in the appropriate side of the Islamic bank's statement of financial position. (para. 3)

- c) Pre-contract costs shall be recognized as deferred costs when they are incurred, and accounted for upon contracting by transferring them to the Istisna'a work-in-progress account. If no contract is signed and it is unlikely that it will be signed in the future, then the deferred costs in question shall be written-off to expense during the current financial period. (para. 4)

2/2 Contract costs in parallel Istisna'a

- a) When a parallel Istisna'a exists, the costs of Istisna'a include the price fixed in the parallel Istisna'a contract (direct costs), together with indirect costs including any pre-contract costs as described in 2/1(c). When the subcontractor bills the Islamic bank for contract costs, these will be debited to Istisna'a costs account and credited to the subcontractor's Al-Sani' account under Istisna'a accounts payable. The Istisna'a costs account shall be reported under assets in the statement of financial position of the Islamic bank. (para. 5)
- b) Progress billings made by the Islamic bank to the ultimate purchaser (Al-Mustasni') during the period shall be accounted for by debiting an Istisna'a accounts receivable account. The same amount shall also be credited to Istisna'a billings account, the balance of which shall be offset against Istisna'a cost account in the Islamic bank's financial statements. (para. 6)

2/3 Istisna'a revenue and profit at the end of a financial period

2/3/1 Istisna'a revenue and profit

Istisna'a revenue is the total price agreed upon between the Islamic bank as Al-Sani' and the client as Al-Mustasni', including the Islamic bank's profit margin on the contract. Istisna'a revenue and the associated profit margin are recognized in the Islamic bank's financial statements according to either the percentage of completion or the completed contract methods as set up below, taking into consideration what is stated in item 2/3/1/2. (para. 7)

2/3/1/1 Percentage of completion method

- a) A part of the 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. (para. 8)

- b) 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 bank's 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, as will be indicated in 2/4 (a) below. (para. 9)

2/3/1/2 Completed contract method

In unusual circumstances where both the percentage of completion and the expected cost to complete the contract cannot be estimated with reasonable accuracy at the end of the financial period, no contract revenue shall be recognized until the contract is fully completed. Thus, until that date, the accumulated contract costs will be carried forward on the Istisna'a work-in-progress account, without any profit element being recognized. (para. 10)

2/3/2 Deferred profits

The contract price may be fully paid by Al-Mustasni' by instalments during the contract based on progress in work. However, all or part of the price may be paid following completion of the contract. In the latter case, the difference between the total price that is paid during the contract and the agreed total price –defined as deferred profits– shall be offset against Istisna'a accounts receivable in the Islamic bank's statement of financial position. This treatment shall

apply whether the percentage of completion method or the completed contract method is used for recognizing and measuring Istisna'a revenues and profit. (para. 11)

Deferred profits shall be recognized using one of the two following methods:

- a) Proportionate allocation of deferred profits over the future financial period of credit whereby each financial period shall carry its portion of profits irrespective of whether or not cash is received. This is the preferred method. (para. 12)
- b) As and when each instalment is received. This method shall be used based on a decision by the Shari'a supervisory board of the Islamic bank or if it is required by supervisory authorities. (para. 13)

2/3/3 Early settlement

- a) If Al-Mustasni' makes a payment in advance of the due date for such a payment, the Islamic bank may waive part of its profit in recognition of this earlier payment. In that case, the amount of profit waived shall be deducted from both Istisna'a accounts receivable account and deferred profits account. (para. 14)
- b) The same accounting treatment as in (a) above shall apply if the facts are the same except that the Islamic bank did not grant a partial reduction of the profit when the payment was made, but reimbursed Al-Mustasni' with this amount after receiving the payments. (para. 15)

2/3/4 Parallel Istisna'a revenue and profit

- a) Parallel Istisna'a revenue and profit for each financial period shall be measured and recognized according to the percentage of completion method, since in parallel Istisna'a both costs and revenues of Istisna'a are known to the Islamic bank with reasonable certainty. (para. 16)
- b) The recognized portion of Istisna'a profits for a financial period shall be added to Istisna'a costs account. Thus, at any

point in time the balance of the Istisna'a costs account shall be equal to the cumulative cost of the Istisna'a contract (the total amount in progress billings authorised by the Islamic bank) plus the total Istisna'a profits recognized up to that point. (para. 17)

- c) If the contract price or part thereof is to be paid following the completion of the contract, the accounting treatments in 2/3/2 and 2/3/3 (a, b) shall apply. (para. 18)

2/4 Measurement of Istisna'a work-in-progress, Istisna'a costs and treatment of contract losses at the end of a financial period

- a) In the event of applying the percentage of completion method for the recognition of Istisna'a revenue and profit, Istisna'a work-in-progress shall be measured and reported in the statement of financial position of the Islamic bank at a value not exceeding its cash equivalent value (i.e., the difference between the contract price and the expected additional cost to complete the contract). (para. 19)
- b) Any expected loss resulting from the valuation of Istisna'a work-in-progress at the end of a financial period shall be recognized and reported in the Islamic bank's income statement. (para. 20)
- c) When a parallel Istisna'a exists, Istisna'a costs shall be treated as in (a) and (b) above. (para. 21)
- d) The subcontractor may fail to honour his obligation in a parallel Istisna'a resulting in additional cost for the Islamic bank to fulfil its obligation towards Al-Mustasni' (the client). Any such additional costs shall be recognized as losses in valuing the Istisna'a costs and reported in the Islamic bank's income statement, except if there is a reasonable degree of certainty that the Islamic bank shall recover these additional costs. (para. 22)

2/5 Change orders and additional claims

- a) The value and cost of change orders authorized by the Islamic bank and Al-Mustasni' shall be added to Istisna'a revenue and costs, respectively. (para. 23)

- b) If requisite conditions for recognizing additional claims are met, a related amount of revenue shall be recognized equal to the additional cost caused by such claims. (para. 24)
- c) If one or more requisite conditions for recognizing additional claims are not met, the estimated value of these claims shall be disclosed in the notes accompanying the financial statements of the Islamic bank. (para. 25)
- d) When a parallel Istisna'a exists, the accounting treatments in (a), (b) and (c) above shall apply for change orders and additional claims. However, the cost of change orders and additional claims are determined by the subcontractor (Al-Sani') in the parallel contract and subject to the approval of the Islamic bank. (para. 26)

2/6 Maintenance and warranty costs of Al-Masnoo'

- a) Maintenance and warranty costs of Al-Masnoo' shall be accounted for on an accrual basis. Such costs shall be estimated and then matched with recognized Istisna'a revenue. Actual maintenance and warranty expenditures shall be charged against a maintenance and warranty allowance account when carried out by the Islamic bank. (para. 27)
- b) When a parallel Istisna'a exists, the maintenance and warranty cost of Al-Masnoo' shall be accounted for on a cash basis, where such costs are charged by the Islamic bank directly to expense accounts when they are incurred. (para. 28)

3. Accounting Treatment of Istisna'a by the Islamic Bank As Al-Mustasni' (A Buyer)

3/1 Istisna'a billings of completed jobs

- a) The amount of progress billings received shall be recognized by debiting an Istisna'a costs account and presented under assets in the statement of financial position of the Islamic bank. The corresponding credit shall be made to Istisna'a accounts payable to Al-Sani'. (para. 29)
- b) When a parallel Istisna'a exists, the accounting treatment in (a) above shall apply. (para. 30)

3/2 Receipt of Al-Masnoo'

3/2/1 Receipt of Al-Masnoo' in conformity with specifications and schedule

- a) The received (Al-Masnoo') assets shall be recorded at historical cost (i.e., the book value) of the Istisna'a costs account. (para. 31)
- b) When a parallel Istisna'a exists, and Al-Masnoo' is delivered to the Al-Mustasni' the balance of the Istisna'a costs account shall be transferred to an asset account that reflects the nature of Al-Masnoo' received. (para. 32)

3/2/2 Late delivery of Al-Masnoo'

If the delay in the delivery of Al-Masnoo' is due to the negligence or fault of Al-Sani' and the Islamic bank is entitled to compensation for damages resulting from the delay, the amount of compensation shall be taken from performance bonds. If the amount of performance bonds is not sufficient to cover the amount of compensation, the balance shall be recognized as Istisna'a accounts receivable due from Al-Sani' and, if necessary, an allowance for doubtful debts account shall be formed. (para. 33)

3/2/3 Al-Masnoo' not conforming to the specification

- a) If the Islamic bank declined to receive Al-Masnoo' due to nonconformity to specifications and did not recover the entire amount of progress payments made to Al-Sani', the balance shall be recorded as Istisna'a accounts receivable, and if necessary, an allowance for doubtful debt account shall be formed. (para. 34)
- b) If the Islamic bank accepted Al-Masnoo' which does not conform to specifications, such assets shall be measured at the lower of their cash equivalent value or historical cost (the book value). Any resulting uncompensated loss shall be recognized in the Islamic bank's income statement for the current financial period. (para. 35)

3/2/4 Al-Mustasni' refuses to receive Al-Masnoo'

If Al-Mustasni' (the client) refuses to receive Al-Masnoo', the Istisna'a assets shall be measured at the lower of their cash equivalent value or historical cost (the book value). Any resulting loss shall be recognized in the Islamic bank's income statement for the financial period in which the loss is realized. (para. 36)

4. Disclosure Requirements

4/1 The Islamic bank shall disclose the following in its financial statements:

- a) Revenues and profits of Istisna'a contracts recognized for the financial period. (para. 37)
- b) Accounting methods used for measuring revenues and profits of Istisna'a contracts for the financial period. (para. 38)
- c) Cumulative (actual) costs of contracts in progress as well as revenues and profits recognized up to the end of the current financial period. (para. 39)
- d) The amount of retention on contracts in progress until they are completed according to the specifications and contractual conditions. (para. 40)
- e) Istisna'a receivable and payable accounts presented in the appropriate side of the statement of financial position of the Islamic bank. These accounts shall not be offset against each other. (para. 41)

4/2 The Islamic bank shall disclose the following in the notes accompanying its financial statements:

- a) Unsettled additional claims and any contingent fines related to the penalty clauses concerning any delay in delivering Al-Masnoo'. (para. 42)
- b) The method used for determining the percentage of completion for contracts in progress. (para. 43)
- c) The value of parallel Istisna'a in progress and the time periods they span. (para. 44)
- d) The value of Istisna'a contracts that the Islamic bank has signed during the current financial year, but has not yet commenced in executing them, and the time periods they span. (para. 45)

4/3 The disclosure requirements in Financial Accounting Standard No. (1): General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions should be observed. (para. 46)

5. Effective Date

This Standard shall be effective for the financial statements for fiscal periods beginning 1 Muharram 1420 A.H. or 1 January 1999 A.D. (para. 47)

Adoption of the Standard

The standard of Istisna'a and Parallel Istisna'a was adopted by the Accounting and Auditing Standards Board in its meeting No. (15) held on 27-28 Safar 1419 A.H, corresponding to 21-22 June 1998 A.D.

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Appendix (A)

Examples of the Application of Some Aspects of the Istisna'a and Parallel Istisna'a Standard

The purpose of this appendix is to illustrate the application of certain aspects of the standard to Istisna'a and parallel Istisna'a. The appendix does not form part of the standard. Paragraph numbers refer to those in the standard.

Example (1): Parallel Istisna'a Does Not Exist: (profitable contract)

Basic data:

- Contract price 500,000 (2-year contract)
- Total estimated (and actual) contract costs \$400,000 (including pre-contract costs of \$15,000).

	Year 1	Year 2
Cumulative costs incurred	300,000	400,000 (including pre-contract costs)
Billings	280,000	220,000
Collections from Al-Mustasni' (Purchaser)	230,000	270,000

Treatments by the Islamic Bank As a Seller (Al-Sani')

Para. No.		Year 1		Year 2	
		Dr	Cr	Dr	Cr
3	1. Istisna'a work-in-progress	300,000		100,000	
4	Deferred cost		15,000		
	Cash (accounts payable, etc.)		285,000		100,000
3	2. Istisna'a accounts receivable	280,000		220,000	
	Istisna'a billings		280,000		220,000
	3. Cash	230,000		270,000	
	Istisna'a accounts receivable		230,000		270,000

End of period:

- a) Percentage-of-completion can be estimated with reasonable accuracy (percentage-of-completion method).

Para. No.		Year 1	Year 2
8	% of completion	$300,000/400,000 \times 100 = 75\%$	25%
	Revenue recognized	$500,000 \times 75\% = 375,000$	125,000
	Istisna'a revenue	$(500,000 - 400,000) \times 75\% = 75,000$	25,000

		Dr	Cr	Dr	Cr
9	Cost of Istisna'a revenue	300,000		100,000	
	Istisna'a work-in-progress	75,000		25,000	
	Istisna'a revenue		375,000		125,000

Financial Accounting Standard No. (10): Istisna'a and Parallel Istisna'a

Income statement:

	Year 1	Year 2
Istisna'a revenue	375,000	125,000
Cost of Istisna'a revenue	300,000	100,000
Istisna'a profit	75,000	25,000

Balance sheet presentation:

Para. No.	Assets	end of year 1	end of year 2 ^(*)
3	Istisna'a work-in-progress	375,000	25%
3	Less: Istisna'a billings	(280,000)	125,000
		95,000 ^(**)	—
	Istisna'a revenue	50,000	—

b) Percentage-of-completion cannot be estimated with reasonable accuracy (completed contract method)

		Year 1		Year 2	
Para. No.		Dr	Cr	Dr	Cr
10	Cost of Istisna'a revenue	—		400,000	
	Istisna'a work-in-progress	—		100,000	
	Istisna'a revenue		—		500,000

(*) Istisna'a transactions are concluded and all Istisna'a related accounts are closed by the end of year 2.

(**) If the balance in Istisna'a billings is greater than Istisna'a work-in-progress, the two balances will be presented and matched within the liability section.

Financial Accounting Standard No. (10): Istisna'a and Parallel Istisna'a

Income statement:

	Year 1	Year 2
Istisna'a revenue	—	500,000
Cost of Istisna'a revenue	—	<u>400,000</u>
Istisna'a profit	—	100,000

Balance sheet presentation:

Para. No.	Assets	end of year 1	end of year 2*
3	Istisna'a work-in-progress	300,000	
3	Less: Istisna'a billings	<u>(280,000)</u>	
		20,000	—
	Istisna'a accounts receivable	50,000	—

Example (2): Parallel Istisna'a Exists: (profitable contract)**Basic data:**

	Istisna'a Contract	Parallel Istisna'a
Contract price (2-year contract)	500,000	400,000

Para. No.	Assets	Year 1	Year 2	Year 1	Year 2
1	Billings by (Al-Sani') subcontractor (x-co.)			300,000	100,000
2	Billings by Islamic bank to (Al-Mustasni') purchaser (y-co.)	280,000	220,000		
3	Payments to x-co.			290,000	110,000
4	Collections from y-co.	230,000	270,000		

Treatments by the Islamic Bank As Both a Seller (Al-Sani') and a Buyer (Al-Mustasni') in Parallel Istisna'a

Para. No.		Year 1		Year 2	
		Dr	Cr	Dr	Cr
5	1. Istisna'a costs	300,000		100,000	
	Istisna'a accounts payable (x-co.)		300,000		100,000
6	2. Istisna'a accounts receivable (y-co.)	280,000		220,000	
	Istisna'a billings		280,000		220,000
	3. Istisna'a accounts payable (x-co.)	290,000		110,000	
	Cash		290,000		110,000
4	Cash	230,000		270,000	
	Istisna'a accounts receivable (y-co.)		230,000		270,000

Financial Accounting Standard No. (10): Istisna'a and Parallel Istisna'a

End of period:

Only percentage-of-completion method is applicable with parallel Istisna'a.
(para. 16)

		Year 1		Year 2	
Para. No.		Dr	Cr	Dr	Cr
17	Cost of Istisna'a revenue	300,000		100,000	
	Istisna'a costs	75,000		25,000	
	Istisna'a revenue		375,000		125,000

Income statement:

	Year 1	Year 2
Istisna'a revenue	375,000	125,000
Cost of Istisna'a revenue	<u>300,000</u>	<u>100,000</u>
Istisna'a profit	75,000	25,000

Balance sheet presentation:

Para. No.		end of year 1	end of year 2
3	Assets		
	Istisna'a costs	375,000	
3	Less: Istisna'a billings	<u>(280,000)</u>	
		95,000	
	Istisna'a accounts receivable	50,000	—
	Liabilities		
40	Istisna'a accounts payable	10,000	—

Example (3): Anticipated Losses on Contract

Assume a 3-year \$8 million contract. Contract costs incurred through 1997, the second year of the contract, was \$5,700,000. At the end of 1997, the estimated remaining contract cost to complete the contract was \$2,500,000.

- Anticipated loss at end of 1997 = $8,000,000 - (5,700,000 + 2,500,000) = \$200,000$.
- Valuation of Istisna'a work-in-progress at the end of 1997 = $8,000,000 - 2,500,000 = \$5,500,000$ (para.19).
- a) If percentage-of-completion method is used

Assume gross profit recognized in 1996 was \$600,000. The balance of Istisna'a work-in-progress through 1997 and the valuation loss will be:

Construction costs incurred through 1997	\$5,700,000
Gross profit recognized in 1996	<u>\$600,000</u>
Istisna'a work-in-progress balance (immediately before valuation at end of 1997)	\$6,300,000
Required valuation (para.19)	\$5,500,000
Loss recognized at end of 1997 (para. 20)	\$800,000 ^(*)
Adjusting entry at end of 1997	
Loss on Istisna'a contracts	800,000
Istisna'a work-in-progress	800,000

(*) Reversal of \$600,000 gross profit recognized in 1996 plus the \$200,000 anticipated loss on the contract.

b) If completed contract method is used:

Under this method no profit is to be recognized until the contract is completed (para.10). Thus, the balance in the Istisna'a costs account through 1997 immediately before end of year adjustments will be \$5,700,000, and the valuation of this account should not exceed \$5,500,000 (para.19).

Adjusting entry at end of 1997 to recognize anticipated loss on contract (para. 20):

Loss on Istisna'a contracts	200,000
Istisna'a work-in-progress	200,000

(Same treatment applies for loss in the case of parallel Istisna'a, except for replacing Istisna'a costs account for Istisna'a work-in-progress account and only percentage-of-completion method is applied).

Appendix (B)

Brief History of the Preparation of the Standard

On 30 Jumada I, 1416 A.H., corresponding to 24 October 1995 A.D., a letter was sent to the Islamic banks to seek their opinion on the standards to be given priority. After taking into consideration the replies from the Islamic banks, the Accounting and Auditing Standards Board decided in its meeting No. (10) held on 14-16 Ramadan 1416 A.H., corresponding to 3-5 February 1996 A.D., in Jeddah, Kingdom of Saudi Arabia, to give priority to the preparation of a standard on Istisna'a and parallel Istisna'a.

On 1 Dhul-Qa'dah 1417 A.H., corresponding to 10 March 1997 A.D., two consultants were commissioned to prepare the preliminary studies on the juristic and accounting aspects of the standard. These studies were discussed in the Accounting Standards Committee meeting No. (11), held on 7 Safar 1418 A.H., corresponding to 12 June 1997 A.D., in Bahrain. The revised juristic and accounting studies as well as an exposure draft of the standard were discussed by the Committee in its meeting No. (12) held during the period of 13-14 Jumada I, 1418 A.H., corresponding to 14-15 September 1997 A.D., in Bahrain. In its meeting No. (13) held during the period of 12-13 Jumada II, 1418 A.H., corresponding to 13-14 October 1997 A.D., in Doha, the Committee reviewed and discussed the revised exposure draft of the standard and necessary amendments were made in light of the discussions that took place and the comments made by the members.

The exposure draft was submitted to the Shari'a Committee in its meeting No. (8), held on 13-15 Rajab, 1418 AH., corresponding to 13-15 November, 1997 A.D., in Bahrain, and the amendments which it deemed necessary were made.

The amended exposure draft was discussed in the Standards Board meeting No. (14) held on 11-12 Ramadan 1418 A.H., corresponding to 10-11 January 1998 A.D., in Jeddah, Kingdom of Saudi Arabia. The Standards Board made further amendments to the exposure draft and decided that it should be distributed to specialists and interested parties to obtain their comments on the exposure draft in order to discuss them in a listening session.

Two listening sessions were held, one in Pakistan on 18 Dhul-Hajjah 1418 A.H., corresponding to 15 April 1998 A.D., and the other in Bahrain on 22 Dhul-Hajjah 1418 A.H., corresponding to 19 April 1998 A.D. The listening sessions were attended by more than 230 participants representing central banks, Islamic banks, accounting firms, Shari'a scholars, academics and others who are interested in this field. Members of the Accounting Standards Committee responded in the listening sessions as well as the oral comments that were expressed in the sessions of the listening sessions.

The Accounting Standards Committee held a meeting on 22 Dhul-Hajjah 1418 A.H., corresponding to 19 April 1998 A.D., to discuss the comments made about the exposure draft. The Committee made the necessary amendments which it deemed necessary in light of the discussions that took place in the two listening sessions.

The revised exposure draft was reviewed and approved by the Shari'a Committee in its meeting No. (8) which was held on 18-19 Muharram 1419 A.H., corresponding to 14-15 May 1998 A.D., after making some changes to the draft.

The Accounting and Auditing Standards Board adopted the proposed standard in its meeting No. (15) held on 27-28 Safar 1419 A.H., corresponding to 21-22 June 1998 A.D.

Appendix (C)

Juristic Rules for Istisna'a and Parallel Istisna'a

1. Characterisation of Istisna'a

According to the majority of Fuqaha (juristic scholars), Istisna'a is a special type of Salam contract, which is used mainly in the field of manufacturing. Hence, according to this viewpoint, Istisna'a is subject to the same provisions and rules as those regulating the contract of Salam.⁽⁵⁾

It should, however, be noted that the emergence of Istisna'a as a separate and independent contract is a result of jurisprudential engineering of the Hanafi school as presented in "*Majallat Al-Ahkam Al-'Adliyyah*" and the resolution of the Islamic Fiqh Academy.⁽⁶⁾ This study is, therefore, based on the provisions of the Istisna'a contract as developed in the Hanafis' jurisprudence and the subsequent development from within that jurisprudence and from other contemporary jurists.

2. Definition

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' -

(5) Al-Dardir, "*Al-Sharh Al-Saghir 'Ala Aqrab Al-Masalik Ila Mazhab Al-Imam Malik*", published along with "*Hashiyat Al-Sawi*", [3: 287-289], Dar Alma'arif: Cairo 1932 A.D.; Ibn Qudamah, "*Al-Mughni*", [3: 313], Modern Riyadh Library, Saudi Arabia, 1401 A.H./1981 A.D., Al-Darir, Al-Siddiq M.A., "*Al-Gharar Wa Atharaho Fi Al-'Uqud*", 2nd edition, Jeddah: Salih Kamil Series of Doctorate Theses on Islamic Economics, 1995 A.D.; Al-Zuhayli, Wahbah, "*Al-Fiqh Al-Islami Wa Adillatuh*," Dar Al-Fikr, Beirut 1409 A.H., [4: 631-35].

(6) "*Majallat Al-Ahkam Al-'Adliyyah*", Istisna'a Contract; Islamic Fiqh Academy, Session No. (7), Resolution No. (67/3/7) held on 7-12 Dhul-Qadah 1412 A.H., corresponding to 9-14 May, 1992 A.D.

undertakes to have manufactured or otherwise acquired Al-Masnoo⁽⁷⁾ (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.⁽⁸⁾ It is a condition of the Istisna'a contract that Al-Sani' should provide either the raw material or the labour.

3. Legitimacy of Istisna'a

3/1 According to the Hanafis, Istisna'a' ought to have been prohibited for contravening the general Shari'a rules of *Qiyas* (analogical deduction). They base their argument on the fact that the subject-matter of a contract of sale ought to be in existence and in possession of the seller, which is not the case in Istisna'a. The Hanafis have, nevertheless, approved the Istisna'a contract on the basis of *Istihsan* (juristic approbation) for the following reasons:

- a) People have been practicing Istisna'a widely and continuously without condemnation, to the extent of furnishing a case of *Ijma'* (Consensus).
- b) It is possible in Shari'a to depart from *Qiyas* based on *Ijma'*.
- c) The validity of Istisna'a is called for on grounds of need. People are often in need of commodities that are not available in the market, and hence, they would tend to enter into contracts to have the goods manufactured for them.⁽⁹⁾

3/2 Istisna'a is also valid in accordance with the general rule of the permissibility of contracts as long as this does not contravene any text or rule of Shari'a.⁽²⁾

3/3 Some contemporary Fuqaha are of the view that Istisna'a is valid on the basis of *Qiyas* and the general rules of Shari'a because the fact that the subject-matter is non-existent at the time of the constitution of the contract is compensated for by its preponderant existence

(7) The subject matter may be a commodity, service or both.

(8) Abdullah, Ahmad Ali, *The Juristic Rules of the contract of Istisna'a and Parallel Istisna'a*, Accounting and Auditing Organization for Islamic Financial Institutions, 1418 A.H.-1996 A.D., (pp. 2-8).

(9) Al-Sarakhsi, *"Al-Mabsut"*, [12: 138-139], Dar Al-Ma'rifah, Beirut.

at the time of delivery in the future. This arrangement makes the delivery of the subject-matter free from Gharar (uncertainty).⁽¹⁰⁾

4. Conditions for the Validity of Istisna'a⁽¹¹⁾

For the validity of Istisna'a, the following rules should be fulfilled:

4/1 Al-Masnoo'

4/1/1 Al-Masnoo' must be known and specified to the extent of removing any lack of knowledge of its:

- a) Kind, e.g., car, airoplane or house, etc.;
- b) Type, e.g., a Toyota car, a Boeing airoplane, a house for low income individuals, etc.;
- c) Quality, e.g., as specified according to established tables of specifications; and
- d) Quantity.

4/1/2 The Hanafis stipulate that the commodity contracted for ought to be of a type of items that people are used to dealing with through Istisna'a. This is important because the legitimacy of Istisna'a is based, according to their viewpoint, on the customary practices of people.

However, since the legitimacy of Istisna'a is also based on *Qiyas*, general rules of Shari'a, permissibility of whatever has not been considered illegitimate, and *Maslaha* (consideration of the public good or common need), it is therefore considered a permissible contract to be used whenever the need arises irrespective to whether or not it has been commonly practised by people.

4/1/3 Fixing a date for delivering Al-Masnoo'

There are three opinions in the Hanafis School relating to fixing a date for delivering Al-Masnoo'.

- a) Imam Abu Hanifa prevented fixing any future date for the delivery of Al-Masnoo'. If a date is fixed, then the contract turns into Salam because this is a characteristic of a binding

(10) Al-Darir, M.S.A., op. cit., (P. 466).

(11) Al-Kasani, "*Bada'i' As-Sana'i' Fi Tartib As-Shara'i*", Cairo, [5: 2-3].

contract such as Salam, but not Istisna'a which is open for options.

- b) Abu Yusuf and Muhammad Ibn Al-Hasan Al-Shaybani, the companions of Abu Hanifah, accepted the condition of fixing a specific future delivery date on the ground that people have been practicing Istisna'a in that manner.
- c) However, Abu Hanifah and his two companions have agreed that in an Istisna'a contract if a delivery date is fixed and it is not in line with what is commonly practised, then the Istisna'a contract turns into a Salam contract.

This standard accommodates the opinion of the two companions of Abu Hanifah who permit fixing a future delivery date. Therefore, fixing a future delivery date is a necessity. This is in line with both the ruling of the Committee of "*Majallat Al-Ahkam Al-'Adliyyah*", which stipulates that Istisna'a is a binding contract, and the resolution of the Islamic Fiqh Academy. This is based on for the following:

- a) Al-Masnoo' is a product that should either be manufactured or obtained from the market. Therefore, fixing a future delivery date becomes a necessity in order to remove Gharar (uncertainty).
- b) The future delivery date depends, on one hand, on the mutual agreement between the two parties involved and on the other hand, on the time required by Al-Sani' to manufacture Al-Masnoo' and/or to obtain Al-Masnoo' from other parties according to the contract.
- c) In Istisna'a contract, fixing a future delivery date is allowed when the need and necessity arise irrespective to whether or not it is commonly practised by people.

4/2 Price

The price should be governed by the following rules:

- a) It should be known to the extent of removing ignorance (i.e., lack of knowledge).
- b) It cannot be increased or decreased on account of the normal increase or decrease in commodity prices or cost of labour.

Price may be changed by mutual consent of the contracting parties because of making modification in Al-Masnoo' or due to unforeseen contingencies.

5. Binding Nature of Istisna'a

5/1 According to the majority of Hanafi jurists, Istisna'a is a valid but not binding contract. Hence,:

5/1/1 Each partner has the option to rescind the contract before it is implemented. Al-Sani' has the right not to commence manufacturing the goods, while Al-Mustasni' has the right to withdraw from buying Al-Masnoo'.

5/1/2 If Al-Sani' manufactured Al-Masnoo', he would not be obliged to deliver it to Al-Mustasni'. Rather, he has the option to dispense with it in the way he deems fit. This is because the contract is not for the manufactured goods themselves, but for Al-Masnoo' of certain specifications. Al-Mustasni' also has the option to accept Al-Masnoo'.

5/1/3 The Hanafis have three different views if Al-Sani' manufactured Al-Masnoo' according to the specifications and decided to deliver it to Al-Mustasni' in fulfillment of his contractual obligations. These are:

- a) The preponderant view is that the contract becomes binding on Al-Sani' who has waived his option by delivering Al-Masnoo'. Yet, the buyer's option remains to be exercised. This view is attributed to the three Imams: Abu Hanifah, Abu Yusuf and Muhammad.
- b) Abu Hanifah is also reported to have said that even at this stage Al-Sani' retains his right on an equal footing with Al-Mustasni'.
- c) Abu Yusuf is also reported to have expressed a second opinion to the effect that in this situation the contract becomes binding on the two parties.⁽¹²⁾

(12) Al-Sarakhsi, op. cit., [12: 139]; Al-Kasani, op. cit., [5: 3-4]; Al-Babarti, *"Al-Inayah 'Ala Al-Hidayah"*, in *"Fath Al-Qadir"*, [7: 116].

5/2 The majority in the Hanafi School opined that the Istisna'a contract is binding once it has been constituted. A number of jurists have argued in favour of this view.⁽¹³⁾

5/3 Provision (392) of "*Majallat Al-Ahkam Al-'Adliyyah*" reads as follows:

Once the contract of Istisna'a is constituted, it becomes binding and no party has the right to revoke it. If, however, Al-Masnoo' does not conform to the required specifications, Al-Mustasni' has the option to revoke the contract. The commentator on the text says: Istisna'a is a contract of sale and not a mere promise. Once it is constituted, no party, according to Abu Yousuf's point of view, has the right to withdraw unless the consent of the other party is secured (see article 375). Accordingly, Al-Sani' has to deliver Al-Masnoo'.⁽¹⁴⁾

5/4 In light of the above, all civil legislations based on Shari'a have treated Istisna'a, in line with the ruling of "*Majallat Al-Ahkam Al-'Adliyyah*", as a binding contract. These are the Jordanian, Yemeni and Sudanese laws of civil transactions as well as the Unified Arab Law proposed by the League of Arab Countries.

5/5 The Islamic Fiqh Academy has also decreed: "The contract of Istisna'a is binding on its parties provided that certain conditions are fulfilled."

These views strengthen one another and confirm that there is a substantiated viewpoint in the Hanafi school professing the binding nature of Istisna'a once it is constituted. It is on this reality that the "*Majallat Al-Ahkam Al-'Adliyyah*", modern civil Islamic legislations and the Islamic Fiqh Academy developed their viewpoint, which is consistent with Shari'a rules and principles.

6. Legal Consequences of Istisna'a

According to the majority of Hanafi jurists, the legal consequences of Istisna'a are: (I) to transfer reciprocally title of ownership between

(13) Al-Tumurtashi, "*Tanwir Al-Absar*", with "*Hashiyat Radd Al-Muhtar*", [5: 223-224] 1386 A.H.; Al-Mihbat Al-Bourhati, Manuscript of Al-Awqaf Library, [2: 575-576] in Al-Qaradaghi, A.M., *Istisna'a Contract*, 1997 A.D.

(14) Al-Kasani, op. cit. [3: 3].

Al-Mustasni' and Al-Sani'; and (II) to establish the entitlement of Al-Sani' to the agreed upon amount of the contract. This is because Istisna'a is a binding contract.⁽¹⁵⁾ This is the view adopted by recent civil Islamic legislations, and modern transactions, whereby both the transfer of title of ownership is automatic and unconditional and Al-Sani' is entitled to the agreed upon amount once the contract is constituted.⁽¹⁶⁾

7. Guarantee

7/1 Al-Mustasni' has the right to obtain collateral from Al-Sani' for:

- a) The total amount that he has paid.
- b) The delivery of Al-Masnoo' in accordance with the specifications and on due time.

7/2 Al-Sani' also has the right to secure collaterals to guarantee that the price is payable on due time.⁽¹⁷⁾

8. Penalty Clause

It is permissible for Al-Mustasni' to insert a penalty clause in the contract against unfulfillment of obligations by Al-Sani'.⁽¹⁸⁾

9. Options on Non-Compliance with Specifications

If Al-Masnoo' is not in conformity with the specifications, Al-Mustasni' has the following options:

- a) Reject Al-Masnoo', or
- b) Accept it without seeking damages.

10. Termination of Istisna'a Contract

The contract of Istisna'a may be terminated under the following conditions:

- a) Normal fulfillment of obligations by both parties.
- b) Mutual consent of both parties.

(15) Al-Kasani, op. cit. [3: 3].

(16) Abdullah, A.A., op. cit., (P. 59).

(17) Abdullah, A.A., op. cit., (P. 59).

(18) Islamic Fiqh Academy, 7th Session, Resolution No. (67/3/7), held on 7/12 Dhul-Qādah, 1412 A.H., corresponding to 9-14 May, 1992 A.D.

- c) Judicial rescission of the contract. This is if a reasonable cause arises to prevent the execution of the contract or its completion, and each party may sue for its rescission.⁽¹⁹⁾

11. Parallel Istisna'a

If Al-Mustasni' (the ultimate purchaser) did not stipulate in the contract that Al-Sani' (the seller) should manufacture the 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. This new contract is known as parallel Istisna'a, which is in essence a subcontract whereby the obligation of Al-Sani' in the first contract are carried out. Nevertheless,:

- a) The Islamic bank as Al-Sani' in the first contract will remain solely responsible for the execution of his obligations as if the parallel contract is nonexistent. Hence, Al-Sani' in the first contract would remain liable for any default, negligence or breach of contract ensuing from the parallel contract.
- b) Al-Sani' in the parallel Istisna'a is accountable to Al-Mustasni' (the Islamic bank) in the way and manner by which he performs his obligations. He has no direct legal relationship with Al-Mustasni' in the first contract. The second Istisna'a is a parallel contract, but not a contingent transaction on the first contract. Legally speaking they are different contracts with respect to the rights and obligations.
- c) The Islamic bank as Al-Sani' is liable to Al-Mustasni' with regard to any mal-execution of the subcontractor and any guarantees arising therefrom. It is this very liability that justifies the validity of the parallel Istisna'a and which also justifies the charging of profit by the Islamic bank, if any.⁽²⁰⁾

(19) See Recent Civil Islamic Legislations; Abdullah, A.A., op. cit, (pp. 61-62).

(20) Abdullah, A.A., op. cit., (pp. 62-66).

Similarities and Differences Between Salam and Istisna'a

Subject	Salam	Istisna'a	Rules and Comments
1. Subject matter of the contract	Al-Muslam Fihi	Al-Masnoo'	Deferred goods, known by specification.
2. Price	Paid at time of contracting	It is permissible to: a) Pay it at time of contracting; b) Defer it; or c) Pay it in instalments.	The means of settlement (in advance, deferred, or instalments) constitute the main difference between Salam and Istisna'a.
3. Nature of contract	Binding	Binding	Salam is originally binding on its parties, However, Istisna'a is considered binding based on the views of some Fuqaha for the sake of <i>Maslaha</i> and for not contravening any Shari'a rule.
4. Parallel contract	Parallel Salam	Parallel Istisna'a	Both parallel Salam and parallel Istisna'a are valid provided that: <ul style="list-style-type: none"> ▪ The two contracts are legally separated; ▪ The legal relationship between the parties to each contract is separate; and ▪ The rights and obligations of each contract are separate.

Appendix (D)

Reasons for the Standard

In their response to AAOIFI's letter of 30 Jumada I, 1416 A.H., corresponding to 24 October 1995 A.D., the Islamic banks gave priority to the preparation of a standard, among others, on Istisna'a and Parallel Istisna'a. This was endorsed by the Accounting and Auditing Standards Board in its meeting No. (9) held on 24-25 Rabi' II, 1416 A.H., corresponding to 19-20 September 1995 A.D., in Bahrain.

Istisna'a and Parallel Istisna'a are important modes of financing used by the Islamic banks. The accounting treatments by the Islamic banks of Istisna'a and parallel Istisna'a give rise to numerous problems due to the multiplicity of alternatives available for the treatment of many issues. Among the issues that are susceptible to significant differences in the accounting treatment are:

- Measurement and recognition of the costs of Istisna'a and parallel Istisna'a contracts.
- Measurement and recognition of the revenues and profits of Istisna'a and parallel Istisna'a contracts.
- Valuation of Istisna'a assets at the end of a financial period, especially when contract losses are expected.
- Measurement and treatment of contract maintenance and warranty costs.
- Scope and mode of disclosure of accounting information and policies relating to Istisna'a and parallel Istisna'a transactions in the financial statements of the Islamic bank.

Differences in the accounting treatments of such issues and their disclosure in the financial statements of the Islamic bank are expected to have adverse effects on the comparability of accounting information presented in the

financial statements of Islamic banks. Thus, the standardisation of accounting treatments of Istisna'a and parallel Istisna'a transactions on bases consistent with Statement of Financial Accounting No. (1): Objectives of Financial Accounting for Islamic Banks and Financial Institutions (Statement of Objectives), and the Statement of Financial Accounting No. (2): Concepts of Financial Accounting for Islamic Banks and Financial Institutions (Statement of Concepts) is necessary in order to provide useful information to users of the financial reports of these banks and for ensuring comparability of such information.

Appendix (E)

Basis for Conclusions

This appendix shows the alternatives taken into consideration when choosing the accounting treatment of Istisna'a and parallel Istisna'a and the justifications of the basis on which the chosen alternative was given preponderance.

The Accounting Standards Committee has reviewed in its meetings a number of alternatives, and the alternatives proposed in the preliminary study⁽²¹⁾ to be adopted in the accounting treatments of Istisna'a and parallel Istisna'a. The Accounting Standards Committee recommended the adoption of the alternatives which were considered to be in compliance with the previous Statement of Financial Accounting No. (1): Objectives of Financial Accounting for Islamic Banks and Financial Institutions (Statement of Objectives), and the Statement of Financial Accounting No. (2): Concepts of Financial Accounting for Islamic Banks and Financial Institutions (Statement of Concepts).

Recognition of Istisna'a Profit

Two alternative treatments were proposed for the recognition of Istisna'a profit:

- a) Percentage of completion method. According to this method, a portion of Istisna'a profit commensurate with the work completed during a period is recognized at the end of the period as a realized profit. That is, Istisna'a profit is allocated over the periods in which the contract is being executed in proportion to the work completed in each period. A crucial condition for applying this method is that the expected cost of completing the contract is estimated with reasonable accuracy.

(21) Abul-Izz, Muhammad Al-Said, "A Study of the Accounting Aspects of Istisna'a and Parallel Istisna'a", Accounting and Auditing Organization for Islamic Financial Institutions, 1418 A.H.-1997 A.D.

- b) Completed contract method. According to this method, the entire contract costs and revenues of Istisna'a contract are recognized at the end of the financial period during which the contract is completed. The first alternative; i.e., percentage of completion method, was chosen for the recognition of Istisna'a and parallel Istisna'a profit, provided that the contract costs can be estimated with reasonable accuracy. However, if the contract costs cannot be estimated with reasonable accuracy, the completed contract method should be used. The percentage of completion method is preferred because it provides for a better matching of Istisna'a revenues and expenses. Furthermore, it reflects in a more accurate manner the outcome of the earning activities of Al-Sani' (the Islamic bank) over the entire time period of contract execution, thereby presenting more relevant information to users of the financial statements.

Furthermore, the percentage of completion method enables investment accountholders to participate in Istisna'a profit as long as they have a contractual relationship with the Islamic bank. However, postponing the recognition of revenue and profits until the contract is completed (i.e., using the completed contract method) denies investment accountholders from their share in Istisna'a profits should they withdraw their funds before the contract is completed. Therefore, the second alternative (the completed contract method) should be applied only in unusual circumstances, i.e., when the first alternative (the percentage of completion method) is not applicable.

Valuation of Istisna'a Assets at the End of a Financial Period

Two valuation bases were considered for measuring Istisna'a assets at the end of the financial period in the financial statements of Al-Sani' (Islamic bank):

- a) Historical cost of Istisna'a assets is represented by both the book value of the Istisna'a work-in-progress account in an Istisna'a contract or the book value of the Istisna'a costs account in the case of parallel Istisna'a.
- b) Historical cost, as defined in alternative (a) above, provided it does not exceed the cash equivalent value.

Alternative (b) was chosen because it allows timely recognition of any expected losses in the execution of the contract at the end of a financial period. Hence, Istisna'a assets would not be inflated as would happen if these assets were not written down to account for the expected losses. Thus, the chosen alternative provides more relevant information for users of the financial statements.

Maintenance and Product Warranty Costs of Al-Masnoo'

The following two alternatives of accounting for maintenance and warranty costs of Al-Masnoo' were considered:

- a) Accrual basis: According to this basis, maintenance and warranty costs expected to take place for each period are estimated and matched against the Istisna'a revenues recognized for the same period. When incurred, actual maintenance and warranty expenditures are charged against the maintenance and warranty allowance account.
- b) Cash basis: According to this basis actual maintenance and warranty costs are charged against income for the financial period in which they take place.

The accrual basis (the first alternative) was chosen for Istisna'a contracts because it provides for a better matching of Istisna'a revenues and expenses. The cash basis (the second alternative), however, was chosen for parallel Istisna'a contracts based on the materiality concept because in a parallel Istisna'a such costs are born by Al-Sani' (i.e., the subcontractor).

Appendix (F)

Definitions

Istisna'a

It 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 acquire Al-Masnoo' (the subject matter of the contract) according to the specifications and sell it to Al-Mustasni' for an agreed upon price and method of settlement whether that be at the time of contracting, by instalments or deferred to a specific future time. It is a condition of the Istisna'a contract that Al-Sani' should provide either the raw material or the labour.

Parallel Istisna'a

If Al-Mustasni' (the purchaser) does not stipulate in the contract that Al-Sani' (the seller) should manufacture Al-Masnoo' by himself, then Al-Sani' may enter into a second Istisna'a contract in order to fulfil his contractual obligations in the first contract. The second contract is called Parallel Istisna'a.

Istisna'a Work-in-Progress Account

This is an asset account in which the Istisna'a contract costs are accumulated. When the percentage-of-completion method is used, a portion of Istisna'a profit commensurate with the work completed during a financial period is also debited to this account.

Istisna'a Costs Account

This is an asset account used when a parallel Istisna'a exists. It accumulates progress billings made by the subcontractor. A portion of the Istisna'a profit commensurate with the work completed during a financial period is also debited to this account.

Percentage-of-Completion Method

An accounting method that recognizes the revenues and profits of Istisna'a contracts as work progresses.

Completed-Contract Method

An accounting method that recognizes Istisna'a costs and revenues only in the financial period in which the contract is completed.

Contract Losses

Losses expected to happen when the sum of the costs accumulated in the Istisna'a account or receivable Istisna'a billing accounts and the estimated additional costs for the completion of the contract exceed the price fixed in the Istisna'a contract.

Change Orders

Approved modifications in the specifications, quantities, design, or other attributes defined in the original Istisna'a contract the implementation of which affects the contract costs.

Additional Claims

Amounts in excess of the agreed Istisna'a contract price which are claimed by Al-Sani' for delays, errors in the specifications and designs or other causes of unanticipated costs caused by Al-Mustasni'. Recognition of these claims by Al-Sani' requires the satisfaction of the following conditions:

- a) The existence of a legal basis for the additional claim supported by objective and verifiable evidence.
- b) Claims must be due to circumstances that were unforeseeable at the contract date and are not the result of the deficiencies, fault or negligence of Al-Sani'.
- c) Costs associated with the additional claim are identifiable and reliably estimable.



