Salam Accounting

Published in Management Accountant-official Journal of ICMA-Pakistan [Volume 25 (3)] 2016

Muhammad Hanif

Associate Professor

Bahria University

Islamabad, Pakistan

hanifacma@gmail.com

1. Introduction

Bai Salam is a form of sale contract where by IFIs purchase goods for spot payment with deferred delivery. Practically it is used in financing of agricultural needs of farmers. Farmers sell their crops prior to harvesting to IFIs in order to get money to purchase seeds and fertilizers. Generally spot price agreed is lesser than future prices on the actual date of delivery, hence IFIs are making profit. As a matter of practice IFIs are entering into a parallel Salam contract with third party to sell the proceeds once taken over however execution of second contract is not conditional to the fulfillment of first contract of Salam (Shari'a standard 10).

Application of Salam as a tool of financing could not get momentum in the operations of IFIs working in Pakistan in spite of having an agrarian economy. Share of agriculture in GDP is about 20% while providing jobs to 65% of the country's population living in rural areas; however, less than 20% of seven millions farm households have access to bank financing. Agricultural sector is vastly underserved as for banking services are concerned and is a potential market for Salam financing.

Future and forward contracts are very much dominating the business world. Futures and forwards are sold and purchased for currencies, stocks, gold, oil and other commodities. How Salam contract is different from futures and forwards is discussed in following paragraphs. Salam sale can be affected for only Halal fungible goods which are generally available in the market at the time of delivery. Physical delivery of goods forming subject matter of Salam contract is required by Islamic law while in case of futures and forwards physical delivery is not required. In most of the cases contract is settled on margins by the parties involved under futures and forwards. This practice of settling contracts on margins has led to short selling which creates imbalance in the market by affecting demand and supply of underlying commodity. Under futures and forwards goods are not sold and purchased rather claims are sold and purchased which create no utility for the society as a whole. It is zero sum game where certain individuals gain on the expense of others. Furthermore future and forward contracts create imbalance in the prices of consumable commodities (generally moving upward) by creating an artificial demand (e.g. prices of oil in 2007-08) which affects ordinary users. Two basic features of Salam sale (immediate payment of price and definite delivery of goods) differentiate it from futures and forwards.

2. Steps in Salam & Parallel Salam

Salam is used by IFIs to provide agricultural finance. As in modern economy role of banks is not trader hence they are not interested to create trading wings. Furthermore national laws are also not allowing banks to act as traders hence Salam sale contract is another device used to avoid interest in commercial transactions. Generally, banks after signing first transaction of Salam, search for a buyer of the goods and enter into parallel Salam contract. In a complete transaction of modern Salam contract normally following steps are involved. Figure 3.1 depicts process of Salam and parallel Salam sales.

1-2. Customer requests to an IFI for finance and sell the commodity with deferred delivery hence Salam sales contract is executed while payment is made by bank at spot.

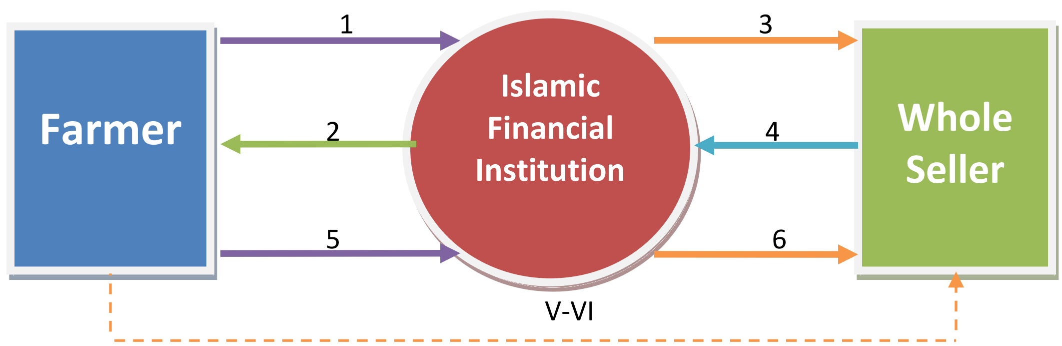
3-4. IFI enters into contract of parallel Salam with another party [usually a whole seller]; receives the payment at spot and signs contract of Salam with promise to deliver the goods at a point in time in future [usually delivery date from farmer].

5. At the date of delivery farmer [Seller in first Salam contract] delivers the goods to IFI to discharge his liability.

6. IFI delivers the goods to whole seller [buyer in Parallel Salam contract] hence transaction closed.

Under some exceptional circumstances goods are directly transferred to whole seller by farmer; however in even in this case IFI needs to bear risk of ownership till the discharge of liability [V-VI].

Figure -3.1. Graphic presentation of Salam sales process



3. Summary of Standard [FAS 7]

FAS-7 is effective from January 1999, addresses the accounting rules of Salam financing and parallel Salam transactions. Following is a summary of rules.

1. Salam financing shall be recognized when the capital of Salam is paid (whether in cash, kind or benefit) to Al-muslam Ileihi [seller of goods] or when it is made available to him. Parallel Salam transactions shall be recognized when the Islamic bank receives the capital of Salam. Capital is measured by the amount paid. Capital provided in kind or benefit shall be measured at the fair value.

I. ABC bank entered into a Salam contract by making payment of PKR 100,000 to Bhola, a farmer, for delivery of 10,000 kgs of wheat at completion of harvesting season. Salam contract duration is six months. After passing three months, bank sold the goods to a whole seller under parallel Salam contract for PKR 12/- Per Kg. On delivery date bank handed over goods to whole seller after taking possession from Bhola and contract completed.

II. Mr. Bhola contacted a local bank to provide a machine costing PKR 100,000, to be paid to bank after six months in the form of rice PKR 50/- per Kg. Bank handed over the required machine for a price of 100,000 [capital of Salam] and signed Salam contract for 2,000 Kgs of rice.
III. Akbar farming and HM bank entered into a Salam contract of 5,000 tons of rice @ price of 70/- per Kg. for miscellaneous banking and consultancy services amounting to PKR 350,000 [fair value of services].

2. At the end of a financial period capital is measured by the amount paid. However if it is probable that seller will not deliver the goods in part or in full or it is probable that value of goods to be delivered will decline, the Islamic bank shall make a provision for estimated deficit. Parallel Salam transaction shall be presented in the financial statement as liability.
Mr. Alam entered into a salam contract to supply 1,000 tons of apple to a local IFI for a price of PKR 70/- per Kg. IFI made the payment to seller immediately. At the time of closing market rate of Salam goods reduced to 60 and it is expected to prevail till the delivery date, IFI is required to charge the loss to income summary.

3. Assets received by the Islamic bank in accordance with the contract are recorded at historical cost. In the case of receipt of a similar kind of goods, but of a different quality; if the market value of the received goods is equal to the value of contracted goods, the received goods shall be measured at book value, however, if the market value is lower, then the difference shall be recognized as loss [same is the treatment for substituted goods].
1. Alam khan entered into a Salam contract with an IFI to supply 2 tons of super Basmati rice after six months @ PKR 80/- per Kg. Bank made the payment of Salam capital amounting to PKR 160,000. At the time of delivery seller could not arrange super Basmati rice and offered 2nd grade Basmati rice equal to 2.3 tons. Market price of 2nd grade is PKR 70/- per Kg. bank accepted the deal and contract completed.
2. Agha Bank purchased 3 tons of rice from Khan Farms under Salam sale for a price of PKR 50/- per Kg, for spot payment and deferred delivery for six months. Bank paid the Salam capital PKR 150,000. At the time of delivery, customer could not provide the specified rice and offered 6.5 tons of wheat, which was accepted by the bank. Market price of wheat per Kg is PKR 25/-

4. In case of failure to receive goods at due date and extension granted to seller, no change in Salam capital. If contract cancelled and client does not repay the capital of Salam the amount shall be recognized as receivable due from the client. In case Islamic bank has the securities pledged for Al-muslam Fihi [Salam goods] and proceeds from sale of the securities are less than book value of Salam goods, the difference is recognized as a receivable due from the client. However if proceeds are more than the book value, then the difference is credited to the client.
I. Raja of Gujar Khan entered into a Salam contract with local bank to provide 100 tons of wheat grade-II @ PKR 10/- per kg after six months for an amount of PKR 1 Million, received at spot. At the time of supply Raja asked for an extension of 30 days. Bank agreed without any change in required quantity to be supplied.

II. Raja of Gujar Khan entered into a Salam contract with local bank to provide 100 tons of wheat grade-II @ PKR 10/- per kg after six months for an amount of PKR 1 Million, received at spot. At the time of supply Raja could not provide the contracted commodity and contract cancelled without any charge.
III. Raja of Gujar Khan entered into a Salam contract with local bank to provide 100 tons of wheat grade-II @ PKR 10/- per kg after six months for an amount of PKR 1 Million, received at spot. Bank and Raja agreed to retain paper of plot of Raja as security. At the time of supply Raja could not provide the contracted commodity and security sold in the open market for an amount of PKR 2 Million. Bank is required to refund the excess amount.

5. At the end of a financial period, assets acquired through Salam financing shall be measured at the lower of cost and cash equivalent value; loss (if any) shall be recognized in income statement.
Bank of Bolan entered into Salam contract with Ch. of Khanewall for 10,000 bales of cotton @ PKR 1,000 per bale for spot payment with six months deferred delivery. After passing six month, customer delivered the required quantity of cotton bales as per specifications. At the time of closing, it was found that market value is 5% less than the cost. It is required as per AAOIFI standard to reduce the historical cost by PKR 500,000 [10,000,000 X 5%].

6. Upon delivery of goods by the Islamic bank to the client in a parallel Salam transaction, the difference between amount paid by the client and the cost of Salam goods shall be recognized as profit or loss.
On January 1, 2010, Aakash and Margalla bank entered into a Salam sales contract to purchase 5,000 tons of wheat for a price of 30,000 per ton and Salam capital paid amounting to 150,000,000, delivery to be made after three months. After passage of 60 days bank entered into a parallel Salam contract with Khan flour mills for 5,000 tons of wheat to be delivered after one month for a price of 160,000,000, paid at spot. In this transaction there is a profit of ten million, however same shall be recognized after delivery of goods to purchaser in parallel Salam contract i.e. April 2010.

4. Bookkeeping

In this section, journal entries are illustrated in the light of AAOFI financial accounting standard on Salam sale.
1. When a customer contacts an IFI for sale of intended commodities and IFI agrees to it, no journal entry is required, only a memorandum entry is made.

2 To record the Salam capital:
I. When Salam capital is paid or made available following journal entry is passed in the books of accounts. On March 1, 2010, Mr. Rashid a farmer enters into a Salam contract with a local Islamic bank to sell one ton (1,000 Kgs) of rice @ 60/- per Kg at the time of harvesting. Bank released an amount of 60,000 to customer in the hope that rice would sell @ 70/- per Kg after taking delivery. The amount of Salam capital is the actual amount paid and not the expected price of the commodity.

Journal

Date	Description	L/F	Debit	Credit
2010 Mar. 1	Investment In Salam Cash Salam capital made available to customer		60,000	 60,000
	Total		**60,000**	**60,000**

II. On March 1, 2010, Mr. Rashid a farmer enters into a Salam contract with a local Islamic bank to sell one ton (1,000 Kgs) of rice @ 60/- per Kg at the time of harvesting. As per agreement Bank provided a machine costing 50,000 for a price of 60,000 (fair value) to customer in the hope that rice would sell @ 70/- per Kg after taking delivery. The amount of Salam capital is the sales price machine, and not the expected price of the commodity.

Journal

Date	Description	L/F	Debit	Credit
2010 Mar. 1	Investment In Salam Machine Gain on disposal Salam capital paid by supplying a machine.		60,000	 50,000 10,000
	Total		**60,000**	**60,000**

III. On March 1, 2010, Mr. Rashid a farmer enters into a Salam contract with a local Islamic bank to sell one ton (1,000 Kgs) of rice @ 60/- per Kg at the time of harvesting. As per agreement Bank provided miscellaneous services for 60,000 (fair value) to customer in the hope that rice would sell @ 70/- per Kg after taking delivery. The amount of Salam capital is the sales price machine, and not the expected price of the commodity.

Journal

Date	Description	L/F	Debit	Credit
2010 Mar. 1	Investment In Salam Service Revenue Salam capital paid by providing services.		60,000	 60,000
	Total		**60,000**	**60,000**

2. On April 31st bank entered into a Salam contract with a local whole seller of rice, for disposal of expected 1,000 Kgs of rice @ 75/- per Kg to be delivered on September 15 and received the price at spot. This is a parallel Salam contract meant for disposing of expected delivery of rice, however as per Islamic financial laws, performance of parallel Salam contract is not conditional on the performance of original Salam contract (first contract). It is important to note, that we have three different prices of underlying commodities are available including a price negotiated with seller 60/- per Kg; a price we were expecting at the time of delivery 70/- per when contract executed; and finally a price agreed with purchaser. However as per AAOIFI standard, the entry shall be made for a price received from purchaser. There is a profit of 15/- per kg of rice, but this profit shall be recognized at discharge of liability by transferring the

goods, hence recognition of profit is postponed. The status of parallel Salam revenue is liability, till the delivery of goods. Following is the journal entry to record foregoing transaction.

Journal

Date	Description	L/F	Debit	Credit
2010 Apr. 31	Cash Parallel Salam Cash received under parallel Salam of goods to be delivered on September 15, 2010.		75,000	 75,000
	Total		**75,000**	**75,000**

3. At the time closing June 30, 2010 market price of rice fallen to 55/- per Kg, hence a reduction in the value of intended commodities is required to be made as under.

Journal

Date	Description	L/F	Debit	Credit
2010 Jun. 30	Loss on revaluation-Salam Investment In Salam Value of Salam commodities reduced		5,000	 5,000
	Total		**5,000**	**5,000**

4. On September 5, 2010, the delivery date, any of the following might emerged:
I-Required amount of goods handed over to bank by customer. As per AAOIFI standard, goods shall be recorded at historical cost.

Journal

Date	Description	L/F	Debit	Credit
2010 Sep. 5	Salam commodities-Rice Investment In Salam Salam goods received as per agreement.		55,000	 55,000
	Total		**55,000**	**55,000**

Goods received from customer were supplied to purchase on September 15, 2010 following journal entry is passed.

Journal

Date	Description	L/F	Debit	Credit
2010 Sep. 15	Parallel Salam Salam commodities-Rice Income Summary Salam contract closed at profit by supplying goods to purchaser as per agreement.		75,000	 55,000 15,000
	Total		**55,000**	**55,000**

II-Suppose customer could not provide the required quality of rice and substituted the rice with wheat at an agreed price of 22/- per Kg (market price 25/- per Kg), and bank accepted 2.727 tons of wheat. On this deal historical price of Salam capital shall be recorded in books as market price of supplied goods is higher than contracted goods, following journal entry is required.

Journal

Date	Description	L/F	Debit	Credit
2010 Sep. 5	Salam commodities-Wheat Investment In Salam Salam contract closed by exchanging one ton of rice with 2.727 tons of wheat.		55,000	 55,000
	Total		**55,000**	**55,000**

III-In the absence of delivery of rice by customer, bank purchased the rice from open market @ 70/- per Kg and delivered to purchaser. Also sold the wheat @ 25/- per Kg, in the open market. Following entries are required to close the deals.

Journal

Date	Description	L/F	Debit	Credit
2010 Sep. 15	Cash Salam commodities-Wheat Income summary Wheat received under Salam contract disposed.		68,175 55,000	 55,000 13,175
Sep. 15	Salam commodities-Rice Cash Goods purchased to be delivered to purchaser		70,000	 70,000
Sep. 15	Parallel Salam Salam commodities-Rice Income summary Goods delivered under parallel Salam and contract closed at profit.		75,000	 70,000 5,000
	Total		**268,175**	**268,175**

5. In case customer could neither provide contracted commodities, nor cash; and bank had to sell security. As a rule, if security sold for an amount not covering cost of contracted goods, balance shall due from customers, however in case of excess amount on sale of security, the difference shall be credited to him. Suppose in this transaction there was a security provided by customer to bank, which sold for 90,000/-; following would be accounting treatment.

Journal

Date	Description	L/F	Debit	Credit
2010	Cash		90,000	

Sep. 15	Investment In Salam Income summary Rashid-Customer Salam contract closed by selling security for 90,000; loss recognized earlier on Investment in Salam reversed, excess amount credited to customer.			55,000 5,000 30,000
	Total		**90,000**	**90,000**

5. Financial Impact of Salam

Financial reporting and financial impact of Salam are discussed in following paragraph. I shall illustrate with a hypothetical balance sheet and show the impact of different transactions on balance sheet of an IFI. Balance sheet of an IFI is little different from balance sheet of a conventional bank in the sense that IFIs are accepting deposits on either as loan which is in line with practices of commercial banks and does not create any difference in balance sheet; or on profit and loss sharing basis under Musharaka and Mudaraba which changes the nature of relationship between customers and IFIs. Deposits under profit and loss sharing (PLS) modes including Musharaka & Mudaraba are not shown as liabilities in the balance sheet rather form part of equity.

On the other hand conventional banks lend money and show advances to customers as assets while IFIs do not lend cash rather sell the goods on credit hence resulting in receivables under Murabaha, Muajjal etc. Furthermore IFIs invest in businesses that need cash financing under scheme of Musharaka & Mudaraba; hence, investment under Musharaka & Mudaraba is shown as investment and not the receivables or advances. Let us look at a simple balance sheet of an IFI.

First Islamic Bank

Balance Sheet, as at December 31, 2009

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. (000)**
Current Assets		**Liabilities**	
Cash and balances	4,586	Payables and balances	400
Accounts R/A	1,000	Current deposits	3,300
Inventory (assets for sale)	500	Accrued expenses	50
Accrued revenue	200	**Total liabilities**	**3,750**
Short term investments	150	**Equities**	
Total current assets	**6,436**	PLS deposits balances	1,500
Investments under PLS	1,000	**Shareholders' equity**	
Property, plant & equipment	2,000	Paid up capital	3,000
Total long term assets	**3,000**	Statutory reserves	400
		R. earnings/ Un appropriated	786
		Total Equities	**5,686**
Total assets	**9,436**	**Total liabilities & Equities**	**9,436**

Suppose on January 01, 2010, Mr. Shah contacted the Lahore branch of First Islamic Bank (FIB) to advance Rs; one million for purchase of seeds and fertilizers for six months to be paid by delivery of 50 tons of wheat by July 30th 2010. FIB agreed to provide required financing in cash by opening current account of Mr. Shah and prepared Salam sale contract duly signed by both parties on 5th January, 2010. At the same day account opening form was signed by Mr. Shah. This transaction has effect on both sides of balance sheet. A current deposit is generated on liabilities side (consequently current deposits increased by one million) and an investment under Salam Financing, of equal amount has been created on assets side.

First Islamic Bank

Balance Sheet, as at January 05, 2010

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. (000)**
Salam financing	1,000	Current deposits	4,300
Other assets	9,436	Other Liabs. & Equities	6,136
Total assets	**10,436**	**Total liabilities & Equities**	**10,436**

Suppose on 1st May, 2010, FIB searched another party Mr. Chaudhary as potential buyer of 50 tons of wheat @ Rs; 21,000 per ton, and enter into parallel Salam of wheat to be delivered on July 31, 2010. Impact of this transaction is shown as follow. Following balance sheet shows impact of cash withdrawn by Mr. Shah the seller of wheat to FIB and cash payment of Mr. Chaudhary the ultimate purchaser from FIB. Withdraw of cash by Mr. Shah reduced the current deposit while payment of amount by Mr. Chaudhary shown under the heading of parallel Salam. On the other hand cash reduced by Rs; 1,000,000 withdrawn by Shah and increased by Rs; 1,050,000 paid by Mr. Chaudhary.

First Islamic Bank

Balance Sheet, as at May 31, 2010

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. (000)**
Salam financing	1,000	Current deposits	3,300
Other assets	9,486	Parallel Salam	1,050
		Other Liabs. & Equities	6,136
Total assets	**10,486**	**Total liabilities & Equities**	**10,486**

Now suppose on June 1, 2010 Islamic bank come to know that prices of wheat has fallen to Rs; 19,000 per ton hence the commodity to be received has lost a portion of its book value. Current market price is 50,000 X 19 = Rs; 950,000. An immediate write off of loss is required as per accounting standard on Salam. Impact of this write off is shown as under. This event affected equities as well as Salam financing by equal amount because loss in value is charged to equities of Islamic bank

First Islamic Bank

Balance Sheet, as at Jun 01, 2010

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. (000)**
Salam financing	950	Current deposits	3,300
Other assets	9,486	Parallel Salam	1,050
		Other Liabs. & Equities	6,086
Total assets	**10,436**	**Total liabilities & Equities**	**10,436**

On July 30, 2010, Mr. Shah provided 50 tons of wheat which handed over to Mr. Chaudhary and shifting expenses (from fields of Shah to storage of Chaudhary) incurred amounting to Rs; 10,000. Financial impact is shown below.

First Islamic Bank

Balance Sheet, as at July 31, 2010

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. (000)**
Current Assets		**Liabilities**	
Cash and balances	4,626	Payables and balances	400
Accounts R/A	1,000	Current deposits	3,300
Inventory (assets for sale)	500	Accrued expenses	50
Accrued revenue	200	**Total liabilities**	**3,750**
Short term investments	150	**Equities**	
Total current assets	**6,526**	PLS deposits balances	1,500
Investments under PLS	1,000	**Shareholders' equity**	
Property, plant & equipment	2,000	Paid up capital	3,000
Total long term assets	**3,000**	Statutory reserves	400
		R. earnings/ Un appropriated	826
		Total Equities	**5,776**
Total assets	**9,526**	**Total liabilities & Equities**	**9,526**

This transaction has affected parallel Salam account, Salam account, cash account (other assets) and retained earnings account (Equities). In fact bank earned a profit of Rs; 100,000 and incurred expenses of Rs; 10,000. Cash decreased by Rs; 10,000 while Salam financing account come to an end as well as parallel Salam account also finished. Let us see the balance sheet as at July 31st 2010.

Suppose Mr. Shah was unable to deliver the goods on due date and FIB had to acquire the goods from market @ Rs.21, 500 per ton to deliver to Mr. Chaudhary because under Salam frame work performance of parallel Salam is independent of Salam contract. FIB has to suffer loss of Rs; 25,000 plus transportation cost of Rs; 10,000. At this point in time Salam financing would become receivables from Mr. Shah hence a profit of Rs; 50,000 realized because FIB reduced the amount of Salam earlier by Rs; 50,000. Now the original amount becomes receivables due to recovery of Rs; 50,000 earlier written off. Net result is loss of Rs; 35,000 on this transaction.

First Islamic Bank

Balance Sheet, as at July 31, 2010

Assets	**Rs. (000)**	**Liabilities & Equities**	**Rs. (000)**
Current Assets		**Liabilities**	
Cash and balances	3,551	Payables and balances	400
Accounts R/A	2,000	Current deposits	3,300
Inventory (assets for sale)	500	Accrued expenses	50
Accrued revenue	200	**Total liabilities**	**3,750**
Short term investments	150	**Equities**	
Total current assets	**6,401**	PLS deposits balances	1,500
Investments under PLS	1,000	**Shareholders' equity**	
Property, plant & equipment	2,000	Paid up capital	3,000
Total long term assets	**3,000**	Statutory reserves	400

		R. earnings/ Un appropriated **Total Equities**	751 **5,651**
Total assets	**9,401**	**Total liabilities & Equities**	**9,401**

6. Comparison of IAS Vs FAS

In this section an account of comparison of conventional and Islamic accounting standards, relating to Salam transactions are presented. Under conventional framework, no such product of a bank, known as Salam or similar, exists. Consequently, no guidance about accounting for Salam financing does exist in international accounting standards framework. However, as we know, both types of institutions (i.e. conventional and Islamic) are working in the same business environment, hence, substitutes do exist. In case of Salam financing, primarily meant for agriculture, whereby IFIs purchase commodities from farmers, by making spot payment of price, with deferred delivery of goods; conventional banks extend agricultural loans for interest. Job of conventional bank is relatively easier as no search for a buyer of Salam goods is required; as well as no risk bearing of reduction in the prices of Salam goods; the only risk is credit risk or default risk, which is equally present in Salam financing for an Islamic banker, in addition to two other types of risks listed above. In order to understand the difference in accounting for two types of contracts i.e. Salam financing and agricultural loan executed by Islamic and conventional banks, respectively, let us look at an illustration as under.

Iftikhar of Norowaal, a farmer, is in need of PKR 1Million for six months, to purchase the seeds and fertilizer for his multi hectors of land, situated at the left bank of Upper Chenab Canal. He has two options i.e conventional and Islamic finances as under.

1. Conventional loan @ 10% interest for six months, payable in lump sum at the end of the period.
2. Salam financing; to sell required quantity of rice @ 50/- per Kg (expected market price 55-60 after six months)

Following is accounting result, under both conventional and Islamic accounting assuming contract started on 1st day of October 2010.

I-Salam Accounting

There can be multi-outcomes under Salam financing contract; however in this section accounting is illustrated based upon normality of everything. It is assumed that Islamic bank faced the both additional challenges (finding customer & price risk) as under:

- At the time of closing fourth quarter of year 2010, bank made a provision of 2% reduction in the value of Salam goods.
- In the mid of March, Islamic bank succeeded in finding a customer for sale of Salam goods through parallel Salam, for a price of 1.1 Million.

Following journal completes the recording of transactions.

Journal

Date	Description	L/F	Debit	Credit
2010	Investment In Salam		1,000,000	
Oct. 1	Cash			1,000,000
	Salam financing provided to customer in exchange for 20 tons of rice @ 50,000 per ton.			
Dec. 31	Income Summary		20,000	
	Provision for reduction in Salam goods price			20,000
	2% Provision for reduction in value of Salam goods is created.			
2011	Cash		1,100,000	
Mar. 15	Parallel Salam			1,100,000
	Goods contracted in Salam financing sold in Parallel Salam			
Mar. 31	Salam commodities-Rice		1,000,000	
	Investment in Salam			1,000,000
	Contracted goods in Salam received as per specification.			
Mar. 31	Parallel Salam		1,100,000	
	Salam Commodities			1,000,000
	Income Summary			100,000
	Goods transferred to purchaser in Parallel Salam as per contract.			
Mar. 31	Provision for reduction in Salam goods price		20,000	
	Income Summary			20,000
	Provision for reduction in price of rice is no longer required, hence reversed to income summary account.			
	Total		**4,240,000**	**4,240,000**

Note: In the light of foregoing entries, following impact is found on financial reporting of an Islamic bank due to this Salam contract.

- Income Summary last quarter of 2010; Nothing earned, but a reduction in the profit by 20,000
- Income Summary first quarter of 2011; Profit earned on closure of transaction amounting to 100,000 and reversal of provision for price reduction generated another 20,000 credit in income summary, hence Increase in profit by 120,000.

II-Conventional Accounting

Quarterly earned interest income is 50,000, entries are recorded as under.

Journal

Date	Description	L/F	Debit	Credit
2010 Oct. 1	Advances-Customer		1,000,000	
	Cash			1,000,000
	Agricultural finance is provided to customer for six months @ 10%.			
Dec. 31	Interest R/A		50,000	
	Interest income			50,000
	Interest income earned for first quarter.			
Dec. 31	Interest income		50,000	
	Income Summary			50,000
	Interest income transferred to income summary			
2011 Mar. 31	Interest R/A		50,000	
	Interest income			50,000
	Interest income earned for 2nd quarter.			
Mar. 31	Interest income		50,000	
	Income Summary			50,000
	Interest income transferred to income summary			
Mar. 31	Cash		1,100,000	
	Advances-Customer			1,000,000
	Interest R/A			100,000
	Amount of agricultural loan received back along with interest income			
	Total		**4,240,000**	**4,240,000**

Note: In the light of foregoing entries, following impact is found on financial reporting of a bank due to this financing contract.

- Income Summary last quarter of 2010; interest income 50,000
- Income Summary first quarter of 2011; interest income 50,000

Assuming that both banks earned a profit of 1,000,000 in last quarter of 2010 and a profit of 2,000,000 in second quarter of 2011, except this financing transaction. Following is the net result for both institutions.

Table 3.7.1-Comparative Income Statements (Quarterly)

Description	LQ:2010	FQ:2011
Islamic Accounting		
Profit other than Salam financing	1,000,000	2,000,000
Provision for reduction in prices of Salam Commodities	-20,000	-0-
Profit on Parallel Salam	-0-	100,000
Reversal of provision no longer required	-0-	20,000
Net Income	**980,000**	**2,120,000**
Conventional Accounting		
Profit other than Agricultural finance	1,000,000	2,000,000
Interest Income	50,000	50,000
Net Income	**1,050,000**	**2,050,000**
Difference	**-70,000**	**+70,000**

Under AAOIFI standards more conservative approach is adopted and profit is postponed, as well as provision for decline in price is also created, hence results are totally different from conventional accounting. It is concluded that application of conventional accounting is not suitable for Salam financing. It is pertinent to note that adoption of AAOIFI standards should be on immediate agenda of stakeholders through relevant legislation.

References

- AAOIFI. 2004. *Shari'a Standards.* P.O. Box 1176, Bahrain.
- AAOIFI.2003. *Accounting and Auditing Standards for Islamic Financial Institutions,* International Institute of Islamic Economics, Islamabad, Pakistan.
- C.I.I. (1980). Council of Islamic Ideology: Report on Elimination of Interest from Economy.
- Hanif, M., (2012). Islamic Banking: Theory & Practice, 2nd edition, Createspace limited liability company, Amazon.com
- Khan, M.A., (1989). Economic Teachings of Prophet Muhammad: A Select Anthology of Hadith Literature on Economics, chapter 6:2, page 72. *International Institute of Islamic Economics,* P.O. Box 1647, Islamabad, Pakistan.
- SBP 2010. [State Bank of Pakistan] *Islamic Banking Bulletins 2007-2010.*
- Usmani, T.S., 2002.An Introduction to Islamic Finance. Maktaba Ma'arif Al Quran, Karachi, Pakistan.