Accounting for Ijarah and Ijarah Muntahia Bittamleek

“said one of them ‘O my father engage him on wages’(2) and “if you had wished, surely you could have exacted some recompense for it”(3)

Chapter 10

CHAPTER LEARNING OBJECTIVES:

- Explain the concept of Ijarah and how Ijarah is used by Islamic banks to finance customers.
- Understand the accounting treatment for Ijarah and Ijarah Muntahia Bittamleek.

(2) Surah al-Qasas verse 26.
(3) Surah al-Kahf verse 77.
10.1 Introduction

Ijarah usually refers to an Islamic leasing contract of land, property or equipment that is leased to a client for a stream of rental payments.

There are two types of Ijarah contacts:

(i) **Ijarah** - operating Ijarah
(ii) **Ijarah Muntahia Bittamleek** – Ijarah with option to transfer ownership of asset to lessee.

10.2 Financing model of Ijarah

The above diagram shows a normal Ijarah transaction. The bank pays (1) the manufacturer or vendor the price of the product (in this case, a car) to be leased. The vendor usually delivers the car (2 and 3) to the bank’s customer. The customer then makes a series of rental payments over the term of the Ijarah contract (4). If it is Ijarah Muntahia Bittamleek, the bank sells the car to the customer at the end of the Ijarah term. If it is Operating Ijarah, the car is returned to the bank to be released or disposed.
In *Ijarah Muntahia Bittamleek*, the ownership of the asset is transferred to the customer at the end of the *Ijarah* term. These can be done in a number of ways:

1. **Gift at the end of the period of the *Ijarah***. This means the ownership of the asset is transferred to the lessee for **no consideration** by entering into a gift contract in fulfilment of a prior binding promise (made at the inception of the *Ijarah* contract), upon the settlement of the last lease rental payment. The title can also be transferred through a gift deed which is conditional on the completion of all *Ijarah* rental payments (i.e. installments).

2. **Sale for a token consideration at the end of the *Ijarah** contract**. The token consideration must be agreed between the parties.

**Note:**

*In cases (i) and (ii), the *Ijarah* rentals would include a portion of the capital cost of the asset. If the asset is not transferred at the end of the *Ijarah* period, and the asset is not impaired, and the lessee has fulfilled his other obligations, then the rent should be adjusted to a fair amount and the balance refunded to the lessee.*
(iii) Sale at the end of the lease for an amount specified in the lease. This is done through an *ijarah* contract together with a promise to enter into a sale contract. The sale contract will include the amount to be paid after the expiry of the *ijarah* period.

(iv) **Sale of the asset at any time during the period of the lease for an amount equal to the remaining installments.** In this case, an *ijarah* contract is executed together with a promise to sell the asset to the lessee, whenever he wishes to buy the asset during the period of the lease for a price equal to the remaining installments. When the lessee exercises the option to buy, the bank will execute a sale contract.

(v) **Sale through gradual transfer of title.** This is executed through an *ijarah* contract with a promise to gradually transfer the title of the asset to the lessee until the asset is fully transferred. In this case, the price needs to be determined so that a proportionate share is transferred at every period. There needs to be a sale contract for each transfer and a reduction in lease rental as the bank’s ownership of the asset decreases.

### 10.3 Recognition of Ijarah transactions and journal entries

**Recognition and Measurement of Ijarah**

Financial Accounting Standard No. 8 (FAS 8) sets out the accounting rules for recognizing, measuring, presenting and disclosing *ijarah* and *ijarah* Muntahia Bittamleek transactions of Islamic financial institutions.

The standard covers acquisition of *ijarah* assets, leasing of the assets, *ijarah* expenses and revenues, gains and losses including balance sheet presentation.
Operating ijarah in the books of the lessor:

(1) Assets acquired for ijarah

Assets acquired is recognized at historical cost. This includes net purchasing price plus all expenses necessary to bring the asset to intended use. Examples of expenses are custom duties, taxes, freight, insurance, installation, testing.

If there is a permanent reduction in the estimated residual value, this reduction is recognized as a loss in the respective financial period.

Leased assets is depreciated on a basis consistent with lessor’s normal depreciation policy for similar assets.

Leased assets are presented in the financial statements as Investments in Ijarah assets.

(2) Ijarah Revenue

Ijarah revenue should be allocated proportionately to the financial period of the lease term. Ijarah revenue is presented in the income statement as ijarah revenue.

(3) Initial direct costs

If material, should be allocated over the lease period consistent with lease revenue pattern. If immaterial, they should be expensed directly in the income statement.
(4) Repairs of leased assets

a) Repairs that are necessary for securing the service of the leased assets shall, if immaterial, be recognized in the financial periods in which they occur.

b) If the repairs are material and differ in amount from year to year over the lease term, then a provision for repairs shall be established by regular charges against income.

c) If the lessee undertakes repairs of a leased asset with the lessor’s consent and the cost of the repairs are chargeable to the lessor, then the lessor shall recognize these repairs as an expense in the financial period in which they are incurred.

(5) At the end of the financial period

a) Amortisation of initial direct cost, if material, shall be recognized as an expense of the period.

b) If a provision for repairs has been established, the cost of repairs for the period shall be charged against the provision.

c) Leased assets shall be depreciated according to the lessor’s normal depreciation policy for similar assets.

d) Ijarah instalments receivable shall be measured at their cash equivalent value.

Operating Ijarah in the books of the lessor

On 20th June, 2007, Islamic Bank bought 10 cars from the manufacturer at a cost of $10,000 each. The freight and registration costs were $500 for each car.

During the year, Islamic Bank managed to lease all its cars on operating Ijarah contract for two years with monthly rental of US$500 per car, payable ½ yearly in advance, starting 1 July 2007.

Journal entries include the following:

20th June 2007
Dr Investment in Ijarah Assets 105000
(10,500*10)
Cr Cash 105000
[Purchase of 10 cars for Ijarah, plus freight and registration charges]

1 July 2007
Dr Cash 30000
Cr Ijarah Revenue 30000
[Rental received]
In the books of the bank as lessee.

In the books of the lessee, the Ijarah installments are recognized as an expenses under the accrual concept over the term of the Ijarah and presented as Ijarah expenses. Initial direct costs, if material, may be allocated over the lease period. If immaterial, they should be charged directly as expense.

**Ijarah Muntahia bittamleek (IMBT) in the books of the lessor bank.**

As there are four permutations to this, the accounting rules will be displayed on a table corresponding to the four types of IMBT.

<table>
<thead>
<tr>
<th>Transactions</th>
<th>Through Gift</th>
<th>Sale for token consideration</th>
<th>Sale for remaining installments</th>
<th>Gradual sale</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Assets acquired for Ijarah</strong></td>
<td></td>
<td>Same as Operating Ijarah</td>
<td></td>
<td></td>
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<tr>
<td><strong>Contracting and beginning of Ijarah</strong></td>
<td></td>
<td>Investment in Ijarah similar to Operating Ijarah</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Ijarah revenue</strong></td>
<td></td>
<td>Same as Operating Ijarah</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Repairs of leased assets</strong></td>
<td></td>
<td>Same as Operating Ijarah</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>End of financial year</strong></td>
<td>Same as Operating Ijarah</td>
<td>Same as Operating Ijarah</td>
<td>Same as Operating Ijarah</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Leased assets shall be depreciated according to the lessor’s normal depreciation policy for similar assets. However, no residual value of leased assets shall be subtracted in determining the depreciable cost of these</td>
<td>The consideration for the transfer of title in a leased asset at the conclusion of a lease (i.e., the asset’s residual value to the lessor) shall be subtracted in determining the depreciable cost of these assets.</td>
<td>if the lessee is not obliged to fulfill his promise to purchase the leased asset and decides not to do so, the asset shall be recognized in the lessor’s statement of</td>
<td></td>
</tr>
<tr>
<td>Transactions</td>
<td>Through Gift</td>
<td>Sale for token consideration</td>
<td>Sale for remaining installments</td>
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<td>----------------------------------</td>
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<tr>
<td></td>
<td>assets since they are to be transferred to the lessee as a gift.</td>
<td></td>
<td></td>
<td>financial position under Assets Acquired for Ijarah and valued at cash equivalent value or net book value whichever is lower. Where the cash equivalent value is less than the net book value, the difference between the two amounts shall be recognized as a loss in the financial period in which it occurs.</td>
</tr>
<tr>
<td><strong>End of Ijarah Term</strong></td>
<td>Legal title of the leased asset shall pass to the lessee, provided that all Ijarah instalments are settled.</td>
<td>Legal title of the leased asset shall pass to the lessee, provided that all Ijarah instalments are settled and the lessee purchases the asset.</td>
<td>Legal title shall pass to the lessee when he buys the leased assets prior to the end of the lease term for a price that is equivalent to the remaining Ijarah instalments and the lessor shall recognize any gain or loss resulting from the difference between the selling price and the net book value.</td>
<td>Upon the full payment of both the Ijarah instalments and the price of the purchased portions of the leased assets, all Ijarah related accounts shall be closed.</td>
</tr>
<tr>
<td><strong>Sale of leased assets</strong></td>
<td></td>
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<td></td>
</tr>
</tbody>
</table>
10.4 Asset and Liability measurement

The balance sheet and Income Statement presentation is as shown:

<table>
<thead>
<tr>
<th>Balance Sheet</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Ijarah or Ijarah Muntahia Bittamleek Assets</td>
<td>XX</td>
</tr>
<tr>
<td>Less : Accumulated Depreciation</td>
<td>(XX)</td>
</tr>
<tr>
<td>Net Book value of Assets</td>
<td>XX</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Income Statement</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Ijarah Revenue</td>
<td>XX</td>
</tr>
<tr>
<td>Less : Depreciation on Ijarah Assets</td>
<td>(XX)</td>
</tr>
<tr>
<td>Less: maintenance and other costs</td>
<td>XX</td>
</tr>
<tr>
<td>Less : Direct costs amortized.</td>
<td>(XX)</td>
</tr>
</tbody>
</table>
1. Mr. ABC leases a car, for 5 years, from an Islamic Bank in a transaction of Ijarah Muntahia Bit'tamleek through sale for a token consideration. At the end of the Ijarah term, the cash equivalent value of the car is US$ 1,000 while the net book value is US$ 1,500. Mr. ABC is not obliged to purchase the car, and at the end of the Ijarah term, he decides not to purchase it. Therefore, the Islamic Bank should do the following:

   a) The car is recognized as Assets Acquired for Ijarah at US$ 1,500 and loss is recognized at US$ 500.
   b) The car is recognized as Assets Acquired for Ijarah at US$ 1,000 and loss is recognized at US$ 500.
   c) The car is recognized as Fixed Assets at US$ 1,500 and loss is recognized at US$ 500.
   d) The car is recognized as Fixed Assets at US$ 1,000 and loss is recognized at US$ 500.

2. An Islamic Bank purchases a building, which is to be leased to its client through an Operating Ijarah. The Islamic Bank incurs US$ 2,000,000 purchase price for the building and US$ 200,000 in taxes for the purchase. In addition, the Islamic Bank also incurs US$ 2,000 – which it considers to be immaterial costs – in arranging the lease agreement with its clients.

   The correct accounting treatment includes:

   a) US$ 2,000,000 shall be recognized as fixed asset and US$ 200,000 shall be allocated over the financial periods of the lease term.
   b) US$ 2,200,000 shall be recognized as fixed asset and US$ 202,000 shall be charged as expenses.
   c) US$ 2,200,000 shall be recognized as fixed asset and US$ 2,000 shall be charged as expenses.
   d) US$ 2,000,000 shall be recognized as fixed asset and US$ 202,000 shall be allocated over the financial periods of the lease term.

3. If an Islamic Bank is a lessee in an Operating Ijarah transaction, the Ijarah installments should be ...

   a) Accrued when incurred.
   b) Segregated into asset cost and rental components.
   c) Recognized when they are paid.
   d) Presented in the lessee’s income statement as Ijarah revenue.
4. Bank Mualamalat entered into an Ijarah Muntahia Bittamleek agreement with Ali & Co. to finance the purchase of factory machinery which runs on gas at $400,000. The terms are as follows:

Ali & Co. to pay a deposit of 10% of the price to the bank on the signing of the Ijarah contract. They are to pay Bank Muamalat Ijarah rental of $50,000 every 6 months for 5 years. At the end of 5 years, the salvage value of the machine would be $50,000. The bank will transfer the ownership of the machine to Ali & Co for $20,000.

Required:

(i) Journal entries in the books of Bank Muamalat for the 5 years period of the ijarah.
(ii) Extract of the balance sheet and income statement for the same period.

5. If an Islamic Bank is a lessee in Ijarah Muntahia Bittamleek through gradual sale of the leased asset, which of the following should apply:

a) Portion of the leased asset purchased by the Islamic Bank is measured at the lower of purchasing price and market value.
b) Portion of the leased asset purchased by the Islamic Bank is depreciated according to its depreciation policy.
c) If the sale price of the leased asset differs from its market value, the difference is allocated over the lease term as adjustment to the Islamic Bank’s Ijarah expenses.
d) All of the above.