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Accounting for the Istisna agreement in financial institutions

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Abstract: This article recognizes istisna, which is one of the methods of financing in financial organizations and banks, the conditions for its implementation, as well as its essence. Based on the requirements of Islamic economics, the requirements for istisna and parallel istisna, specific aspects of exemption are reflected in the article. The procedures for reflecting istisna and parallel istisna in accounting, various aspects of reflection in traditional accounting are explained. Conclusions are made about the advantages of using the istisna instrument.

Keywords: Istisna, financing, production of goods, contract, payment schedule, exceptional expenses

Introduction

Istisna financing is a type of contract that is a special form of sale used in infrastructure, construction, manufacturing and other types of production involving materials or work in progress. It is a sales contract between an end buyer and a manufacturer who agrees to produce or purchase manufactured products according to agreed terms. In this type of financing, the value can be paid in advance, in installments or at a future date. In addition to istisna, there is also a parallel istisna agreement, a type of agreement that occurs when the final buyer does not stipulate that the manufacturer will not subcontract [Abdullaev, 2020]. Thus, it allows the manufacturer to enter into a second contract to fulfill the obligations of the first contract. In this case, two istisna agreements arise, but they should not be dependent on each other. The contractual obligations under each contract are separate and its provisions affect only the contracting parties. For example, a consumer enters into an istisna contract to receive goods from an IFI (Islamic Financial Institution) with a prepayment for delivery. The IFI takes the payment received as an obligation and

records it as a payable [Kharisova, 2018]. The IFI then finds a manufacturer to produce the goods. The amount paid by the bank to the producer of the goods is recorded as istisna financing. The two contracts are separate, with the IFI acting as the producer in the first contract and the intermediary-buyer in the second. Typically, istisna financing is used in the industrial and infrastructure sectors of the economy because it provides greater flexibility than the Salam contract and combines the advantages of leasing with unique risk-sharing features.

Literature review.

The istisna tool is considered a future-oriented tool. The word "Istisna" comes from the Arabic root "sana" which means "to produce something" or "to build". The meaning of the word is an order or request to produce something in which the requesting party invites, encourages or forces the other party to make or produce a product for him. Istisna is a contract between two parties to produce a certain product according to certain specifications, at a specified price and within a specified time [Burvina, 2024]. Naimov, on the other hand, gives a broader definition of istisna. In his opinion, istisna is a type of trade, which is realized before the manufacture of goods and means placing an order with the manufacturer for the manufacture of a certain product for the buyer. If the manufacturer undertakes to produce the goods from his own materials, an istisna agreement arises [Naimov, 2020]. In istisna, the bank's profit is determined in advance by the difference between the purchase and sale prices of the two contracts (with the contractor and the customer) in an intermediary transaction, and istisna is used in the implementation of large projects, such as the construction of housing complexes [Makoveeva, 2019]. According to Valinurova [Valinurova, 2020], for istisna to be valid, the price must be set by agreement between the parties and the necessary characteristics of the goods to be produced must be fully discussed between them.

An istisna is defined as a type of contract based on buying something now at a certain price that can be produced or built at a later date. The object of an istisna often does not exist at the time of the agreement, but is subsequently prepared by the manufacturer or contractor. An istisna is a sales contract that covers the manufacture

of products to predetermined specifications rather than based on known characteristics. This type of contract is only valid for items to be manufactured or constructed. However, if this condition is not specified in the contract, the seller is not obliged to manufacture the goods himself. In this case, the type, quality, and quantity of the subject matter of the istisna contract (the item to be manufactured or constructed) must be known and precise.

Research Methodology.

In the course of the research such methods as observation, comparison, systematic and comparative analysis were used. Numerous domestic and foreign literary sources on the topic were studied and analyzed. The current trend on the topic was assessed.

Analysis and discussion of the results.

This contract can be found in practice in many countries in the garment industry, where the customer seeks a tailor to design, measure, cut and sew a customized garment and pays a deposit for the subsequent delivery of the finished product with full payment. As a manufacturer, the tailor provides his own materials and labor to complete the order. Similar processes can be observed in various professions, such as builders, carpenters and other craftsmen, where a constructive binding contract is made between the buyer and the producer based on the characteristics of the goods, only the price, payment and delivery terms [Garifullin, 2019]. The price is determined on the basis of estimated production costs, taking into account additional costs if necessary. The method of payment can be in the form of full or partial prepayment, in advance payments or a lump sum payment at the end of the term after delivery. Deliveries are made at the end of the cycle and are continuously monitored and evaluated at various stages of the production process. While they provide flexibility in terms of financing, the risks are different. In general, credit risk relates to non-delivery as well as non-repayment of the financing amount, and risk mitigation tools in the form of collateral and performers are used to address the various risks. In traditional circumstances, it is believed that a customer engaged in selling products is able to raise funds to finance the production process. However,

in the areas of industrialization and large scale construction of real estate and infrastructure, banks are engaged in long term project financing. The istisna payment is accepted as a means of financing and the process of financing istisna is accepted as a means of financing production. Flexibility in the financing structure of istisna contracts is realized on the basis of the following scenarios.

Table 1

Funding istisn

	Period	Payment	Delivery
The first scenario	The same validity period applies to both contracts.	Same payment schedules	Same delivery dates
Second scenario	The same validity period applies to both contracts.	Various payment schedules	Same delivery dates

In the first scenario, the IFI finances the producer with funds received from the customer without involving its shareholders and investors. The difference between the price offered to the customer and the price received from the producer at special prices is the profit of the IFI, which fully assumes the risk of not receiving the products from the producer on time. Market risk may also arise in the execution of the second contract. In the second scenario, the IFI finances the producer by raising its shareholders and stock funds. At the end of the contract term, the amount financed will be repaid from the payments made by the client. The profit from this price difference generates a financial profit that takes into account the risk of late delivery of the goods to the customer as well as the risk also associated with the maturity of the second contract.

Full information should be provided on the type of products produced, their quality and total utilization. Information on delivery dates, milestones or specific dates shall be determined by negotiation between the contracting parties. However, in the terms and conditions of general use, the delivery date may also be defined and specified. This is considered a mandatory condition of the contract. However, the actual delivery date may differ from the specified date. The price shall be known in advance and may vary depending on reasonable increases or decreases in material and labor costs. Changes to the contract may be made by mutual agreement or due to

unforeseen circumstances. Prior to the expiration of the contract, both parties have the right to terminate the contract if either party does not agree to a material change in the contract. In other words, the customer may withdraw and the manufacturer may decide not to continue the contract. The supplier is not obliged to deliver the goods at the time of manufacture and the customer is not obliged to accept the goods. This is because the contract does not cover the final product, but rather the product at various stages of the manufacturing process. However, the customer may retain the right not to accept the contract, but both the supplier and the buyer may waive such rights, thereby making the contract binding. Some legal viewpoints indicate that the contract is binding on both parties based on the terms and conditions set out therein. The legal aspect of an exclusive contract is that once all the specified conditions are met, the goods are automatically transferred from the manufacturer to the buyer at an agreed price.

By ensuring timely payment and delivery of goods and services, the IFI plays an important role in facilitating delivery when necessary and making the necessary payments to ensure timely completion of the production process [Danchenko, 2015]. In doing so, the IFI must ensure timely payment from the customer at each stage of production. If payment is made before the goods are delivered, the customer has the right to demand similar guarantees or security. The contract may include a penalty clause in case the builder fails to fulfill its obligations, for example, overestimating the cost of the project. Failure of products to meet specifications gives the customer the option to reject or accept the production facility without claiming damages. Termination of a contract occurs when both parties agree to terminate the contract, provided that both parties have fulfilled their obligations, or when a court orders termination if there are justifiable reasons preventing performance or completion of the contract.

Financial Accounting Standard No. 10 of the Accounting and Auditing Organization for Islamic Financial Institutions establishes accounting rules for tax-exempt and concurrent tax-exempt contracts. The standard regulates the recognition and measurement of expenses and revenues and gains and losses in financial

accounting and their presentation and disclosure in financial statements. The standard clarifies the financial reporting requirements of the manufacturer and the purchaser. Istisna costs include the direct cost of the product and indirect costs associated with the contract on an objective basis. In other words, the cost of the product is recognized as an istisna cost. Period costs such as selling, general and administrative expenses and research and development costs are not included in istisna costs [Makoveeva, 2019].

The cost of production as well as pre-contract costs determined during the financial period should be recognized in the istisna work-in-progress account and reported as assets in the statement of financial position. However, this financial accounting transaction is classified as an istisna expense in the financial accounting records of the financial institution (as seller) in parallel with istisna. Invoices issued by the IFI for payments to the customer are recorded as istisna invoices and istisna receivables. Istisna income is subsequently calculated against the expenditure recorded in the Istisna account or the Istisna expense account. In the event that costs falling under Istisna are incurred, they will be recovered from the difference between the price agreed with the manufacturer and the purchaser. Istisna transactions are recorded in the accounting records as follows:

Table 2

Accounting operations

№	**Description of accounting translation**	**Accounting entry**
1.	When the bank executes the contract as a seller	DT Deferred expenses KT Money
2.	When direct and indirect material costs are incurred under the contract	Dt Istisna Production Kt Cash
3.	Transfer of pre-contract costs to cost of sales upon contract termination	Dt Istisna Production Kt Deferred expenses
4.	Recognition of istisn income	DT Istisna production (including profit) DT Expenses related to true revenue (equal to the difference between revenue and profit)

5.	After the buyer has made payment	Dt Accounts receivable for the cost of goods and services Kt Istisna Settlement
6.	Upon receipt of payment	Dt Cash Kt Accounts receivable for the cost of goods and services
7.	Generally, the customer's next payments begin when the goods are received and deferred revenue is determined and amortized in proportion to the next payments received	DT Istisna income KT Deferred benefit (in full) Dt Deferred benefit (installment ratio on accounts receivable) KT Profit and Loss Account
8.	If the customer makes a prepayment	Dt Deferred benefit Kt Accounts receivable
9.	If there is a reduction in the value of work in progress or contractual losses arise	Dt Profit and loss Kt Istisna Production
10.	Maintenance and warranty costs	DT Profit and loss Istisna Kt Istisna
11.	When additional costs are incurred due to changes in an order placed by the customer (these additional costs can be charged to the customer and therefore become income for the bank)	Dt Istisna Production Kt Cash
12.	If the seller refuses to accept the asset	Dt Active istisna account Kt Istisna Production
13.	If the cash equivalent of the cost of an istisna asset is less than the carrying amount of that asset, the accounting entries will be different	DT Profit and loss DT Active Istisna account KT Istisna production Dt Cash Kt Active istisna account
14.	Situations in which the bank acts as a purchaser. Recognition of expenses	DT Istisna Cost Account KT Cash
15.	Payment received from contractor	Dt Istisna Costs Account Kt Paid invoice
16.	Payments are made to the contractor	Dt Paid invoice istisna Kt Cash
17.	Asset acquisition process	DT Active istisna Kt True Cost Account
18.	When an asset is acquired, its cost is written down to its cash equivalent	Dt Asset istisna DT Profit and Loss Account Kt Paid invoice

19.	When an Islamic bank does not accept non-compliant assets	Dt Accounts receivable for the cost of goods and services Kt Istisna Costs Account

The revenue from an IFI's Istisna is the total price agreed between the IFI and the ultimate buyer. The price of the first Istisna contract is also classified as parallel Istisna. It includes a profit margin, which is defined as the difference between the Extraordinary Costs and Extraordinary Expenses accounts. Istisna revenue and the corresponding profit margin are measured and recognized using the matching or accrual method. The former covers different phases of the contract period, with revenue and profit recognized proportionately. In the second, revenue is recognized at the end of the contract period. Parallel istisna revenue and profit are recognized using the percentage-of-completion method because sales and cost prices are known with moderate accuracy [Kazieva, 2020]. The recognized portion of the profit is added to the Extraordinary Expenses account. Thus, the balance in the account is equal to the total cost of the istisna agreement and the benefit from istisna is recognized before the balance sheet date.

A portion of the agreed revenue is recognized over the term of the contract together with related costs. These are added to the company's work-in-progress account. Deferred profit represents the difference between the total price paid (to the project contractor) and the total price agreed (with the end user) over the contract period and is included in the istisna receivable. The preferred method of recognizing profit is the proportionate allocation of deferred profit. An alternative method, if required by the Supervisory Board (NS), is to use the recognition method upon payment. Upon early settlement, a portion of the profit is canceled and deducted from the accounts receivable and deferred profit istisna. Both the istisna work-in-progress account and the istisna costs should be measured at a value that does not exceed the equivalent value in cash, i.e. the contract value should be recognized net of the additional costs incurred to fulfill the contract.

Any expected loss is included directly in the income statement. Such a loss to the IFI may arise if the manufacturer fails to deliver according to specifications. Any

orders or claims agreed between the customer and the IFI shall be duly taken into account. The calculation of maintenance and warranty costs should be in line with non-taxable income. Upon receipt of invoice from the IFI, the payment for istisna shall be remitted to the IFI with the relevant istisna calculations attached. Once the product is completed in accordance with the specifications, the assets are recorded at original cost. If the originally agreed requirements are not met, the customer terminates the contract, causing full payment to the IFI and payments from the manufacturer to become receivable, or accepts the product with unrecovered losses. Below is an example of Istisn's financing:

The value of the two-year contract of the Islamic Finance Institute is 800,000 c.u.. A contract has been concluded with a customer for the construction of the facility, with an estimated contract value of 500,000 c.u. In parallel, the IFI has concluded a contract with a construction organization in the amount of 500,000 c.u. for the construction of the facility.

The following was noted during the contract period:

Table No. 3

Displaying the istisn operation in the

	1 year	**2**
Costs	300000 c.u.	200000 c.u.
Required calculations	400000 c.u.	400000 c.u.
Customer commissions	350000 c.u.	450000 c.u.

Table No. 4

Record the true transaction in the report (financial result)

	1 year	**2**
Fulfillment, %	75%	25%
Income	000	200000
Eastisna cost of sales	(375000)	(125000)
Istisna income	225000	75000

At the end of the second year, all accounts are closed

Conclusions

Thus, the tax exemption agreement will facilitate the financing of future delivery of goods and projects. The risk of contingency does not arise from non-payment as in Murabaha scheme financing, but from failure to execute the project within the planned timeframe or to deliver the goods. In Salam scheme financing, the goods must meet the qualitative and quantitative characteristics of the customer as specified in the contract and payment must be made in advance. Coordination of overheads in construction and production activities financed in istisna is required. A flexible payment and staged delivery system was adopted to allow both the financier and the developer to coordinate payments with deliveries at different stages of the project. Meeting expectations for quality, quantity, cost, time and other requirements specified in the contract is critical to the completion of the delivery process. Any changes in the specifications of the goods that reduce the value of the goods are accounted for as damages at the time of delivery. The two contracts (Istisna and Parallel Istisna) are separate contracts and are not related to each other in terms of contractual rights and obligations. As a financing agreement, Istisna financing facilitates the construction or manufacture of products, while Parallel Istisna provides flexibility in the payment schedule for the end buyer, thereby allowing the end buyer to obtain a longer credit period than the financing period granted to the manufacturer. In addition, each party has the right to waive the right not to deliver or accept the product, thereby making the contract binding on one or both parties. The product, not the period, is recognized as an istisna cost. Istisna costs and precontract costs are recognized as assets in the work-in-progress account. Estisna is settled on the basis of figures corresponding to receivables.

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