ZAKAT

هيئة الزكاة والضريبة والجمارك
Zakat, Tax and Customs Authority

Guideline

Manual of Transition to the International Financial Reporting Standards

and its impact on Calculating Zakat for Taxpayers Obligated to Maintain Statutory Accounts in the Kingdom of Saudi Arabia

IAS 1 "Presentation of Financial Statements" and IAS 37

Version One November 1 2021

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This Manual is indicative and constitutes the concept and interpretation of the Zakat, Tax and Customs Authority (ZATCA) with regard to the implementation of the Executive Regulations of Levying Zakat promulgated by the Ministerial Resolution No. (2216) dated 07 Rajab 1440 AH. It is not a statutory document, and its provisions are indicative, non-binding to ZATCA, and it does not eliminate the need to peruse the Executive Regulations for Levying Zakat and the relevant rules and resolutions.

This Manual is indicative, and includes a summary of the most important considerations with respect to application of International Financial Reporting Standards (IFRSs) approved in the Kingdom of Saudi Arabia. It is not a statutory document. The provisions thereof are guiding, and it does not eliminate the need to peruse to the International Financial Reporting Standards approved in the Kingdom of Saudi Arabia and other standards and publications approved by the Saudi Organization for Chartered and Professional Accountants. All diagrams and drawings contained herein are for illustrative purposes and may not include all requirements and exceptions to the standards. The Authority expressly disclaims itself for any duties or obligations towards any person or entity that may result from its use of this attached Manual. Please note that this Guideline does not include any conclusion on appropriate accounting processing based on specific facts and does not recommend accounting policies or treatments that the user of this Guideline should choose or apply.

Introduction

Purpose of Manual:

This Manual aims to provide a summary of the most important effects that resulted from the transition to International Financial Reporting Standards (IFRSs) at the expense of Zakat. It should be noted here that the mentioned standards were adopted by the Saudi Organization for Chartered and Professional Accountants to become applicable by companies listed in the Saudi Financial Market effective from the Fiscal Year January 2nd, 2017.

Further, this Manual is intended to contribute to raising awareness on changes in the accounting treatments contained in international standards, which may have changed the Zakat handling for some items. ZATCA aims that the Manual will also contribute to narrowing the gap between the understanding of taxpayers and the Authority's expectations concerning the mechanisms for estimating and calculating Zakat in light of the transition to these standards.

This Manual addresses the following international standards:

- International Accounting Standard (IAS) No. (1) "Presentation of Financial Statements".IAS 41 "Agriculture".
- International Accounting Standard (37) "Provisions, Contingent Liabilities and Contingent Assets".

The Manual has been prepared based on the International Financial Reporting Standards approved in the Kingdom of Saudi Arabia (issued in 2020).

Overview of the transition to the approved International Financial Reporting Standards in the Kingdom of Saudi Arabia:

International Financial Reporting Standards have been endorsed by the Saudi Organization for Chartered Auditors and Accountants to become applicable by companies listed in the Saudi financial market effective from the fiscal year 1 January 2017.

In the interest of the Zakat, Tax and Customs Authority to keep pace with this fundamental transition, the Authority has listed and formulated the most prominent effects of the transition on the account of Zakat for private sector companies and institutions in the Kingdom of Saudi Arabia.

1. Overview of IAS 1 and 37

1.1. International Accounting Standard No. (1)

1.1.1. Standard objective:

This standard sets out the basis for the presentation of general-purpose financial statements to ensure that they are comparable with the entity's financial statements in prior periods and with the financial statements of other entities. It sets out the overall requirements for the presentation of financial statements, the Manuals for their structure, and the minimum requirements for their content.

1.1.2. Scope Summary:

Most Important Exceptions to IAS (20)	Applicable Standard	Standard Name
The structure and content of the condensed interim financial statements	International Accounting Standard 34	International Accounting Standard 34 "Interim Financial Reporting"

Effective Date

This standard shall be effective for financial statements covering periods beginning on or after January 1, 2009 AD.

The international standard that replaced

This standard replaces IAS 1 "Presentation of Financial Statements", revised in 2003 .

The Saudi Standard

General Presentation and Disclosure Standard.

1.1.3. Standard Objective:

The objective of this standard is to ensure that appropriate recognition controls and measurement bases are applied to provisions, contingent liabilities and contingent assets and sufficient information is disclosed in the notes to enable users to understand their nature, timing and amount.

1.1.4. Scope Summary:

Most Important Exceptions to IAS 37	Applicable Standard	Standard Name
Financial instruments (including guarantees)	International Financial Reporting Standard 9	IFRS 9 "Financial Instruments".
When another standard deals with a specific type of provision, contingent liability or contingent asset; the entity applies that standard instead of this standard.	International Accounting Standard 12 International Financial Reporting Standard 16 International Accounting Standard 19 International Financial Reporting Standard 4 International Financial Reporting Standard 3 International Financial Reporting Standard 15	For example, but not limited: International Accounting Standard 12 "Income Taxes". International Financial Reporting Standard 16 "Lease Contracts". International Accounting Standard 19 "Employee Benefits". International Financial Reporting Standard 4 "Insurance Contracts". International Financial Reporting Standard 3 "Business Combinations". International Financial Reporting Standard 15 "Revenue from Contracts with Customers"

Effective Date

This standard shall be effective for financial statements covering periods beginning on or after January 1, 1999 AD.

2. International Accounting Standard 1 Requirements

2.1. International Accounting Standard No. (1)

2.1.1. Overview of IAS 1

The objective of IAS 1 is to determine the basis for presenting general purpose financial statements, to ensure comparability with the financial statements of prior periods and the financial statements of other entities.

The general requirements	The general requirements
Presentation of financial statements **Guidelines for its Structure** **Requirements for its content except for statement of cash flows (IAS 7)**	• IAS 1 requires that financial statements be identified and distinguished from other information in the same published document. • Each item of the financial statements shall contain the name of the entity for which the report is prepared, information on whether the financial statements pertain to an individual or group, the report date and the period covered, the presentation currency and the level of rounding. • Comparative information in respect of the prior period.

2.1.2. Structure of Financial Statements

Statement of Financial Position

Equity and Liabilities

- Trade and other payables.
- Provisions
- Financial Liabilities.
- Non-controlling interest in equity.
- Issued capital and reserves attributable to the owner of the parent entity.

- Assets and liabilities under IFRS 5.
- Current income tax assets and liabilities.
- Deferred income tax assets and liabilities.

Assets

- Real Estate, equipment and machinery.
- Investment Real Estate
- Intangible Assets.
- Financial Instruments.
- Investments accounted for using the equity method.
- Biological assets.
- Inventory.
- Trade and other receivables.
- Cash and cash equivalents.

IAS 1 does not specify the exact form of the statement of financial position. Instead, many formats are accepted if they meet all the above-described requirements.

Further sub-classifications of items shall be disclosed either directly in the statement of financial position or in the notes.

2.1.3. Category

Current Assets/Liabilities	Non-Current Assets/Liabilities
• It is expected to be realized/settled in the normal operating cycle of the entity. • They are mainly retained for the purpose of trading. • It is expected to be realized (for assets) or to be settled (for liabilities) within 12 months after the reporting date. • They are either cash or equivalent, unless restricted for use.	• All other assets/liabilities are classified as non-current. • Deferred tax shall not be allowed to be classified as current.

Current liabilities include long-term financial liabilities:

- When it is scheduled to be settled within (12) months of the statement of financial position date.
- When an entity breaches a long-term loan agreement on or before the statement of financial position date and the liability becomes payable on demand.

There is no unconditional right to defer the settlement of a liability for at least (12) months after the statement of financial position date.

2.1.4. Expense Classification

- An entity may choose to classify recognized expenses in profit or loss for the period by nature or function.
- The choice between the expense function method and the expense nature method will depend on historical and industry factors and the entity's nature.
- Both methods provide a reference to such costs that may vary, either directly or indirectly, with the entity's level of sales or production.

Analysis of Expenses according to its Nature	Analysis of Expenses by Function
For some entities, "reliable and more appropriate information" can be achieved by grouping expenses to present them in profit or loss by nature (e.g., depreciation, purchase of materials, transport costs, employee benefits and advertising costs), rather than re-allotting them between different functions within the entity. This method may be easy to apply due to the unnecessary allotment of expenses on functional classifications.	or some entities, "reliable and more appropriate information" can be achieved by grouping expenses to present them in profit or loss by function (e.g., distribution costs or administrative activities). At a minimum, an entity discloses its cost sales under this method, separately, from other expenses. This method can provide more appropriate information to users than the classification of expenses by nature, but allotting costs to functions may require random allotments and involve a great deal of personal judgment.

2.1.5. Statement of Comprehensive Income: Required Content

Comprehensive Income Statement
Profit or Loss
• Revenues. • Profits and losses on derecognition of financial assets at amortized cost. • Financing costs. • Share of profits or losses in associates and joint ventures using the equity method. • Tax expenses. • Post-tax profit/loss or loss from operations or assets according to IFRS 5 "Non-current Assets Held for Sale and Discontinued Operations". • Investments at fair value through profit or loss according to IFRS 9 "Gain or Loss Arising from Change in Fair Value".

Other Comprehensive Income

- Each item of other comprehensive income is classified by nature.
- The share of other comprehensive income of associates and joint ventures calculated using the equity method.
- Total Comprehensive Income.

Profits or losses for the period and comprehensive income are presented in the provision:

IAS 1 prohibits reporting on any transaction or item as exceptional.

2.1.6. Main Items Included in the Other Comprehensive Income:

1. Changes in revaluation surplus.
2. Re-measurement of defined-benefit plans.
3. Profits and losses from investments in certain equity instruments at fair value through other comprehensive income.
4. For certain liabilities defined as at fair value through profit or loss, the amount of change in fair value attributable to changes in liability-related credit risk.
5. Profits and losses on financial assets measured at fair value through comprehensive income.
6. Profits and losses arising from the translation of financial statements into foreign currencies.
7. Effective portion of gains and losses on hedging instruments used in cash flow hedge, and gains and losses on hedging instruments that are hedging investments in equity instruments measured at fair value through other comprehensive income.

8. Changes in the value of the forward components of forward contracts when the forward components are separated from the spot components of a forward contract and the changes in the spot components are designated as only the hedging instrument. Changes in the value of the difference based on the foreign exchange rates of a financial instrument when being excluded from designating such financial instrument as a hedging instrument.

2.1.7. Reclassification Adjustments:

Certain items in other comprehensive income are reclassified to profit and loss in subsequent years and other items are not allowed to be reclassified. IAS 1 requires items that can be reclassified (or "recycled") to profit or loss at some point in the future (e.g., upon derecognition or settlement) to be presented separately from items that will never be reclassified.
Other comprehensive income items that may be reclassified to profit or loss: ● Profits and losses arising from the translation of financial statements into a foreign currency (IAS 21). ● Profits and losses on financial assets measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of IFRS 9. ● Effective portion of Profits and losses on hedging instruments used in cash flow hedge, and Profits and losses on hedging instruments that are hedging investments in equity instruments measured at fair value through other comprehensive income (IFRS 9). ● Changes in the value of the forward components of forward contracts when the forward components are separated from the spot components of a forward contract and the changes in the spot components are designated as only the hedging instrument. Changes in the value of the difference based on the foreign exchange rates of a financial instrument when being excluded from designating such financial instrument as a hedging instrument (IFRS 9).

Other comprehensive income items that may be reclassified to profit or loss:

- Changes in revaluation surplus (IAS 16 and 38).
- Re-measurement of defined-benefit plans (IAS 19).
- Profits and losses from investments in certain equity instruments at fair value through other comprehensive income (IFRS 9).
- For certain liabilities defined as at fair value through profit or loss, the amount of change in fair value attributable to changes in liability-related credit risk (IFRS 9).

2.1.8. Presentation and Disclosure: Comprehensive Income Statement

An entity may choose to present all recognized income and expenses items in a period either in:

- A single statement of profit or loss and comprehensive income; or
- If an entity presents in a single statement, the sections shall be presented together, with the profit or loss section presented first, followed directly
- In the two-statement approach, it shall precede the separate profit or loss statement and then immediately the statement presenting comprehensive

2.1.9. Presentation and Disclosures

1

An entity shall disclose its significant accounting policies, which include:

- The basis (bases) for measurement used in the preparation of financial statements; and
- Other accounting policies used in relation to the understanding of financial statements.

2

An entity shall disclose information on assumptions it makes about the future and other key sources to estimate uncertainty at the end of the reporting period, which involve significant risks leading to substantial adjustment to the carrying amounts of assets and liabilities within the next fiscal year. With respect to such assets and liabilities, the notes shall include the following details:

(A) Its nature.

(B) Its book value as at the date of the financial statements.

3

An entity shall disclose information that enables users of its financial statements to assess the entity's objectives, policies and operations for capital management.

An entity shall disclose the following:

A. The amount of dividends proposed or declared before the financial statements are approved for issue but not recognized as dividends to owners during the period and the amount associated with the share.

B. The amount of any cumulative preferred share dividend not recognized.

If not disclosed elsewhere in the information published with the financial statements, an entity shall disclose the following:

A. The entity's domicile and legal form, country of incorporation and address of its registered office (or principal place of business if different from the registered office).

B. A description of the nature of the entity's main operations and activities.

C. Name of parent and final parent entity of the group.

D. If it is a limited going concern entity or information regarding the term of going concern.

3 International Accounting Standard 37 Requirements

3.1. Introduction

Provision — **Uncertain Liability regarding Time or Amount**

A liability is a current obligation arising from a past event expected to be settled through the flow of economic benefits from the entity.

Previous Event

Legal Obligation

Arising from legislation, contract, or legal practices

Example: Payment of Zakat, end of service benefits, fines, accounts payable

Implicit Obligation

It arises from certain commercial practices and creates an expectation in third parties to fulfill the obligation.

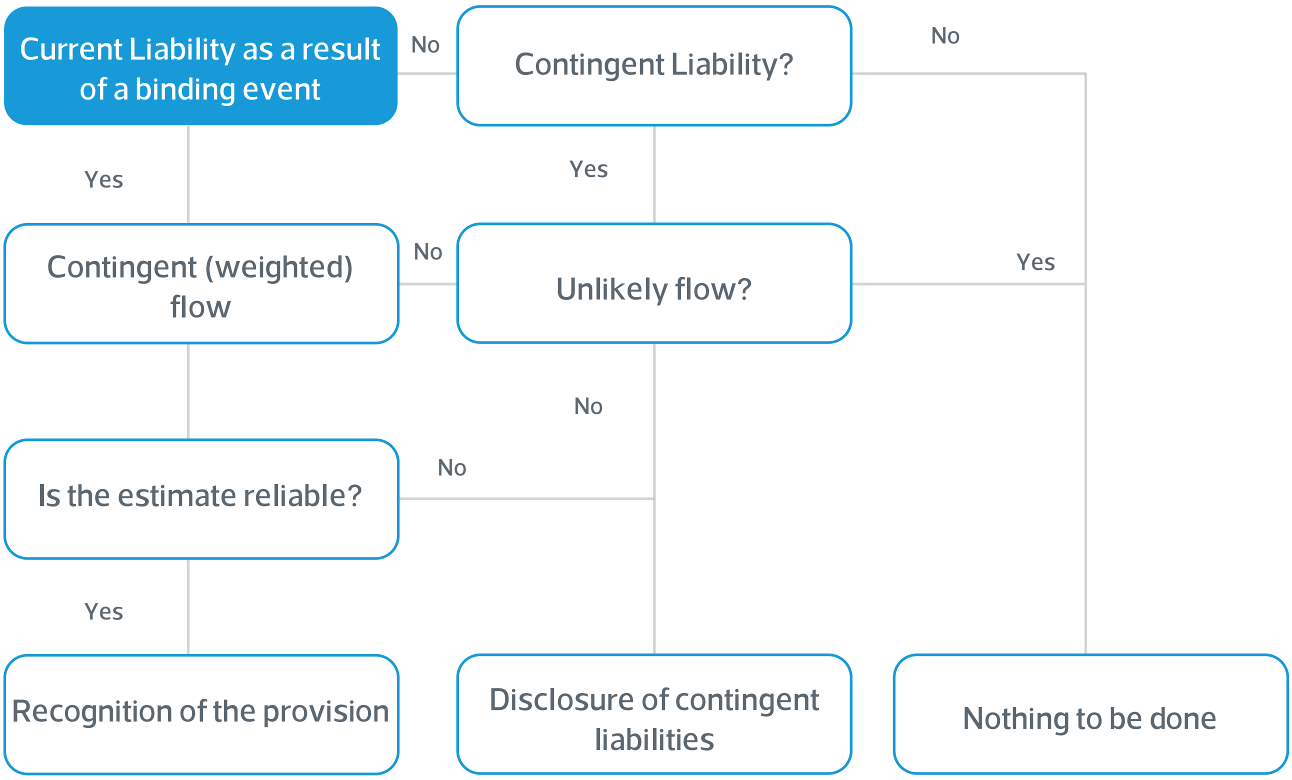
Example: Donation Announcement

3.2. Relationship between liabilities, provisions and contingent liabilities

Liabilities	Provisions	Contingent Liabilities
• Current Liability - previous events (binding). • Flow of economic resources. • Reliably measured.	• Uncertain Liability regarding Time or Amount.	• Contingent Liability, or • Unweighted flow, or • Unreliable measurement.
In Statement of Financial Position	In Statement of Financial Position	Off Statement of Financial Position
International Accounting Standard 32 and the International Financial Reporting Standard	Accounting Standard 37	

3.3. Proof of benefits

The following chart shows the procedures for establishing provisions:



3.4. Outcome Probability:

1. Almost certain (e.g., >98% probable).
2. Probable (weighted) (e.g., 95-50% probable).
3. Possible but unweighted (e.g., 50-5% probable).
4. Remote controlling (e.g., <5% probable).

3.5. Measuring of Provisions

Recovery	Future Events	Current Value	Concept of Best Estimation
It shall be treated as a separate asset.	It shall be reflected in the provision amount when there is sufficient substantive evidence of its occurrence.	When the effect of the time value of money is material, the provision amount shall be the current value.	The amount recognized as a provision shall be the best estimate of the expenses required to settle the current liability at the statement of financial position date.
• Recognized as a separate asset, when almost certain. • Offsetting of profits and losses is permitted. • It appears separately in the statement of financial position.	If a new technology emerges, it shall be supported by sufficient substantive evidence to be reflected in the provisions.	• Specific risks, pre-tax rate. • Increased provision is recognized as an assumption cost.	• A large number of items • One Liability • Expected Value • The most weighted outcome with adjustments

3.6. Provisions in Certain Circumstances

Contingent Liabilities

- A contingent liability that arises from past events, and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the entity's control; or
- A current liability that arises from past events that has not been recognized because it is unlikely that there would be an outflow of economic benefits to settle the liability or the liability amount could not be reliably measured.

Contingent Assets

- A contingent asset that arises from past events, and the existence of which will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the entity's control.

1

Future Operating Losses

- No provision may be recognized for future operating losses. Future operating losses do not meet the definition of a liability nor the general standards developed for recognizing provisions.
- Forecasting future operating losses is an indication of the potential devaluation of certain operating assets. The entity tests these assets to determine the devaluation under IAS 3.

2

Useless Contracts

- If an entity has a useless contract, the obligation under the contract shall be recognized and measured as a provision.
- A contract in which the unavoidable costs of fulfilling the obligations under the contract are greater than the economic benefits expected to be received under the contract. A provision shall be recorded in the amount of the unavoidable costs of fulfilling the contract or fines for the failure to fulfill the contract obligations, whichever is lower.

4. Impact of Transition to IAS on the Calculation of Zakat

4.1. International Accounting Standard No. (1)

In terms of zakat, this standard does not have a direct financial impact that would affect Zakat calculation for the following reasons:

- This standard sets out the overall requirements for the presentation of financial statements and guides for their structure, and the minimum requirements for their contents.
- Moreover, this standard clarifies the general requirements of financial statements and the key concepts of financial statements such as going concern, the accounting accrual basis, and a comparison of current and non-current assets and liabilities.
- In respect of the requirements for recognition, measurement and disclosure of precise and specific processes, they have been left to other relevant standards.
- The method of presentation and disclosure in the financial statements does not have a direct financial impact on them; thus an impact may appear on Zakat base as a result of the transition to this particular international standard. However, specific standards dealing with the recognition and measurement requirements of financial statements items shall be addressed and linked to this standard, and then compare them with the disclosure and presentation requirements to determine whether there is an impact on Zakat processing when compared with the previous standard in force before the transition to IFRS.
- Other Comprehensive Income Items: the presentation of the other comprehensive income statement separately in the financial statements as a result of the transition created some complexity and raised many questions about how these items could be processed in terms of Zakat. The table below summarizes the other comprehensive income statement items and their Zakat processing:

Other Comprehensive Income Items that may be Reclassified to Profit or Loss:	Zakat Handling
Profits and losses arising from the translation of financial statements into a foreign currency (IAS 21).	No adjustment of net profit or loss is required for Zakat purposes. However, profits or losses realized in subsequent years will be recycled to automatically become in profits or losses for Zakat purposes.
Profits and losses on financial assets measured at fair value through other comprehensive income in accordance with paragraph 4.1.2A of IFRS 9, except for simple equity instruments such as investments in common shares.	No adjustment of net profit or loss is required for Zakat purposes. However, when these investments are disposed of and mentioned, e.g., investments in debt instruments classified as fair value investments through other comprehensive income, realized profits or losses will be recycled to automatically become in the statement of profits or losses in the disposal year to be subjected to Zakat as part of adjusted net profit for Zakat purposes.
Effective part of profits and losses on hedging instruments used in cash flow hedge.	No adjustment of net profit or loss is required for Zakat purposes. However, profits or losses realized in subsequent years will be recycled to automatically become in profits or losses for Zakat purposes.
Changes in the value of the forward components of forward contracts when the forward components are separated from the spot components of a forward contract and the changes in the spot components are designated as only the hedging instrument. Changes in the value of the difference based on the foreign exchange rates of a financial instrument when being excluded from designating such financial instrument as a hedging instrument (IFRS 9).	No adjustment of net profit or loss is required for Zakat purposes. However, profits or losses realized in subsequent years will be recycled to automatically become in profits or losses for Zakat purposes.

Other comprehensive income items that may be reclassified to profit or loss:	Zakat Handling
Changes in the revaluation surplus (IAS 16 and IAS 38).	It is handled as part of the additions to Zakat base due to its finance deducted from the Zakat base (tangible and intangible assets). In all cases, the outcomes of the re-evaluation that are recognized in the statement of other comprehensive income do not require an adjustment to the outcome of the activity due to the nature of the mentioned item and its lack of impact on the statement of profit or loss (the activity outcome).
Actuarial Profits and losses from defined benefit plans (IAS 19).	This item shall not be adjusted for profit or loss for Zakat purposes as it is not part thereof.
Profits and losses from investments in equity instruments measured at fair value through other comprehensive income (IFRS 19).	Realized Profits and losses shall be adjusted with profits or losses for the purposes of calculating adjusted net profit for Zakat purposes as they will not be recycled, if realized, to profits or losses (the activity outcome). For unrealized profits or losses, this does not require an adjustment to the activity outcome regarding them.
Profits and losses on hedging instruments that are hedging investments in equity instruments measured at fair value through other comprehensive income (IFRS 9).	Realized Profits and losses shall be adjusted with profits or losses for the purposes of calculating adjusted net profit for Zakat purposes as they will not be recycled, if realized, to profits or losses statement For unrealized profits or losses, this does not require an adjustment to the activity outcome regarding them.

4.2. International Accounting Standard No. (37)

According to IAS 37, the requirements for recognition of provisions may differ from those before the transition. However, this does not lead to a difference in the method of Zakat handling of these provisions and remains the same in accordance with Article (4) of the Executive Regulations of levying Zakat as follows:

- If any provision is recognized (e.g., provision for employee benefit plans, provision for dismantling and removal of fixed assets, provision for issues, etc.), the component part during the year will affect the profits or losses; thus it is among the non-deductible expenses for the purposes of calculating adjusted net profit for Zakat purposes (the adjustment to the activity outcomes).
- After the deduction of the portion used, the opening balance is added to the tax base, unless the balance is used during the year to finance a deducted asset.

5. Theoretical Applications

5.1. International Accounting Standard No. (1)

Example 1: Determining whether liabilities shall be presented as current or non-current.

The following is some common scenarios regarding debt covenants:

Scenario 1

The entity has a long-term loan arrangement that contains a debt covenant. The specific requirements in the debt covenant shall be met as at December 31 of each year. The loan is repayable in more than (12) months. The entity breaches the debt covenant at the end or before the end of the period. Consequently, the loan is repayable on demand.

Scenario 2

Let's assume the same facts as Scenario 1 but the loan arrangement stipulates that the entity has a grace period of (3) months to correct the breach during which the lender cannot demand immediate repayment.

Scenario 3

Let's assume the same facts as Scenario 1 but the lender agrees not to demand repayment as a result of the breach. The entity obtains this assignment:

A. At the end or before the end of the period, and the waiver is for more than (12) months after the end of the period.

B. At the end or before the end of the period, and the waiver is for less than (12) months after the end of the period.

C. After the end of the period but before the financial statements are approved for issue.

Scenario 4

The entity has a long-term loan arrangement that contains a debt covenant. The loan is repayable in more than (12) months. At the end of the period, the debt covenants shall be fulfilled. However, circumstances change unexpectedly and the entity breaches the debt covenant after the end of the period but before the financial statements are approved for issue.

IFRS 7 requires the following disclosures for any repayable loan recognized at the reporting date:

1. Details of any defaults during the period of the principal, interest, sinking fund or refund terms.

2. The booking value of the non-performing loans repayable at the reporting date.

3. Whether the default is corrected or the outstanding debt covenants are renegotiated before the financial statements are approved for issue.

If during the period there is a breach of the terms of the loan agreement other than those mentioned above, the same information shall be disclosed if such breaches allow the lender to demand immediate repayment (unless the default is corrected or the debt covenants are renegotiated on or before the reporting date).

Moreover, IAS 1 requires certain disclosures on the refinancing and correction of breach of the loan agreement that takes place after the end of the reporting period and before the statements are permitted to be issued.

The table below shows whether the debt will be presented as current or non-current and whether the disclosures mentioned are required.

	Scenario					
	1	2	3. (A)	3. (B)	3. (C)	4
At the end of the period, does the entity have an unconditional right to defer settlement of the obligation for at least (12) months?	No	No	Yes	No	No	Yes
Classification of Liability	Current	Current	Not Current	Current	Current	Not Current
Is disclosure of IFRS 7 above required?	Yes	Yes	No	Yes	Yes	No
Are disclosures in IAS 1 required?	No	No	No	No	Yes	No

Example 2: Analysis of Expenses according to its Nature

For some entities, "reliable and more appropriate information" can be achieved by grouping expenses to present them in profit or loss by nature (e.g., depreciation, purchase of materials, transport costs, employee benefits and advertising costs), rather than redistributing them by function within the entity. According to IAS 1, this method may be easy to apply due to the unnecessary allotment of expenses on functional classifications. The standard clarifies the classification using the nature of expenses method as follows:

According to the Nature of Expenses		
Revenues		×××××
Other revenue		×××××
Changes in finished goods inventory and production in operation	×××××	
Raw materials and consumables used	×××××	
Employee Benefits	×××××	
Depreciation and amortization expenses	×××××	
Other expenses	×××××	
Total Expenses		×××××
Profits before taxes		×××××

Example 3: Analysis of Expenses by Function

For some entities, "reliable and more appropriate information" can be achieved by grouping expenses to present them in profit or loss by nature (e.g., depreciation, purchase of materials, transport costs, employee benefits and advertising costs), rather than redistributing them by function within the entity. According to IAS 1, this method may be easy to apply due to the unnecessary allotment of expenses on functional classifications. The standard clarifies the classification using the nature of expenses method as follows:

According to the Function of Expenses	
Revenues	×××××
Sales Cost	×××××
Total Profit	×××××
Other revenue	×××××
Distribution Cost	×××××
Administrative Costs	×××××
Other expenses	×××××
Profits before taxes	×××××

5.2. International Accounting Standard No. (37)

Example 1: Example 1: Initial Measurement of Provisions - Issues

A customer sues the entity for personal injury when using one of the entity's products. The entity's lawyers estimate from the experience that at the reporting date (December 31, 2011); the entity is 30% required to pay compensation to the customer in an amount of 2 million Saudi riyals and is 70% required to pay compensation in an amount of SAR 300,000.

A judgment is expected to be delivered in two years. The risk-free discount rate on the basis of two-year government bonds is 5 percent. The entity determines that a discount rate of 4 percent is appropriate to adjust the risk of liability.

- The Answer

The result is expected to be cash outflows of either 2 million Saudi riyals or SAR 300,000 within two years. The most likely result is compensation of SAR 300,000 to settle the obligation. However, given that the other potential result is higher than the most likely result, the best estimate of the obligation settlement on December 31, 2011 will be higher than the current value of the most likely result of SAR 300,000.

In accordance with the principle of determining the amount required to settle the obligation on December 31, 2011 AD, the entity can use the expected value approach to determine the amount. Thus, it would be appropriate to recognize a current value provision for the expected value of SAR 810,000. In this case, the entity will recognize a provision of approximately SAR 748,891 on December 31, 2011 AD.

- Calculations:

Expected Value: (30% x SAR 2,000,000) + (70% x SAR 300,000) = SAR 810,000.
Risk-adjusted current value of expected value: SAR 810,000 x (1/1.04) x (1/1.04) = SAR 748,891.

- Zakat Handling

Regardless of the methodology used to calculate the provision amount, Zakat handling is as follows:

Minimum: Adjustment of the activity outcome (adjusted net profit for zakat purposes) with the component part of the provision which is (748,891 + 61,109 = 810,000). Zakat base: The opening balance minus the used or reversed amount from this provision is added to Zakat base.

Example 2: Example 1: Initial Measurement of Provisions - Issues

Assuming the same facts provided in Example 1. However, in this example, the entity's lawyers estimate that the entity has a 60 percent chance of earning the case; thus avoiding the payment of compensation. In addition, the entity's lawyers estimate that the entity has a 20 percent chance of paying the customer compensation of 2 million Saudi riyals and 20 percent to pay compensation of SAR 300,000.
For the purpose of this example, liability risks and time value of money was disregarded.

- The Answer

In this case, the entity shall disclose a contingent liability rather than recognition of provision. The contingent liability is not recognized in the entity's statement of financial position, because it does not meet the criteria for recognizing the provision mentioned in the standard. Accordingly, the entity does not have to recognize any entries in its books. In terms of Zakat, it does not require any adjustment to the activity outcome or Zakat base, given that the standard requirement here is only disclosure of a contingent liability, which has no financial impact.

Example 3: Example 1: Initial Measurement of Provisions - Issues

The entity sells 1,000 units of a product with warranties under which the entity will repair any manufacturing defects that appear within the first six months after purchase. If a product is found to have a minor defect, it will result in an estimated repair cost of SAR 100.

If a product is found to have a major defect, it will result in an estimated repair cost of SAR 400. The entity's experience along with its future expectations indicates that 75 percent of the goods sold have no defects and 20 percent of the goods sold have minor defects.
5 percent of the goods sold have major defects.
For the purpose of this example, liability risks and time value of money was disregarded.

- The Answer

When the provision includes a large number of items, the best estimate of the amount reflects a weighting of all possible outcomes through their associated possibilities

- Calculations:

The expected value of the repair cost is (75% x 1,000 units sold x zero Saudi riyal) + (20% x 1,000 units x SAR 100) + (5% x 1,000 units x SAR 400) = SAR 40,000. Thus, the provision amount of SAR 40,000 would be appropriate.

- Zakat Handling

Regardless of the methodology used to calculate the provision amount, Zakat handling is as follows:

Minimum: Adjustment of the activity outcome (adjusted net profit for zakat purposes) with the component part of the provision recognized in the statement of profits and losses, which is SAR 40,000.

Zakat Base: The opening balance minus the used or reversed amount from this provision is added to Zakat base.

External document

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