O ye who believe! When you deal with each other, in transactions involving future obligations in a fixed period time, reduce them to writing (Baqara 2:282):

Ibn Abbas is reported to have said: the Prophet peace be upon him has came to Medina and found that people were selling dates for deferred delivery after a duration of one or two years on a Salam basis. The Prophet peace be upon him said: whoever pays for dates on a deferred delivery basis (salam) should do so on the basis of a specified scale and weight. In another version of the hadith whoever pays on a deferred delivery basis should do so on the basis of a specified scale, weight and date of delivery(Sahih Al Bukhari, 2/781)

CHAPTER 11

CHAPTER LEARNING OBJECTIVES:

At the end of this chapter you will, insha Allah you will be able to:

i. Explain the meaning of salam and parallel salam and how this contract is used by Islamic banks to finance customers

ii. List the principles of salam and parallel salam and as well as the shari’a rules.

iii. Journalize accounting entries for salam and parallel salam.

iv. Prepare the balance sheet and income statement extracts for salam and parallel salam transactions

v. Apply shari’a and accounting principles as per FAS 7 to solve accounting problems for complex events.
11.1 Introduction

Normal fiqh rules insist that goods for sale must exist, owned by the seller and deliverable, for the validity of a sales contract. This is to prevent gharar and fraud regarding the quality and existence of the subject matter of the contract. However, Islam is practical in that it allows flexibility in the rules to allow for the needs of the community to transact legitimately.

For example, if the above conditions are insisted upon, then tailoring, manufacturing to order and food catering have to close shop, because the goods (tailored shirt to fit irregularly shaped people), aero planes, buildings and catered food are not available at the time of ordering or sale. It will only be available in the future. Certain industries especially in agriculture and construction have a long lead time which involves time, effort and substantial costs. For example, in growing crops, the farmer has to plough the land, seed the land and add fertilizer, irrigate and weed and protect it from animals, weather and people. This requires a lot of money. The traditional non-Islamic way has been and in many countries, still is to usurious loan which is ruinous to the farmer and his family and has resulted in wealth transfer to the money lending class. The salam contracts helps to prevent this.

Salam and Istisna are the two main contracts allowed in Islam, which allows the sale of something which does not exist at the time of sale. However, as with all Islamic contract fiqh rules, these contracts come with conditions to protect the buyer and seller and diminish the gharar aspects of this type of transaction.

Salam is a contract where a buyer purchases a commodity for future delivery in exchange for immediate payment. Istisna is similar; however the seller in istisna manufactures the goods to specification before delivery, whereas in a salam, he either grows it or buys it from the market to deliver at the promised time.

From an accounting perspective, the payment made is an asset in the books of the buyer and a liability in the books of the seller until the goods are delivered. In istisna however, we have to track costs and value work in progress and accounting for billings in case of progressive payments, which makes it much more complex as construction accounting contracts.

We shall explore salam in this chapter and istisna in the next.
11.2 Definition and financing model of Salam and Parallel Salam.

### Definitions

**Salam**

Purchase of a commodity for deferred delivery in exchange for immediate payment according to specified conditions or sale of a commodity for deferred delivery in exchange for immediate payment.

- **al-Muslam fihi**: The commodity to be delivered
- **al-Muslam ileihi**: The seller
- **al-Muslam**: The purchaser

**Ras-almal**

Capital (cost) paid (in cash, kind or benefit) in a Salam contract, i.e. price.

**Parallel Salam**

A Salam contract whereby al-muslam ileihi depends, for executing his obligation, on receiving what is due to him – in his capacity as al-muslam – from a sale in a previous Salam contract, without making the execution of the second Salam contract dependent on the execution of the first one.

How does the Islamic bank use the salam contract to make profits? The following diagrams two ways in which it can be done.

(i) use a selling agency.

When the time specified in the salam contract arrives, the bank can instruct the al-muslam ileihi to deliver the commodity to a selling agency of the bank. The agent will then sell the commodity for a fee and deliver the net proceeds to the bank.
Chapter 11. Accounting for Salam and Parallel Salam

Fig 11.1 Salam financing using a selling agency

1. Islamic Bank pays advance to the seller for future delivery

2. The seller delivers per instruction of the bank to the agent

3. The agent sells the commodity to the ultimate buyer

4. The ultimate buyer pays the agent.

5. The agent pays the bank less his commission.

However, the normal method of use of the salam contract in IFI’s is through the use of a parallel salam contract. As noted in the definitions box, a parallel salam is a contract to sell, what the bank will get as a buyer in another salam contract, to a buyer who pays the bank in advance. The difference in price between the parallel salam and the salam contract is the profit to the bank. This is illustrated in figure 11.2

The Islamic bank pays the al muslam ileihi in the salam contract. The Islamic bank receives a payment from the buyer in a parallel salam contract.
Chapter 11. Accounting for Salam and Parallel Salam

The muslam ileihi in the salam contract delivers the goods to the bank at the agreed time. The bank delivers the commodity to the al muslam in the parallel salam contract.

In actual fact, the bank may request the muslam ileihi to deliver the goods direct to the bank’s customer. Further the bank may enter into the salam contract with the customer first or at the same time in order to be a bit more certain of the profits.

Besides the financing of agriculture, salam can also be used to finance trade inventory, where the Islamic bank pays an advance for the customer to purchase inventory from a wholesaler and deliver to the bank which the bank can either resell to the customer at a higher price through a parallel salam contract or to a third party.
### 11.3 Salam & Parallel Salam principles, rules and complexities

<p>| | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
</tr>
</thead>
</table>
| 1 | **Legitimacy**  
Salam has its legitimacy in the Qur’an (2:282) and Sunnah and Ijma (consensus). On the wisdom of its legitimacy, Ibn Qudamah said “Because people had a need for Salam and because farmers, market gardeners and tradesmen needed money for their living expenses and to spend on their businesses to bring them to fruition, and so faced financial need, Salam was made permissible so that they could benefit from it as well as al-muslam having the benefit of its permissibility”.  
Hence, is legitimacy is from the strongest sources of the shari’a. |
| 2 | **Capital**  
The payment should be in cash. However, the standard takes the view of some other fuqaha who permit payment in trading assets. According to Malikis, payment can be in benefit. However, it is agreed that it cannot be in the form of a cancellation of a debt due from the seller. (almuslam ileihi) as a precaution against riba.  
The payment needs to be paid at the time of contract execution to prevent introduction of debt by al muslam. However, a short delay is permitted my Malikis. |
| 3 | **Al Muslam fihi (the subject matter of the contract)**  
The commodity to be supplied should be known as to kind (wheat or cotton, type (e.g. Syrian wheat, quality (superior, medium or inferior Syrian wheat) and amount. (qty in kg. or bushels). Specification to be based on description given by al muslam ileihi. And should not be confined to be made from a specific source such as a particular farm or production from a specific country.  |
| 4 | **Delivery date.**  
Delivery should be deferred to a future date although shafiis allow prompt delivery.  
Specifying future date is permissible, eg. Last day of October and should not be contingent. Fuqahas equire a degree of specificity on the delivery date and so a range of delivery dates is acceptable.  
The future delivery date should be matched to the time when muslam fihi would most likely be commonly available to prevent gharar (e.g next harvest season) to enable the seller to discharge the contract. |
| 5 | **Place of delivery**  
Parties to the contract can designate |
| 6 | **Sale of subject matter before** |

---

(1) Al Mughnee, Vol. 4, p.305.
| 6 | **Replacement of subject matter:**  
Normally replacement of subject matter is prohibited (especially if it is food, unless it is similar goods. Of same or less quantity and regarded as suitable to the muslam fihi in the salam contract.  
Classical scholars only allow for the substitution if it is not food and: Substitute is similar to muslam fihi or lower quality to negate riba  
Should take delivery of substitute in order not to replace debt with debt and  
The relation between substitute and price should be free of riba. |
|---|---|
| 7 | **Nullification or cancellation of contract**  
Complete nullification is permissible if the Salam capital is repaid to the Muslam. Partial cancellation of delivery with partial corresponding repayment is also allowed.  
In case, al muslam fihi is not fully or |
| 8 | **Delivery of different specification on its due date or before due date.**  
Al muslam ileihi shold deliver the al muslam fihi on its due date and according to agreed quality, quantity and al muslam should accept it. |

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¹ Rajhi Banking and Investment Corporation, Shari’a supervisory board, Fatwa No. 41, (paraphrased).
Chapter 11. Accounting for Salam and Parallel Salam

11.4 Recognition of Salam & Parallel Salam transactions and journal entries

11.4.1 Recognition and Measurement of Salam and Parallel Salam Financing

FAS No. 7: Salam and Parallel Salam is a standard for the provision of salam and parallel salam financing and deposit taking by the Islamic bank.

Contract execution

When the capital is paid to the muslam ileihi placed in his disposition (for example, credited to his account) then Salam Financing is recognized as an asset by debiting Salam Financing and crediting cash.

If the capital is in the form of kind or benefit, the amount shall be recognized at fair value of the asset or benefit provided (in effect, the amount agreed between the bank and the client).

In case a superior quality is delivered, the al muslam ileihi cannot ask for a higher price.
If an inferior quality is delivered, then al muslam ileihi has the option to reject the delivery or accept the lower quality without asking for a lower price.
There is difference of opinion of delivery a different type of al muslam fihi then the one agreed upon.

IF DELIVERY IS BEFORE DUE DATE
Al muslam can accept if it is of the same quality and quantity as agreed.
Al muslam fihi cannot be of superior quality nor in greater quantity
Al muslam fihi cannot be of inferior quality or in lesser quantity (as this would be riba)

Pledge/Guarantee of al muslam fihi

Al muslami fihi can be transferred or pledged or used as guarantee.
Chapter 11: Accounting for Salam and Parallel Salam

For parallel salam, it is recognized when the amount is received.

At the end of the financial year

Capital is measured at the initial cost or fair value of the benefit or kind agreed at the initial execution of the contract. However, if it is probable that the al-muslam ileihi will not deliver al muslam fihi in part or in full, and it is probable that the value of the al muslam fihi will decline, a provision for the deficit is made.

If the muslam fihi is received but not disposed off at the financial year end, it shall be measured at the lower of historical cost and cash equivalent value and the if the cev is lower, the difference is treated as a loss for the financial year

Salam financing is presented in the Bank’s Balance Sheet as Salam Financing whereas parallel salam is recognized as a liability and presented as Parallel Salam.

When the bank delivers the al muslam fihi, the difference between the amount paid by the client and the cost of the al muslam fihi is taken as the profit or loss during the year.

Receipt of al muslam fi hi.

Assets received in a salam contract is recognized at historical cost.

In case the muslam fi hi is similar in kind but different quality:

(i)if the maket or fair value of the received al muslam fi hi is equal to the contracted muslam fihi, then al muslam fi his is recorded at book value.

(ii)however, if the market or fair value is lower, the muslam fihi is recorded at the market or fair value and the different recognized as a loss.

In case of delivery failure:

(a), if the delivery date is extended, the book value is maintained
(b) if the financing is completely or partially cancelled and the amount is unpaid, then the amount is recognized as a receivable from the client.

Failure due to client’s misconduct or negligence.

In this case, when there is partial o complete failure, the amount shall be recognized as a receivable. Where securities has been pledged by the customer, the proceeds
from the sale of the security is less than book value, the difference will be receivable from the client. The bank may charge the client any additional amounts which are established in favour of the bank.

In case of substitution of another kind of goods, the same treatment as discussed above under delivery is used.

<table>
<thead>
<tr>
<th>No.</th>
<th>Transactions /Events</th>
<th>DR</th>
<th>CR.</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Recognition of Salam on payment (Being capital paid to almuslam ileihi)</td>
<td>Salam Financing</td>
<td>Cash</td>
</tr>
<tr>
<td>2</td>
<td>On receipt of payment from customer</td>
<td>Cash</td>
<td>Parallel Salam</td>
</tr>
<tr>
<td>3</td>
<td>Reduction in value of al muslam fi hi yet to be delivered</td>
<td>Profit and Loss</td>
<td>Provision in loss in value of al muslam fihi</td>
</tr>
<tr>
<td>4</td>
<td>Normal contract conclusion Delivery of inventory to buyer Profit from sale When the inventory is delivered direct to the customer, a composite journal entry can be made without going through inventory</td>
<td>Dr Inventory (historical cost) Parallel Salam Parallel salam</td>
<td>Salam Financing Inventory Profit and Loss</td>
</tr>
<tr>
<td>5</td>
<td>End of year inventory decline If at the end of the fiscal year, the cev of inventory acquired through salam financing is lower than the acquisition cost</td>
<td>Dr Profit and loss</td>
<td>Inventory</td>
</tr>
<tr>
<td>6</td>
<td>Termination of salam due to non delivery and delivery date not extended</td>
<td>A/receivable</td>
<td>Salam Financing</td>
</tr>
</tbody>
</table>
11. Accounting for Salam and Parallel Salam

6. In case of sale of securities for less than salam contract value
   - Dr Cash
   - Dr A/Receivable with difference between cash proceeds and contract value
   - Salam Financing

7. In case of sale of securities for more than salam contract value
   - Dr Cash
   - Cr Salam financing
   - Cr accounts payable (with excess of proceeds)

11.5 Asset and Liability measurement

AAOIFI: presentation and disclosure of Salam & Parallel Salam Financing

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Salam Financing</td>
<td>XX</td>
</tr>
<tr>
<td>Less: Provision for decline in value of muslam fi hi</td>
<td>(XX)</td>
</tr>
<tr>
<td>Net Salam Financing</td>
<td>XX</td>
</tr>
<tr>
<td>*Jointly or self finance assets</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Income statement</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit on sale of commodity in a parallel salam</td>
<td>XX</td>
</tr>
</tbody>
</table>

11.6 Accounting Problem – Salam and parallel Salam

On 1st February, 2007, Bank Syari’ah Malaysia Berhad entered into a salam financing contract with Perak Islamic Rubber Growers Cooperative to supply 100 metric tons of RSS1 (superior grade) rubber on the 1st week of June 2007 at @$1,000 a metric ton. As security, the Cooperative’s clubhouse was pledged to the bank. The amount was paid to the muslam ileihi on the same day. On 25th of May, 2007, the bank entered into a parallel salam contract to supply the same to Bata shoe Malaysia bhd. @$1200 a metric ton on 1st week of June 2007.
On the 1st week of June 2007, the cooperative only delivered only half the promised quantity of RSS1 rubber. It also delivered 25 tons of RSS2 (lower grade) rubber which the bank accepted to take. The cooperative informed that since it is insolvent, it cannot afford to pay the difference to the bank.

Meanwhile, Bata refused to take delivery of the RSS2 rubber. The bank was forced to buy RSS1 from the market at $1150 per metric ton to deliver to fulfil its commitment to Bata. RSS2 rubber had a cash equivalent value of $950 per metric ton at the end of the year on 31st December 2007. In August 2007, the security pledged by the cooperative was sold for $50,000 and the appropriate amount refunded to the cooperative.

Required:

(i) Show the journal entries in the books of Bank Syari’ah for all the above entries.
(ii) Show extracts of the income statement and the balance sheet of bank syari’ah for the year ended and as at 31.12.2007.

<table>
<thead>
<tr>
<th>Solution: salam accounting problem</th>
</tr>
</thead>
<tbody>
<tr>
<td>(i) bank syari’ah bhd journal entries</td>
</tr>
<tr>
<td>feb 1 07</td>
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<tr>
<td></td>
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<tr>
<td>May 25</td>
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<tr>
<td>Jun-07</td>
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<tr>
<td>Jun-07</td>
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<td></td>
</tr>
</tbody>
</table>
### Chapter 11. Accounting for Salam and Parallel Salam

<table>
<thead>
<tr>
<th>Date</th>
<th>Transaction Description</th>
<th>Debit</th>
<th>Credit</th>
</tr>
</thead>
<tbody>
<tr>
<td>Aug-07</td>
<td>Cr. Cash</td>
<td>57500</td>
<td>12500</td>
</tr>
<tr>
<td></td>
<td>Profit on parallel salam- p &amp; loss ac</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>purchase of 50mt of RSS1 to fullfill parallel salam contract and profit and net profit on parallel salam</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>dr cash</td>
<td>50000</td>
<td>25000</td>
</tr>
<tr>
<td></td>
<td>cr a/c receivable</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>cash</td>
<td>25000</td>
<td></td>
</tr>
<tr>
<td></td>
<td>proceeds from sale of security set off against amount owing and balance refunded</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Dec-31</td>
<td>Dr Profit and Loss</td>
<td>1250</td>
<td>1250</td>
</tr>
<tr>
<td></td>
<td>Inventory RSS2</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>Reduction of inventory to cev (1000-950)x25tons</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>income statement 31.12.07</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>profit from parallel salam</td>
<td>12500</td>
<td>1250</td>
</tr>
<tr>
<td></td>
<td>loss from devaluation of inven</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>the loss cannot be claimed from perak coop because the the bank accept the lower quality</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Which of the following statements is true?

a) Salam requires full payment upfront while in Istisna’ the repayment must be gradual.

b) Salam is a contract to purchase goods for later delivery while Istisna’ is a contract to purchase goods for future payment.

c) Salam is a contract to produce goods that may be weighed, measured or counted while Istisna’ is a contract to transform a raw material into their natural state through the process of manufacturing.

d) All of the above is true.

(CIPA July 2006)
2 Which of the following is incorrect for Salam financing:

a) Salam assets (al-muslam fihi) received by an Islamic bank shall be recorded, upon receipt, at historical cost if the assets are in accordance with the contract.

b) At the time of contracting, Salam capital shall be provided only in kind.

c) Salam capital provided in kind shall be measured at a value agreed between an Islamic bank and its client.

d) None of the above.

3: Which of the following is incorrect for replacement of Salam assets (al-muslam fihi) by substituting another kind of goods:

a) Most Islamic jurists (fuqaha) have prohibited the replacement of al-muslam fihi before it is received except by substituting another kind of similar goods.

b) Some fuqaha are of the view that the substitute goods should not consist of higher quantity than the intended al-muslam fihi so that the purchaser does not obtain additional profit.

c) Some fuqaha are of the view that the substitute goods should be similar to al-muslam fihi or of a lower quality.

d) Some fuqaha are of the view that the substitute goods should not be similar to al-muslam fihi.

4: The general rules regarding delivery of Salam assets (al-muslam fihi) before or on its due date include the following, except:

a) If a superior quality of al-muslam fihi is delivered, the purchaser (al-muslam) may accept it on the condition that the seller (al-muslam ileihi) does not ask for a higher price.

b) If an inferior quality of al-muslam fihi is delivered, al-muslam may accept or reject it.

c) If al-muslam fihi is delivered on its due date and according to the agreed quality and quantity, al-muslam must accept it.

d) Regardless of any conditions being met, it is impermissible to deliver al-muslam fihi before its due date.

(Question 2-4 are from CIPA sample questions)
Chapter 11. Accounting for Salam and Parallel Salam

المعالجة الحسابية للسّلّم والسّلّم الموازي
Chapter 11. Accounting for Salam and Parallel Salam
المعالجة الحسابية للسَّلَم والسَّلَم المُوازٍ

Question 11-1

Explain from your knowledge on fiqh rules on salam, how the fuqah attempt to avoid gharar and riba on salam contracts.

Question 11-2

The validity of a Salam contract is dependent on satisfying certain terms and conditions relating to al-muslam fihi.

Specify any 5 terms and conditions of a typical Salam contract, which are considered necessary for the validity of the contract.

(A.I.A, Professional Examination II, 2002, Q 4a)

Question 11.3

1. Explain with the aid of a diagram how an Islamic bank can profit from a salam and a related parallel salam contract. The diagram should show entities, cash flows and goods flows. If an Islamic bank is allowed to form trading subsidies, how does this enable the bank to profit from a salam contract without entering into a parallel salam contract?
Chapter 11. Accounting for Salam and Parallel Salam

On the 1st of March 2003 Gulf Finance House (an Islamic Bank) bought 25 tons of aluminum from Alba- a local Aluminum producing company- on the basis of Bai-asalam (Salam) contract. The purchase price of this quantity of aluminum was $25,000 ($10,000 per ton) paid in full to Alba on the day the contract was signed. It was agreed that Alba would deliver the commodity in two shipments as follows:

- First shipment on June 15th, 2003 for the delivery of 10 tons.
- Second shipment on July 30th, for delivery of 15 tons.

On April the 5th 2003 the bank entered into a parallel Salam contract with a trading company based in Kuwait to sell them 25 tons of aluminum for total value of $275,000 ($11,000 per ton). The bank signed-up to deliver the commodity in two shipments as lows:

- First shipment on the 20th of June 2003 for delivery of 10 tons.
- Second shipment on the 5th of August 2003 for delivery of 15 tons

Required:

1. Record the journal entries for the Salam and Parallel Salam transactions in the books of the bank if deliveries, in both transactions, were made as contracted.

2. If Alba defaulted on the second delivery and the bank had to buy equal quantity of commodity from another company for $170,000 and delivered it to the trading company in Kuwait, how will this case affect the bank's books of accounts?

3. Outline the basic features of the Salam contract showing its potentials for the Islamic banking business.

(A.I.A, Professional Examination II, 2004, Q 3)
Chapter 11. Accounting for Salam and Parallel Salam

The Farmers Association approached Meezan Muamalat Bank, which is actively involved in agricultural financing to finance the wheat crop of its members, that is expected to be harvested in the year 2006 using Salam contract. On 30 September 2005, Meezan Muamalat Bank entered into a Salam contract whereby it bought from Farmers Association 100,000 metric tons of wheat (the specifications of which are detailed in the contract) for $200 million. It was agreed that Farmers Association would deliver the wheat after 6 months from the date of signing the contract. On 5 October 2005, Meezan Muamalat Bank paid the full amount of the contract into the account of Farmers Association.

On 31 October 2005, Meezan Muamalat Bank entered into a separate parallel Salam contract with K Company whereby it was agreed that the former sell to K Company 100,000 metric tons of wheat for $250 million. The specifications of the wheat are identical to those that will be supplied by Farmers Association and it was agreed by the two parties that Meezan Muamalat Bank would deliver the wheat after 5 months from the date of signing the contract. On 5 November 2005, K Company paid half of the amount of the contract to Meezan Muamalat Bank.

On 31 March 2006, Farmers Association delivered 100,000 metric tons of wheat to Meezan Muamalat Bank and the bank delivered the wheat to K Company. K Company paid the remaining amount of the wheat on the same date.

Required:

a. Prepare the necessary journal entries in the books of Meezan Muamalat Bank to record the Salam and parallel Salam contracts;

b. Show how the necessary transactions should be presented in the financial statements of Meezan Muamalat Bank at the end of the year 2005 assuming...
that the value of al-muslam fihi has declined by 20%. Should Meezan Muamalat Bank recognise any earnings at the end of the year?

c. Assume that Farmers Association was not able to deliver the wheat on the agreed date and only able to deliver after 7 months from the date of signing the contract. Meezan Muamalat Bank has to buy the wheat from other supplier for $260 million. Show journal entries to record this transaction.

d. ‘The validity of a Salam contract is dependent on satisfying certain terms and conditions relating to al-muslam fihi’.
Specify any 5 terms and conditions of a typical Salam contract, which are considered necessary for the validity of the contract.

(IIUM B.A cc, semester 2, 2006/2007, Q1)