[Exposure Draft (No. F2/2018) v.5.3 of the]

Financial Accounting Standard No. __

Ijarah
<table>
<thead>
<tr>
<th>Contents</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Preface</td>
<td>6</td>
</tr>
<tr>
<td>Introduction</td>
<td>7</td>
</tr>
<tr>
<td>Overview</td>
<td>7</td>
</tr>
<tr>
<td>Rationale for issuing this standard</td>
<td>7</td>
</tr>
<tr>
<td>Significant changes from previous standard</td>
<td>7</td>
</tr>
<tr>
<td>Objective of the Standard</td>
<td>9</td>
</tr>
<tr>
<td>Scope</td>
<td>9</td>
</tr>
<tr>
<td>Definitions</td>
<td>9</td>
</tr>
<tr>
<td>Identifying (and separating) an Ijarah</td>
<td>12</td>
</tr>
<tr>
<td>Separating components within the Ijarah contract</td>
<td>12</td>
</tr>
<tr>
<td>Lessee</td>
<td>12</td>
</tr>
<tr>
<td>Lessor</td>
<td>12</td>
</tr>
<tr>
<td>Classification of Ijarah</td>
<td>12</td>
</tr>
<tr>
<td>Ijarah term</td>
<td>13</td>
</tr>
<tr>
<td>Assessment of probability of exercising the extension (including non-termination) options</td>
<td>13</td>
</tr>
<tr>
<td>Subsequent re-assessment of Ijarah term</td>
<td>14</td>
</tr>
<tr>
<td>Accounting and financial reporting by the lessee</td>
<td>14</td>
</tr>
<tr>
<td>Initial recognition</td>
<td>14</td>
</tr>
<tr>
<td>Advance rentals paid</td>
<td>14</td>
</tr>
<tr>
<td>Initial recognition</td>
<td>14</td>
</tr>
<tr>
<td>Initial recognition of right-of-use asset</td>
<td>14</td>
</tr>
<tr>
<td>Initial recognition of Ijarah liability</td>
<td>15</td>
</tr>
<tr>
<td>Special considerations for Ijarah MBT through gradual transfer</td>
<td>15</td>
</tr>
<tr>
<td>Deferred Ijarah cost</td>
<td>15</td>
</tr>
<tr>
<td>Prime cost of the right-of-use asset</td>
<td>15</td>
</tr>
<tr>
<td>Underlying asset cost method</td>
<td>15</td>
</tr>
<tr>
<td>Estimation based on liability method</td>
<td>16</td>
</tr>
<tr>
<td>Subsequent measurement</td>
<td>16</td>
</tr>
<tr>
<td>Subsequent measurement of the right-of-use asset</td>
<td>16</td>
</tr>
<tr>
<td>Amortization of right-of-use asset</td>
<td>16</td>
</tr>
</tbody>
</table>
Appendix B: Basis for conclusions

Amendments to other standards

Effective date

Other related accounting treatments

Sale and Ijarah-back transactions

Sale of the asset

Accounting for the sale of the asset – by seller-lessee

Accounting for the buyer-lessee

Forward Ijarah

Hamish Jiddiyyah (security deposit)

Charity

Effective date

Transitional provisions

Amendments to other standards

APPENDICES

Appendix A: Adoption of the Standard

Members of the Board

Reservation

Working group Members

Executive team

Appendix B: Basis for conclusions

Reason for revision of the standard

Key distinguishing factors between an Ijarah MBT and conventional finance lease

Accounting for usufruct / right-of-use asset

Recognition of usufruct and its amortization

Charity

Scope exclusions - Service Ijarah

Ijarah MBT through gradual transfer

Commencement date vs. inception date

Advances, deposits and Hamish Jiddiyah
Determining the ‘prime cost’ of the right-of-use asset ................................................. 34
Costs and expenses related to the right-of-use asset .......................................................... 35
Accounting and financial reporting by the Lessor ................................................................. 35
Residual value – usufruct and underlying asset ................................................................... 35
Lease term and extension options ....................................................................................... 36
Appendix D: Brief history of the preparation of the standard .............................................. 37

AAOIFI Financial Accounting Standard No. __ “Ijarah” is set out in paragraph 01-112. All the paragraphs have equal authority. This standard should be read in the context of its objective and the Conceptual Framework for Financial Reporting as endorsed by AAOIFI.

All AAOIFI FASs shall be read in conjunction with the definitions, Shari’ah rules and principles and key considerations provided by AAOIFI Shari’ah standards in respect of such products and matters.
Preface

PR1 Ijarah and Ijarah Muntahia Bittamleek (Ijarah MBT) in its different forms are amongst the most common Islamic finance transactions. These are used very commonly by Islamic financial institutions (IFIs / the institutions) for providing assets to customers in need of financial resources in different sectors. A significant proportion of underlying assets in Sukuk structures are also based on such transactions.

PR2 AAOIFI’s Accounting Board (AAB), in its strive for improvements of the existing financial reporting standards, decided to revise the existing FAS 8 “Ijarah and Ijarah Muntahia Bittamleek” in order to address the issues faced by the market and the observations noted over past several years, as well as, to improve the existing accounting treatments in line with the global best practices. This standard accordingly supersedes the existing FAS 8 “Ijarah and Ijarah Muntahia Bittamleek”.

PR3 This standard brings a fundamental shift in the accounting approach for Ijarah transactions, particularly, in the hand of the lessee. In contrast to the earlier accounting approach of the off-balance sheet accounting for Ijarah, the new standard prescribes an altogether different model of accounting in the hand of lessee which entails recognition of the lessee’s unencumbered right to the benefits from the use of the asset as “right-of-use asset” and corresponding liability.

PR4 It is expected that the new standard will improve the overall accounting and financial reporting practices of the Islamic finance industry and will bring the same closer to the global best practices, without any compromise on Shari’ah principles or the essence of the transaction.
Introduction

Overview

IN1 This standard improves upon and supersedes AAOIFI’s Financial Accounting Standard 8 “Ijarah and Ijarah Muntahia Bittamleek” (FAS 8) issued in 1995. This standard aims at setting out principles for the classification, recognition, measurement, presentation and disclosure of Ijarah type transactions including their different forms entered into by the Islamic financial institutions (IFIs / the institutions), in both the capacities of lessor and lessee.

Rationale for issuing this standard

IN2 The AAOIFI’s accounting board (the Board), after its constitution in 2015, approved a strategy and plan for improvement in and revision of a significant number of existing FAS. Revision of FAS 8 “Ijarah and Ijarah Muntahia Bittamleek” was already on agenda of the earlier board, and a limited scope revision was already under discussion at the accounting standards committee. However, considering the then expected changes in the generally accepted accounting principles with regard to lease accounting, it was decided that that standard revision shall be made duly considering the principal changes in accounting by the global accounting standard setters.

IN3 The Board was also mindful of the fact that eliminating or reducing the financial reporting requirements with regard to any demonstrable differences between Ijarah and Ijarah MBT against conventional leases will jeopardize the sanctity of the transaction’s financial reporting and may also impact the reputation of the Islamic finance industry negatively.

IN4 A review of FAS 8 “Ijarah and Ijarah Muntahia Bittamleek” and preliminary study on the topic duly considering the above factors identified that there were needs for improvement in the same in line with the changes in the industry and the global best practices of accounting. Certain observations and comments of certain terminology and approaches used in the said standard were noted from the Shari’ah perspective as well. Accordingly, the Board decided to issue a revised standard on the subject of Ijarah.

Significant changes from previous standard

IN5 This standard (FAS ___) brings significant changes from its predecessor standard (FAS 8), inter alia, in the following aspects:

a. changes in the classification. Ijarah in this standard are classified into the following:
   a. Operating Ijarah;
   b. Ijarah MBT with expected transfer of ownership after the end of the Ijarah term – either through a sale or gift; and
   c. Ijarah MBT with gradual transfer – with gradual transfer ownership during the Ijarah term including Diminishing Musharaka Ijarah;

1 Both the International Accounting Standards Board (IASB) and Financial Accounting Standards Board (US FASB) were working on a converged project for revision and improvement in accounting for leases, and exposure drafts of the standards were issued. The project resulted in both the bodies in revising their respective standards, principally on the same lines although they still maintain significant differences in respect of certain accounting issues.
b. requirement to identify and separate Ijarah and non-Ijarah components, if needed;

c. new recognition and measurement for initial recognition for right-of-use, Ijarah Liability and advance payments for lessee and lessor accounting;

d. further simplification of measurement requirements for Ijarah liabilities, in particular the requirements for variable Ijarah payments;

e. in an Ijarah MBT through gradual transfer / Diminishing Musharaka Ijarah, where the ownership and right-of-use of the underlying asset co-exist, the lessee shall recognize the ‘combined asset’ (including the right-of-use asset and the proportionate asset already owned by him) whereas the lessor shall recognize the proportionate asset owned. FAS 8 requirements of recording monthly depreciation and gain and loss are done away with;

f. testing for impairment of right-of-use asset shall be subject to requirements of FAS 30 “Impairment, Credit Losses and Onerous Commitments”;

g. the standard allows a simplified approach for the lessee, subject to certain conditions;

h. detailed guidelines are provided for presentation and disclosures with enhanced disclosure by lessor and lessee of information as compared to previous requirements in FAS 8.
Objective of the Standard

1. The objective of this standard is to set out principles for the classification, recognition, measurement, presentation and disclosure for Ijarah (asset Ijarah, including different forms of Ijarah Muntahia Bittamleek) transactions entered into by Islamic financial institutions (IFIs / the institutions) on both ends of the transaction i.e. as a lessor and lessee. An institution shall consider the terms and conditions of contracts and all relevant facts and circumstances when applying this standard, and shall apply the same on a consistent basis.

Scope

2. This standard shall apply for accounting and financial reporting for a lessor or lessee, for all Ijarah (asset Ijarah, including Ijarah Muntahia Bittamleek (Ijarah MBT)) transactions unless specifically excluded under paragraph 3.

3. This standard shall not be applied for accounting of:
   a. Sukuk based on Ijarah which shall be subject to accounting under respective FAS;
   b. Ijarah or lease agreements for exploration or use of natural resources, such as oil, gas, timber, metals and the like;
   c. Ijarah or lease transactions concerning licensing agreements of certain items such as motion pictures, video recordings, manuscripts, patents and copyrights; and
   d. Service Ijarah transactions including employment / labour contracts and hiring of professional services and other service based contracts (not involving tangible assets).

Definitions

4. For the purpose of interpreting and applying this standard, the following short definitions are relevant:
   a. Combined asset – is an underlying asset subject to Ijarah MBT through gradual transfer, or any other form of Ijarah MBT, in which proportionate ownership and right-of-use co-exist on the same asset;
   b. Commencement date – is the date on which the lessor makes an underlying asset available for use by the lessee, in a condition suitable for intended purpose and use;
   c. Contract – is an agreement between two or more parties that creates enforceable rights and obligations;
   d. Control – an institution controls an asset or business, when it has substantially all risks and rewards incidental to ownership of such asset or business, duly meeting both of the following conditions:
      i. it is directly exposed to, or has rights to, variable returns (negative or positive, respectively) from its involvement with such assets or business; and
      iii. it has the ability to affect those returns through its power over the assets or business;
   e. Deferred Ijarah cost – shall be as defined in paragraph 29;
f. Diminishing Musharaka (Shirkat ul Milk) Ijarah – is a hybrid Ijarah product similar to ‘Ijarah Muntahia Bittamleek through gradual transfer’ comprising of:
   i. a co-ownership in which two parties share the ownership of a tangible asset in an agreed proportion (without intention to engage in common business with respect to such asset); and
   ii. a promise under which one of the co-owners undertakes to buy in periodic installments the proportionate share of the other co-owner until the ownership / title to such tangible asset is completely transferred to the purchasing co-owner (whereby each transaction takes place as a sale); and
   iii. a separate Ijarah contract, whereby one co-owner (lessor) rents out its proportionate share in the asset to the other co-owner (lessee);

g. Effective rate of return method [also referred to as effective profit rate method] – is a method of allocating income from an asset or venture uniformly, and equitably over the contractual (or expected) period of expected benefit from the asset or continuity of venture. This method allocates the cash flows from asset or venture through a uniform rate of return including all cash flows considering all contractual terms (or best expectations) excluding expected future losses. Any fee paid or received, the transaction costs, premiums or discounts are included in the cash flows insofar as these are part of the base contract, or are ancillary costs;

h. Fair value – is the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date;

i. Fixed Ijarah rentals – are fixed Ijarah rentals paid by a lessee to a lessor for the right to use an underlying asset during the Ijarah term, excluding variable Ijarah rentals, and include in-substance fixed Ijarah rentals;

j. Forward Ijarah (Ijarah Mawsufah fi al-Dhimma) – is an Ijarah contract for an unidentified (and at times, presently non-existent) asset undertaken by the lessor to be delivered to the lessee according to the agreed specifications;

k. Hamish Jiddiyah (security deposit) – is the amount deposited as a security against fulfillment of a contract, or promise, or completion of a transaction by one of the parties to other;

l. Ijarah – is a contract, or part of contractual arrangement, that transfers the usufruct of an asset (the underlying asset) for a period of time in exchange for consideration, from a lessor (the owner of the underlying asset) to a lessee. It has three major elements:
   i. a form – which includes an offer and an acceptance;
   ii. two parties – a lessor and a lessee; and
   iii. the object of the (Ijarah) contract – which includes the rental amount and the service benefit;

m. Ijarah contract modification – is a change (with mutual consent of the parties) in the scope of an Ijarah, or the consideration for an Ijarah, that was not part of the original terms and conditions of the Ijarah (for example, adding or terminating the right to use one or more underlying assets, or extending or shortening the contractual Ijarah term);

n. Ijarah Muntahia Bittamleek (Ijarah MBT) – is a hybrid Ijarah arrangement which, in addition to the Ijarah contract, includes a promise resulting in transfer of the ownership of the underlying asset to the lessee, either after the end of the term of the Ijarah period or by stages during the term of the contract. Such transfer of the ownership is executed through a sale or a gift, or a series of sales transactions – independent of Ijarah contract;
o. **Ijarah rentals (Ujra)** – represents consideration due to the lessor from lessee against transfer of the usufruct (right-of-use) and includes fixed rentals including in-substance fixed rentals, and variable rentals, but does not include any consideration paid or promised for transfer of ownership or proportionate ownership, either as lump sum or as a gradual payment or as a residual value guarantee;

p. **Ijarah term** – represents the binding period covered by the Ijarah contract, as well as, the reasonably certain optional periods (see paragraph 13);

q. **Initial direct costs** – are the incremental costs of executing an Ijarah transaction that would not have been incurred if the Ijarah transaction had not been executed except for such costs incurred by a manufacturer or dealer lessor in connection with an Ijarah MBT;

r. **In-substance fixed Ijarah rentals** – in-substance fixed Ijarah rentals are rentals that may, in form, contain variability but that, in substance, are unavoidable;

s. **Lessee** – is a party in Ijarah contract that obtains the usufruct of an underlying asset for a period of time in exchange for consideration;

t. **Lessor** – is a party in Ijarah contract that provides the usufruct of an underlying asset for a period of time in exchange for consideration;

u. **Onerous commitment** – is a commitment, in which the unavoidable costs of meeting the obligations under the commitment, exceed the economic benefits expected to be received under it;

v. **Operating Ijarah** – is an Ijarah that is not accompanied with an option of transfer of ownership of the underlying asset to the lessee;

w. **Residual value of underlying assets** – is the amount which is expected to be recovered for these assets at the end of their useful life, net of the expected cost of disposal. Residual value of underlying assets is to be estimated at the commencement of the Ijarah;

x. **Residual value of right-of-use assets** – is the amount, if any, expected to be recovered for these assets computed in accordance with paragraph 37;

y. **Right-of-use asset (usufruct asset)** – is an “intangible” asset that represents a lessee’s legally enforceable right-of-use (or control of usufruct) of an underlying asset (normally being a tangible asset) for the Ijarah term, and includes a ‘combined asset’ for the purpose of application of this standard;

z. **Short-term Ijarah** – is an operating Ijarah that, at the commencement date, has an Ijarah term of 12 months or less;

aa. **Sub-Ijarah** – is an Ijarah transaction for which an acquired right-of-use asset is given on an independent Ijarah basis by a lessee (‘intermediate lessor’) to a third party, and the original Ijarah contract (‘head-Ijarah’) between the head-lesser and lessee remains in effect;

bb. **Underlying asset** – is an asset that is the subject of an Ijarah contract, for which the usufruct has been transferred by a lessor to a lessee;

c. **Useful economic life** – is the period over which an asset is expected to be available for use; or the number of production or similar units expected to be obtained from an asset;

d. **Usufruct** – is a legally enforceable limited right related to an asset including the two property interests of (i) **usu** (use), being the right to use or enjoy such asset and (ii) **fructus** (fruit), being the right to derive profit or benefit from such asset, but does not entail risks and rewards incidental to ownership;
Variable Ijarah rentals – are the portion of rentals paid by a lessee to a lessor for the right to use an underlying asset during the Ijarah term that varies because of changes in facts or circumstances occurring after the commencement date, other than the passage of time.

Identifying (and separating) an Ijarah

5. At inception of a contract, an institution shall assess whether the contract is, or contains, an Ijarah. A contract is, or contains, an Ijarah if the contract transfers the usufruct (but not control) of an identified asset for a period of time in exchange for consideration. Where applicable, the period of time may be agreed in terms of usage factors, rather than the lapse of time factor alone.

6. An institution shall reassess whether a contract is, or contains, an Ijarah only if the terms and conditions of the contract are changed.

Separating components within the Ijarah contract

7. For a contract that is, or contains, an Ijarah, an institution shall account for each Ijarah component within the contract as an Ijarah separately from non-Ijarah components (e.g. service fee, maintenance charges, toll manufacturing charges etc.) of the contract, unless the institution applies the simplified approach as defined in paragraph 10.

8. Unless the simplified approach under paragraph 10 is applied, a lessee shall account for non-Ijarah components applying relevant FAS, or generally accepted accounting principles, in absence thereof, subject to the condition that such accounting policy shall be in line with the Shari’ah principles and rules.

Lessee

9. For a contract that contains an Ijarah component and one or more additional Ijarah or non-Ijarah components, a lessee shall allocate the consideration in the contract to each Ijarah component on the basis of the relative estimated stand-alone price of the Ijarah component and the aggregate estimated stand-alone price of the non-Ijarah components, that may be charged by the lessor, or a similar supplier, to the lessee.

10. As an alternate, a lessee may adopt a simplified approach whereby the lessee may elect, by class of underlying asset, not to separate non-Ijarah components from Ijarah components, and instead account for each Ijarah component and any associated non-Ijarah components as a single Ijarah component.

Lessor

11. For a contract that contains an Ijarah component and one or more additional Ijarah or non-Ijarah components, a lessor shall allocate the consideration in the contract to each Ijarah and non-Ijarah component (performance obligation identified in the contract) on an estimated relative stand-alone price basis. In case of similar characteristics of different Ijarah components, the lessor may opt to consider the same as a single Ijarah component.

Classification of Ijarah

12. An institution, in its capacity either as a lessor or lessee, shall classify each of its Ijarah as:
   a. an operating Ijarah (see paragraph 4(v));
   b. an Ijarah MBT (see paragraph 4(n)), including the following types:
      i. an Ijarah MBT – with expected transfer of ownership after the end of the Ijarah term – either through a sale or a gift; or
      ii. an Ijarah MBT with gradual transfer – with gradual transfer of ownership during the Ijarah term (including Diminishing Musharaka Ijarah).
**Ijarah term**

13. An institution, in its capacity of either a lessor or lessee, shall determine the Ijarah term, including the contractually binding period (which may be denoted in terms of units of production or consumption), as well as, the reasonably certain optional periods including:
   a. extension options (periods covered by an option to extend the Ijarah) – if it is reasonably certain that the lessee will exercise that option; and / or
   b. termination options (periods covered by an option to terminate the Ijarah) – if it is reasonably certain that the lessee will not exercise that option.

**Assessment of probability of exercising the extension (including non-termination) options**

14. In assessing the probability of extension of Ijarah term in line with paragraph 13(a) or 13(b), an institution shall consider all relevant facts and circumstances that create an economic incentive for such extension, including, the following:
   a. as to whether the contractual terms and conditions for the optional periods are at market rates, such as:
      i. the amount of payments for the Ijarah in any optional period;
      ii. the amount of any variable payments for the Ijarah or other contingent payments, such as payments resulting from termination penalties and promise to purchase; and
      iii. the terms and conditions of any options that are exercisable after optional periods (for example, a purchase option that is exercisable at the end of an extension period at a rate that is currently below market rates or transfer of asset through gift);
   b. significant improvements over the underlying assets (leasehold improvements) undertaken (or expected to be undertaken) over the term of the contract that are expected to have significant economic benefit for the lessee when the option to extend or terminate the Ijarah, or to purchase the underlying asset, becomes exercisable;
   c. costs relating to the termination of the Ijarah, such as negotiation costs, relocation costs, costs of identifying another underlying asset suitable for the lessee’s needs, costs of integrating a new asset into the lessee’s operations, or termination penalties and similar costs, including costs associated with returning the underlying asset in a contractually specified condition or to a contractually specified location;
   d. the importance of that underlying asset to the lessee’s operations, considering, for example, whether the underlying asset is a specialized asset, the location of the underlying asset and the availability of suitable alternatives; and
   e. conditions associated with exercising the option (i.e. when the option can be exercised only if one or more conditions are met), and the likelihood that those conditions will exist.

15. It would generally be considered that the lessee is reasonably certain to exercise the extension option if:
   a. an option to extend or terminate an Ijarah is combined with one or more other contractual features (for example, a promise to purchase) in a manner that the lessee still pays more or less the same amount, in total, as it would otherwise pay by exercising the option;
   b. the binding period of an Ijarah is very short – as the exercising such option would generally be economically more feasible;
   c. the lessee’s past practice regarding the period over which it has typically used particular types of assets (whether under Ijarah or owned), and its economic reasons for doing so, determine
the exercising of the option to be economically more feasible and in line with the lessee’s past trends.

16. There is a rebuttable presumption that expressed intention of the lessee to exercise the extension option(s) provides reasonable certainty with regard to extension of Ijarah term.

**Subsequent re-assessment of Ijarah term**

17. A lessee shall reassess whether it is reasonably certain to exercise an extension option, or not to exercise a termination option, upon the occurrence of either a significant event or a significant change in circumstances that:
   a. is within the control of the lessee; and
   b. affects whether the lessee is reasonably certain to exercise an option not previously included in its determination of the Ijarah term, or not to exercise an option previously included in its determination of the Ijarah term.

18. An institution shall revise the Ijarah term if there is a change in either the contractually binding period or reasonably certain optional periods of an Ijarah. For example, the Ijarah term shall be revised if:
   a. the lessee exercises an option not previously included in the institution’s determination of the Ijarah term;
   b. the lessee does not exercise an option previously included in the institution’s determination of the Ijarah term;
   c. an event occurs that contractually obliges the lessee to exercise an option not previously included in the institution’s determination of the Ijarah term; or
   d. an event occurs that contractually prohibits the lessee from exercising an option previously included in the institution’s determination of the Ijarah term.

**Accounting and financial reporting by the lessee**

**Initial recognition**

**Advance rentals paid**

19. Any rentals paid in advance by the lessee prior to the commencement date shall be accounted for and presented as ‘advance Ijarah rentals paid’.

20. Once the Ijarah term is commenced, and the gross Ijarah liability and net Ijarah liability are determined, such advance rentals shall be netted-off with the gross Ijarah liability.

**Initial recognition**

21. At the commencement date, a lessee shall recognize:
   a. a right-of-use (usufruct) asset; and
   b. a net Ijarah liability, duly comprising of the following elements:
      i. gross Ijarah liability;
      ii. deferred Ijarah cost (shown as a contra liability).

**Initial recognition of right-of-use asset**

22. At the commencement date, a lessee shall measure the right-of-use asset at cost.

23. The cost of the right-of-use asset shall comprise:
   a. the “prime cost” of the right-of-use asset (determined in line with the paragraphs 31 or 32);
   b. any initial direct costs incurred by the lessee; and
c. dismantling or decommissioning costs.

Initial recognition of Ijarah liability
24. The gross Ijarah liability shall be initially recognized as gross amount of total Ijarah rentals payable for the Ijarah term.

25. At the commencement date, the total Ijarah rentals included in the measurement of the Ijarah liability comprise the following payments for the right to use the underlying asset during the Ijarah term:
   a. fixed Ijarah rentals less any incentives receivable;
   b. variable Ijarah rentals that depend on an index or a rate, initially measured using the index or rate as at the commencement date (see paragraphs 4(ee) and 26) including the supplementary rentals; and
   c. payments of additional rentals, if any, for terminating the Ijarah, if the Ijarah term reflects the lessee exercising an option to terminate the Ijarah, subject to Shari’ah requirements.

26. Variable Ijarah payments that depend on an index or a rate include, for example, payments linked to a consumer price index, payments linked to a financial market or regulatory benchmark rate or payments that vary to reflect changes in market rental rates.

Special considerations for Ijarah MBT through gradual transfer
27. In case of Ijarah MBT through gradual transfer, or any other form of Ijarah MBT, in which proportionate ownership and right-of-use co-exist on the same asset, the lessee shall account for the combined asset under Ijarah MBT through gradual transfer, comprising of the proportionate:
   a. right-of-use asset; and
   b. ownership of the tangible asset.

28. A combined asset under Ijarah MBT through gradual transfer shall be accounted for in a manner similar to a right-of-use asset in line with the requirements of this standard.

Deferred Ijarah cost
29. Deferred Ijarah cost, being the difference between the gross Ijarah liability and the prime cost of right-of-use asset, shall be initially deferred through a deferred Ijarah cost account.

30. Deferred Ijarah cost account shall be presented as a contra-asset of respective liability.

Prime cost of the right-of-use asset
Underlying asset cost method
31. At the commencement date, the prime cost of the right-of-use asset (except for an operating Ijarah) shall comprise of:
   a. either of:
      i. preferably, the cost of the underlying asset – if acquired specifically by the lessor for the purpose of the intended Ijarah transaction; or
      ii. alternatively, the fair value of the underlying asset as of the commencement date – if not acquired specifically by the lessor for the purpose of the intended Ijarah transaction or if the cost is not known to the lessee;
   b. less any expected terminal value of the underlying asset (at the end of the Ijarah term), being either of:

---

2 Dismantling or decommissioning costs, if any, shall be accounted for in line with the generally accepted accounting principles, subject to necessary Shari’ah approvals.
i. the promised value (being nil value, in case of expected gift) at which the transfer may take place after the end of the Ijarah term; or

ii. expected fair value of the underlying asset at the end of the Ijarah term, in case of absence of a promised value.

**Estimation based on liability method**

32. If, the prime cost of the right-of-use asset may not be determined under the underlying asset cost method defined in paragraph 31 due to lack of sufficient information (particularly, in case of an operating Ijarah) the same may be determined through estimation based on the fair value of the total consideration paid or payable (i.e. total Ijarah rentals) against the right-of-use asset, under a similar transaction.

**Subsequent measurement**

**Subsequent measurement of the right-of-use asset**

33. After the commencement date, a lessee shall measure the right-of-use asset at:

   a. cost;
   b. less – any accumulated amortization;
   c. less – any accumulated impairment losses;
   d. add / less – adjustment for any effect of Ijarah modification or reassessment specified in paragraphs 44-46.

**Amortization of right-of-use asset**

34. A lessee shall amortize the right-of-use asset from the commencement date to the end of the useful economic life of the right-of-use asset which coincides with the end of the Ijarah term.

35. Amortizable amount of a right-of-use asset shall be amortized according to a systematic basis that is reflective of the pattern of utilization of benefits from the right-of-use asset.

36. Amortizable amount shall generally represent the cost of a right-of-use asset less residual value, if any.

37. Residual value of right-of-use asset shall be equal to:

   a. nil value – in case of:
      i. an operating Ijarah; or
      ii. an Ijarah MBT through sale at fair value after the end of the Ijarah term; or
      iii. an Ijarah MBT that does not meet the condition specified in paragraph 37(c); or
   
   b. the estimated “residual value of the underlying asset” at the end of the Ijarah term – in case of an Ijarah MBT through gradual transfer; or

   c. the estimated “residual value of the underlying asset” at the end of the Ijarah term less promised purchase price (if any) – in case of Ijarah MBT through sale or gift after the end of the Ijarah term, if it is highly likely that the option of transfer of ownership of the underlying asset to the lessee shall be exercised through purchase or gift.

**Impairment of right-of-use asset**

38. A lessee shall apply FAS 30 “Impairment, Credit Losses and Onerous Commitments” to determine whether the right-of-use asset is impaired and to account for any impairment loss identified. The impairment testing shall take into consideration the estimated residual value of the asset in line with the paragraph 37(c).
39. A lessee shall also assess as to whether any commitment(s) including promise(s) to purchase the underlying asset after the end of the Ijarah term or through gradual transfer is onerous in nature and if so, shall account for the same in line with the requirements of FAS 30 “Impairment, Credit Losses and Onerous Commitments”.

**Subsequent measurement of the Ijarah liability**

40. After the commencement date, a lessee shall measure the net Ijarah liability by:

   a. reducing the carrying amount of the gross Ijarah liability to reflect the Ijarah payments made;

   b. increasing the net carrying amount to reflect return on the Ijarah liability – by way of amortization of deferred Ijarah cost; and

   c. re-measuring the carrying amount to reflect any reassessment or Ijarah modifications specified in paragraphs 45 and 46, or to reflect revised fixed Ijarah rentals.

41. The effect of re-measuring of the carrying amount of Ijarah liability (in line with paragraph 40(c)) shall be recognized as a change in the deferred Ijarah cost.

42. Deferred Ijarah cost shall be amortized to income over the Ijarah term on a time proportionate basis. It is a rebuttable presumption that for most Ijarah transactions, the appropriate method to apply the time proportionate basis shall be the effective rate of return method.

43. After the commencement date, a lessee shall recognize in income statement, unless the costs are included in the carrying amount of another asset (e.g. inventory, property, plant and equipment, Istisna’a assets etc.), both:

   a. amortization of deferred Ijarah cost; and

   b. variable Ijarah rentals (not already included in the measurement of the Ijarah liability) – in the period in which the event or condition that triggers those payments occurs.

**Changes in the Ijarah term or future Ijarah rentals**

44. After the commencement date, a lessee shall account for changes in the Ijarah term or future Ijarah rentals, as follows:

   a. change in the Ijarah term – re-calculation and adjustment of the right-of-use asset, the Ijarah liability and the deferred Ijarah cost; or

   b. change in future Ijarah rentals (resulting from a change in an index or a benchmark rate used to determine those rentals) – re-calculation of the Ijarah liability and the deferred Ijarah cost only, without impacting the right-of-use asset.

**Ijarah modifications**

45. An Ijarah modification shall be considered as a separate Ijarah for the lessee, if both of the following conditions are met:

   a. the modification increases the scope of the Ijarah by adding the right to use one or more underlying assets; and

   b. the consideration for the Ijarah increases by an amount commensurate with the stand-alone price for the increase in scope and any appropriate adjustments to that stand-alone price to reflect the circumstances of the particular contract.

46. For an Ijarah modification that does not meet the criteria provided in paragraph 45, the lessee shall consider and account for the Ijarah as a modified Ijarah as of the effective date. Accordingly, the lessee shall recalculate the Ijarah liability, deferred Ijarah cost and the right-of-use asset respectively, as if it was a new Ijarah, duly de-recognizing the earlier Ijarah transaction and balances.
Expenses related to underlying asset

47. Operational expenses related to underlying asset, including any expenses contractually agreed to be borne by the lessee, in line with the Shari‘ah principles, shall be recognized by the lessee on an accrual basis in the period in which these are incurred.

48. Major repair and maintenance, Takaful and other expenses incidental to ownership of underlying assets, if incurred by the lessee as an agent, shall be recorded as receivable from lessor.

Recognition exemptions and simplified accounting for the lessee

49. A lessee may elect not to apply the requirements of Ijarah recognition and measurement (in line with paragraphs 20 to 48), to:
   a. short-term Ijarah (see paragraphs 51 and 52); and
   b. Ijarah for which the underlying asset is of low value (see paragraphs 53 and 54).

Accounting for the exempt Ijarah

50. In case of exempt Ijarah (as determined in line with paragraph 49), the lessee shall recognize the Ijarah rentals as an expense on either a:
   a. straight-line basis over the Ijarah term; or
   b. another systematic basis, if that basis is more representative of the pattern of the lessee’s benefit.

Short-term Ijarah

51. In case of short-term Ijarah considered exempt under paragraph 49, the lessee shall re-consider the Ijarah as a new Ijarah in case of an Ijarah modification or a change in the Ijarah term.

52. The election for short-term Ijarah shall be made by class of underlying asset to which the right of use relates. A class of underlying asset is a grouping of underlying assets of a similar nature and use in an institution’s operations.

Low value Ijarah

53. The choice for Ijarah transactions for which the underlying asset is of low value can be made on an individual asset or Ijarah transaction basis. A lessee shall assess the value of an underlying asset based on the value of the asset when it is new, regardless of the age of the asset at the time of Ijarah transaction.

54. An underlying asset can be of low value only if:
   a. the lessee can benefit from use of the underlying asset on its own or together with other resources that are readily available to the lessee; and
   b. the underlying asset is not highly dependent on, or highly interrelated with, other assets.

Presentation and disclosure

Presentation

55. Right-of-use assets and net Ijarah liability shall be presented in the lessee’s statement of financial position as ‘right-of-use assets’ (between ‘property, plant and equipment’ and ‘intangible assets’) and as a liability, respectively.

56. Advance Ijarah rentals paid in respect of Ijarah transactions yet to commence shall be presented as receivable.

57. Net Ijarah cost shall be presented in the lessee’s income statement as a single ‘operating expense’ commensurate with the nature of use of the right-of-use asset comprising of, and disclosing separately, the:
a. amortization of right-of-use asset;
b. amortization of deferred Ijarah cost;
c. variable Ijarah rentals; and
d. gain or loss on Ijarah modifications and other adjustments.

Disclosures

58. In addition to the disclosure requirements stated in FAS 1: “General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions” following are the minimum disclosure requirements in the financial statements of the lessee:

a. the accounting policies adopted for the accounting treatments of Ijarah and Ijarah MBT transactions as a lessee duly explaining the types of Ijarah transactions the lessee has entered into;
b. the amount of right-of-use assets by each major class of assets net of accumulated amortization and accumulated impairment, if any, as well as, disclosing the other balances included or deducted therefrom in line with this standard;
c. the breakup of the combined assets acquired under Ijarah MBT through gradual transfer, as regards to the proportionate carrying value of:
   i. right-of-use asset; and
   ii. tangible asset;
d. a summary of, the amount of the gross and net Ijarah liability – distributed as per amount due:
   i. within next 12 months;
   ii. in more than 12 months, but within next 5 years; and
   iii. in more than 5 years.
e. future cash outflows to which the lessee is potentially exposed that are not reflected in the measurement of Ijarah liabilities. This includes exposure arising from:
   i. variable Ijarah rentals;
   ii. extension options and termination options;
   iii. commitments / or expected exercise of options to purchase, either the underlying asset after the end of Ijarah term (in case of Ijarah MBT) or the proportionate ownership units of the underlying units during the Ijarah term (in case of Ijarah MBT through gradual transfer);
   iv. Ijarah not yet commenced to which the lessee is committed;
f. future cash outflows as required to be disclosed under paragraph 58(e), shall be preferably disclosed, if material, with a distributions of cash outflows:
   i. within next 12 months;
   ii. in more than 12 months, but within next 5 years; and
   iii. in more than 5 years.
g. disclosure of nature of assets sold during the period under sale and Ijarah-back transactions and necessary information including:
   i. sale price;
ii. carrying value prior to sale;
iii. gain / loss on execution of sale and Ijarah-back transaction;
iv. principal terms and conditions of the transaction(s), if considered material;
h. unamortized deferred Ijarah costs against Ijarah liabilities, providing a movement of the same during the period duly disclosed as a deduction from the outstanding amount of Ijarah liabilities;
i. outstanding amounts of Hamish Jiddiyah at the end of the financial period;
j. the excess of expected cumulative amount of residual value of right-of-use assets in case of Ijarah MBT in line with paragraph 37(c), which may be subject to contingent impairment in case of either:
i. termination of Ijarah MBT; or
ii. non-execution of the sale or gift transaction after the end of the Ijarah term.
k. the amount of Ijarah rentals waived by the lessor, if any, according to their respective nature, during the period; and
l. the amount of charity payments made and payable, if any, against defaults in payments and other breaches if any.

Accounting and financial reporting by the lessor

Initial Recognition

Advance to vendor
59. Any advance paid by lessor for acquisition of the underlying asset, before the control of the underlying asset is transferred to the lessor, shall be recorded and reported as an advance payment to vendor.

Advance rentals received
60. Any advance rentals received by lessor in respect of an Ijarah transaction (including prospective Ijarah), shall be recorded and reported as obligation against advance rentals.

Timing of recognition of underlying asset
61. Underlying asset shall be recognized in the books of the institution once it controls the underlying asset i.e. the time when it essentially acquires substantially all risks and rewards incidental to ownership of such underlying asset.

Recognition of underlying asset
62. Underlying asset shall be initially recognized at cost. The cost of underlying asset shall comprise all costs of purchase and other costs incurred in bringing the underlying asset to its present location and condition. It includes all types of taxes (other than those subsequently recovered), transportation and handling costs including related Takaful cost and all other costs directly attributable to bring the underlying asset to its present location and condition, including those incurred by the customer in capacity of agent and any fee paid to the agent. Trade discounts, rebates and similar items should be deducted from the costs.

63. In cases where underlying asset is acquired on a piecemeal basis or in tranches, each tranche of asset received shall be recognized when the conditions defined in paragraph 61 are met with respect to such tranche.

Initial direct costs
64. Transaction costs, not being eligible for inclusion in the cost of underlying asset, duly incurred by the lessor for arranging the Ijarah transaction shall be recognized and deferred as initial direct costs.
65. Initial direct costs shall be allocated to income statement through amortization over the periods in the Ijarah term in a pattern consistent with that used for allocating Ijarah revenues.

Subsequent measurement
66. Subsequent to initial recognition, the underlying assets shall be measured at cost less accumulated depreciation less accumulated impairment, if any.

Depreciation
67. Depreciable amount of an underlying asset shall be charged to income over its useful economic life on a pattern which is reflective of the expected pattern of economic benefits arising from the same. Normally the straight line method can be considered as most appropriate pattern of flow of economic benefits, unless another systematic method is determined to be more appropriately reflecting such pattern.

68. Depreciable amount shall represent the cost of the underlying asset less residual value.

69. Residual value in respect of an underlying asset shall represent:
   a. the estimated fair value of the underlying asset at the end of the Ijarah term – in case of an operating Ijarah, or an Ijarah MBT through sale at fair value after the end of the Ijarah term; or
   b. nil value – in case of an Ijarah MBT through gift after the end of the Ijarah term; or
   c. the promised sale value – in case of an Ijarah MBT through sale at promised sale value after the end of the Ijarah term; or
   d. the lower of cost or estimated realizable value – in case of an Ijarah MBT through gradual transfer. [Explanation: estimated realizable value to be applicable only if the units’ sale is carried out at fair value, and there is an indication of decline in the realizable value at the time of respective proportionate unit transfers. Accordingly, there will generally be no depreciation of such assets].

70. The useful economic life of the underlying asset shall generally represent:
   a. the Ijarah term – in case of all Ijarah transactions except for those on which paragraph 70(b) applies; or
   b. period equivalent to the useful economic life of similar assets (including lessor’s own similar assets) – in case of such operating Ijarah transactions whereby, after the end of the Ijarah term, the underlying asset is intended to be used, either for the own use of the lessor, or for use in respect of further (one or more) unrelated operating Ijarah transactions.

Impairment
71. An underlying asset shall be subject to the impairment requirements of FAS 30 “Impairment, Credit Losses and Onerous Commitments”.

72. In case of Ijarah MBT through gradual transfer, an underlying asset shall be subject to the provisions related to net realizable value (NRV) of FAS 30 “Impairment, Credit Losses and Onerous Commitments”

Accounting for commitments
73. Any promises / undertakings made by the lessor in relation to an Ijarah transaction, resulting in an onerous commitment shall be accounted for and reported in line with the requirements of FAS 30 “Impairment, Credit losses and Onerous Commitments”.

21
**Ijarah revenue and costs**

**Ijarah revenue**

74. Ijarah revenue shall be recognized in income statement of the lessor on an accrual basis, applying, either:
   a. a straight-line basis – preferred method; or
   b. another systematic basis.

75. The lessor shall apply another systematic basis if it can be established that such basis may be representative of the pattern in which benefit from the use of the underlying asset is diminished.

**Applying the effective rate of return method**

76. It is a rebuttable assumption that in various Ijarah MBT transactions, the effective rate of return method is better representative of the pattern in which the use of the underlying asset is diminished.

77. Under this method, the gross Ijarah revenue is allocated to income statement over the term of Ijarah in such a manner that a uniform rate of return is produced in form of net Ijarah revenue, over net investment in Ijarah assets whereby:
   a. net Ijarah revenue is the amount of gross Ijarah revenue, net of Ijarah costs (depreciation and amortization); and
   b. net investment in Ijarah assets is the net carrying value of the underlying asset, including the unamortized initial direct cost.

78. While applying the effective rate of return method, any excess of Ijarah revenue recognized over the Ijarah rentals due shall be recognized as accrued Ijarah rentals.

**Applying the systematic method for Ijarah MBT through gradual transfer**

79. It is a rebuttable assumption that in case of Ijarah MBT through gradual transfer, the most suitable systematic method would be to recognize Ijarah revenue in the financial period in which it is due, on accrual basis, taking into consideration that the revenue shall progressively decrease as the lessee acquires a greater share of the underlying asset.

**Ijarah costs**

80. Ijarah costs, incurred in earning the Ijarah revenue shall be recognized as an expense in the income statement of a lessor. These include:
   a. depreciation of the underlying asset;
   b. amortization of the initial direct cost; and
   c. other costs incidental to ownership of underlying asset e.g. major repair and maintenance (other than operational repair and maintenance), Takaful and taxes etc.

**Presentation and disclosures**

81. Ijarah assets shall be presented in the lessor’s statement of financial position as ‘Ijarah assets’.

82. Net Ijarah revenue shall be presented in the lessor’s income statement comprising of:
   a. gross Ijarah revenue recognized during the period;
   b. less: depreciation of underlying asset;
   c. less: expenses related to Ijarah assets including Takaful, registration, legal and repair and maintenance.

83. Advance Ijarah rentals received shall be recognized and presented as a liability in the lessor’s statement of financial position.
84. Initial direct costs shall be shown as an addition to the carrying value of the Ijarah assets, reflecting total initial direct costs and unamortized initial direct costs.

Disclosures

85. In addition to the disclosure requirements stated in FAS 1: “General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions” following are the minimum disclosure requirements in the financial statements of the lessor:

a. the accounting policies adopted for the accounting treatments of Ijarah and Ijarah MBT transactions as a lessor duly explaining the types of Ijarah transactions the lessor has entered into;

b. the amount of Ijarah assets by each major class of assets, as well as, by each classification of Ijarah transactions, net of (and disclosing separately) accumulated depreciation and accumulated impairment, if any, as well as, disclosing the other balances included or deducted therefrom in line with this standard;

c. amortization of initial direct costs;

d. future cash inflows related to Ijarah transactions. This includes cash inflows arising from:
   i. Ijarah rentals;
   ii. extension options and termination options;
   iii. committed / or expected exercise of options to sell, either the underlying asset after the end of Ijarah term (in case of Ijarah MBT) or the proportionate ownership units of the underlying units during the Ijarah term (in case of Ijarah MBT through gradual transfer);
   iv. committed purchases of assets including those ordered, to be procured and given on Ijarah basis;
   v. Ijarah rentals related to Ijarah not yet commenced to which the lessee is committed;

e. future cash outflows as required to be disclosed under paragraph 85(d), shall be preferably disclosed, if material, with a distributions of cash outflows:
   i. within next 12 months;
   ii. in more than 12 months, but within next 5 years; and
   iii. in more than 5 years.

f. outstanding amounts of Hamish Jiddiyah at the end of the financial period;

g. the amount of Ijarah rentals waived by the lessor, if any, according to their respective nature, during the period; and

h. the amount of charity payments made and payable, if any, against defaults in payments and other breaches if any.

Ijarah MBT: transfer of underlying asset’s ownership

Timing of recognition of the transfer of underlying asset

86. In case of an Ijarah MBT, the transfer of asset’s ownership may take place through transfer of control (entailing risks and rewards incidental to ownership of such asset) under a separate (i.e. separate from the Ijarah contract):

a. contract of sale – after the end of the Ijarah term (including, in certain circumstances, after early termination of the Ijarah term); or
b. contract of gift – after the end of the Ijarah term; or

c. contracts of sale of proportionate ownership (generally in form of ownership units) – during the Ijarah term.

87. A contract(s), as referred to in paragraph 86 constitutes an offer and acceptance (whereby, either party may offer and other accepts), and shall not be confused with the promise for execution of such transaction, at a future date (which is not binding on one of the parties, at least).

88. Transfer of underlying asset’s ownership (or proportionate ownership) shall be accounted for by both parties on transfer of control of the underlying asset to the lessee generally coinciding with the timing of consummation of the relevant contract (also see paragraph 89).

**Ijarah MBT through gradual transfer – special considerations**

89. Gradual transfer of underlying asset’s proportionate ownership shall be accounted for by both parties on transfer of corresponding control of the underlying asset to the lessee coinciding with the timing of consummation of the relevant contract, through:

   a. offer and acceptance of the transfer of proportionate ownership; or
   
   b. payment against purchase of such units as a continuing arrangement (and acceptance of such payment) if so allowed by the contract and in line with Shari’ah principles, in absence of individual offer and acceptance against each such transfer.

**In the books of the purchaser / transferee (previously lessee)**

**After completion of the Ijarah term**

90. On acquisition, the underlying asset acquired, shall be recognized in the books of the purchaser (earlier, the lessee) as an item of property, plant and equipment or investment property or any other category of assets, as suitable according to the nature of the asset, at:

   a. cost, being the consideration paid or payable for the acquisition of asset;
   
   b. plus: the carrying value of the right-of-use asset, if any (residual value in line with paragraph 37) duly reclassified from the right-of-use asset.

**Ijarah MBT through gradual transfer – special considerations**

91. The combined asset acquired completely as owned asset, on full transfer of ownership units, shall be reclassified as an item of property, plant and equipment or investment property or any other category of assets, as suitable according to the nature of the asset, at the carrying value (including asset cost, less accumulated amortization (now classified as depreciation), less accumulated impairment, if any)

**In the books of the seller / transferor (previously lessor)**

92. The underlying asset’s sale or gift after the end of the Ijarah term or in case of early termination / settlement shall be recorded by the seller / transferor (being previously the lessor) and any gain or loss arising on the same being the difference between the carrying value and the consideration received or receivable, shall be recognized in income statement currently.

**Ijarah MBT through gradual transfer – special considerations**

93. The proportionate ownership of the underlying asset sold under each distinct transaction of ownership transfer shall be accounted for in the books of the seller (earlier, the lessor) by recognizing the consideration received or receivable as the income on unit sales, the corresponding proportionate cost at carrying value, being the cost of sold units while recognizing any gain or loss on such unit sales in the income statement currently.
Transfer of underlying assets with early termination / settlement of Ijarah

94. In case an Ijarah is prematurely terminated and the underlying asset is transferred by the lessor to the lessee, both the transactions shall be accounted for separately in line with the Shari’ah requirements and contractual terms. In such situation, prior to transfer of underlying asset, the Ijarah contract shall be concluded and any gain or loss on the same shall be recognized in the income statement at the time of termination of the Ijarah contract.

95. Once the Ijarah contract is terminated, transfer of underlying asset, shall be accounted for in accordance with paragraphs 96 and 97.

In the books of the purchaser / transferee (previously lessee)

96. In case of an Ijarah transaction being early terminated and purchase of underlying asset by the purchaser (previously lessee), the underlying asset acquired shall be recognized in the books of the purchaser (earlier, the lessee) as an item of property, plant and equipment or investment property or any other category of assets, as suitable according to the nature of the asset, at:
   a. cost, being the consideration paid or payable for the acquisition of asset (but excluding any additional payments made for early settlement / termination of Ijarah, not being a part of purchase consideration);
   b. plus: the carrying value of the right-of-use asset;
   c. less: impairment identified as a result of early settlement / termination, if any.

In the books of the seller / transferor (previously lessor)

97. In case of an Ijarah transaction being early terminated and sale or gift of underlying asset by the seller / transferor (previously lessor), the underlying asset acquired shall be de-recognized from the books of the seller / transferor (earlier, the lessor) and following shall be recognized, separately, in the income statement currently:
   a. gain or loss on early settlement of Ijarah; and
   b. gain or loss on disposal of Ijarah asset – being the difference between the consideration received or receivable (if any) and the carrying value of the underlying asset.

Sale and Ijarah-back transactions

98. If an institution (the seller-lessee) transfers an asset to another institution (the buyer-lessee) and duly fulfilling the Shari’ah requirements in this respect, the buyer-lessee unconditionally executes an Ijarah transaction on the same asset back to the same seller-lessee, both the seller-lessee and the buyer-lessee shall account for the transfer contract and the Ijarah applying paragraphs 99-104.

Sale of the asset

99. The sale of the underlying asset from the seller-lessee to the buyer-lessee takes place when the control of the underlying asset duly entailing the risks and rewards incidental to ownership are transferred to the buyer-lessee.

100. the seller-lessee shall measure the right-of-use asset arising from the Ijarah-back at the proportion of the previous carrying amount of the asset that relates to the right of use retained by the seller-lessee. Accordingly, the seller-lessee shall recognize only the amount of any gain or loss that relates to the rights transferred to the buyer-lessee.

Accounting for the sale of the asset – by seller-lessee

101. The seller-lessee shall record the transfer of control of the underlying asset and execution of Ijarah as two distinct, independent contracts. This generally includes the legal title as well, unless it can be
established otherwise, that the control is transferred, irrespective of the legal title not being transferred.

102. If the fair value of the consideration for the sale of an asset does not equal the fair value of the asset transferred, any gain or loss arising on the same shall be:
   a. immediately recognized in the income statement – in case of an operating Ijarah; or
   b. deferred and amortized over the Ijarah term – in case of all other types of Ijarah.

103. Deferred gain or loss on sale of the asset shall be shown as a deduction from or addition to, respectively, the Ijarah liability.

**Accounting for the buyer-lessee**

104. A buyer-lessee shall account for a sale and Ijarah-back transaction in line with this standard without any special consideration.

**Other related accounting treatments**

**Forward Ijarah**

105. In respect of a forward Ijarah transaction, any advance payment made by the prospective lessee to the prospective lessor shall be accounted for in line with the paragraphs 19 and 60 by the lessee and the lessor, respectively. Commitments in respect of forward Ijarah transactions shall be disclosed in accordance with paragraph 58(e)(iv). A forward Ijarah transaction shall be subject to other provisions of the standard, on the commencement of Ijarah.

**Hamish Jiddiyah (security deposit)**

106. Subject to the terms of the contract, the Hamish Jiddiyah paid by the lessee shall be recognized as a receivable from the lessor and shall not be netted-off with the Ijarah liability, unless it is to be adjusted against consideration for transfer of ownership or adjustment against rental liability if agreed upon between the parties, at the time of such event taking place. The lessor shall recognize a corresponding liability for the same.

107. Adjustment of, or forfeiture of, Hamish Jiddiyah, against breach of promise or default or other adverse conditions shall be governed by the Shari’ah rules and contractual arrangement between the parties, and accounted for accordingly.

108. Once the Ijarah contract is terminated, Hamish Jiddiyah shall:
   a. either be returned by the lessor to the lessee; or
   b. shall be adjusted with the sale price / consideration for the transfer of ownership of the underlying asset under a specific authorization of the lessee.

**Charity**

109. Any charity payment against defaults and delayed payments by the customer shall not be recognized as an income of the seller and shall be taken directly to charity payable, when received.

**Effective date**

110. This standard shall be effective on the financial statements of the institutions beginning on or after 01 January 2021. Early adoption of the standard is permitted.
Transitional provisions

111. The institutions may opt to apply this standard on a prospective basis for transaction executed on or after the effective date. If an institution applies this transitional provision, it shall disclose a fair estimate of the impact of the same.

Amendments to other standards

112. This standard supersedes the earlier FAS No. 8 “Ijarah and Ijarah Muntahia Bittamleek”.
APPENDICES

Appendix A: Adoption of the Standard

This standard was presented for the approval in the AAOIFI Accounting Board’s meeting No. ____ held on ______ corresponding to _________ and was duly approved.

Members of the Board
1. Mr. Hamad Abdulla Al Oqab – Chairman
2. Mr. Mohamed Bouya Ould Mohamed Fall – Deputy Chairman
3. Mr. Abdelhalim Elsayed Elamin
4. Dr. Abdulrahman M. Alrazeen
5. Dr. Bello Lawal Danbatta
6. Mr. Firas Hamdan
7. Mr. Hondamir Nusratkujaev
8. Mr. Irshad Mahmood
9. Mr. Mohamed Ibrahim Hammad
10. Mr. Muhammad Jusuf Wibisana
11. Mr. Nader Yousif Rahimi
12. Dr. Saeed Al-Muharrami
13. Mr. Sulaiman AlBassam
14. Mr. Syed Najmul Hussain
15. Mr. Tarik Bolukbas

Reservation
The standard was approved unanimously.
Working group Members
1. Mr. Firas Hamdan - Chairman
2. Mr. Ali Chreif
3. Mr. Aly ElAzhary
4. Mr. Jusuf Wibisana
5. Mr. Saqib Mustafa
6. Mr. Syed Najmul Hussain
7. Mr. Yaser Aljar

Executive team
1. Mr. Omar Mustafa Ansari (AAOIFI)
2. Ms. Farida Cassim (AAOIFI)
3. Mr. Mohammad Majd Bakir (AAOIFI)
4. Ms. Zahra Jassim ALSairafi (AAOIFI)
Appendix B: Basis for conclusions

Reason for revision of the standard

BC1 The AAOIFI Accounting Board (AAB / the Board) deliberated on the need for revision of FAS 8 “Ijarah and Ijarah Muntahia Bittamleek” in its revised AAOIFI strategy in 2015, after reconstitution of the new board, whereas a limited scope revision project for the same had already been initiated by the predecessor board. FAS 8 developed in 1995 catered and responded to the need to separate a Shari’ah compliant lease from a conventional lease. Since then with the evolution of new financing systems over the last few decades there have been different innovations in the structure of Ijarah – a few amongst which are considered not permissible by Shari’ah. This standard duly re-named as “Ijarah” attempts to accommodate various common types of Ijarah and Ijarah related products reflecting the changes in the market and practices.

BC2 The Board also considered that globally there have been significant changes in the lease accounting more recently including major projects by the IASB and the FASB resulting in their respective new standards, which are quite similar to each. In line with the new strategy for financial accounting standards setting, the Board decided that the revised standard shall be as close as possible to the new global accounting standards, duly addressing the specific Shari’ah requirements not being addressed by global practices, and the specific structure of Ijarah transactions which is not captured by them.

Key distinguishing factors between an Ijarah MBT and conventional finance lease

BC3 An Ijarah is principally a lease transaction. The issue of difference with conventional transactions arises only in the terms and conditions, which are generally attached to a conventional finance lease which make it impermissible from Shari’ah perspective and hence Ijarah MBT is principally different from the conventional finance lease.

BC4 The Board considered that in Ijarah MBT, the risks and rewards incidental to ownership are with the lessor throughout the lease term, while in case of conventional finance lease, the significant risks and rewards incidental to ownership are transferred to the lessee at inception of lease and accordingly an Ijarah MBT transaction is different from the conventional finance lease transactions, and may require different accounting treatments, where needed. This may be confirmed by the following factors:

a. the lessor, by virtue of Shari’ah and legal requirements, and in substance (as being a Shari’ah requirement), remains the owner of the asset (legally and / or beneficially), carries the market risk on the price of asset till the end of the lease term and carries the operational risk of the asset till the end of lease term;

b. two contracts i.e. contract of lease and contract of sale, accordingly to Shari’ah, cannot be combined; and

c. a future contract of sale (other than Salam or Istisna’a) is not legitimate, and a future promise to that effect is not a contract as of current date, particularly when the relevant terms and conditions are contradicting with that of the Ijarah contract, which is already in effect.

BC5 However, the Board also noted that there are no significant differences between an operating Ijarah and an operating lease.
A key difference of Ijarah MBT transactions with conventional lease accounting is that Shari’ah doesn’t allow two contracts to be commingled as one contract. Therefore, Ijarah sale is separate from an Ijarah contract.

A future sale contract is not permissible in Shari’ah (unless being in form of Salam or Istisna’a). Accordingly, the option of sale is in the form of a promise, which may be binding on only one party cannot take form of a mutually binding contract or a mutually binding promise. The permissibility of an Ijarah will depend on various issues that arise out of the terms and conditions in the contract. In general, most types of operating leases are permissible in Shari’ah. The contention lies in the structure of a conventional finance lease, where it involves a sale and a lease as one and not two distinct transactions. These conditions are further specified in the SS 9 “Ijarah and Ijarah Muntahia Bittamleek”.

The subject matter of an Ijarah transaction is the usufruct whereas the subject matter of a conventional finance lease is seen as a financing and the financing disbursed to the customer. This is the reason that the conventional accounting standards focus on recognition of liability, as the primary requirement.

Another distinguishing factor is ‘risks and rewards’ incidental to ownership which belong to the lessor whereas the use benefit relates to the lessee. Ijarah in essence are considered to be similar to an operating lease because of the “risk and reward” factor. However, there are also Shari’ah conditions for permissibility of such transactions i.e. if an Ijarah is Shari’ah compliant in both, form and substance, the risks and rewards incidental to ownership are not transferred to the lessee and as a result Ijarah falls within the definition of an operating lease and its accounting should be in line with the same. This issue was debated by the Board and further research showed that most other Islamic finance standard setters have also developed their standards for Ijarah in line with accounting treatment for operating leases.

Shari’ah principles reject the idea of time value of money. Therefore, price (Ijarah rental) is calculated and charged on the use benefit of asset rather than time value of money. Ijarah rental cannot be charged and recorded until the underlying asset is in possession of the lessee. In conventional finance lease, the lessor normally commences charging and recording interest on the day financing is disbursed even if the asset is not in existence or in possession.

The Board also considered other Shari’ah matters such as when ownership of the assets remains with the lessor, and only its usufruct is transferred. The liabilities arising from the ownership are borne by the lessor. However, the lessee is liable to compensate the lessor for any harm caused by misuse or negligence. Until such time the assets to be leased are delivered to the lessee, lease rentals do not become due and payable. Other Shari’ah requirements also include factors such as an Ijarah can be terminated before the expiry of the Ijarah term but only with mutual consent of both parties with the reasons for termination adequately documented. The rentals must be clear and unambiguous and require to be agreed in advance. An Ijarah is considered terminated if the subject matter ceases to provide the services as required in the Ijarah contract. There are also factors that are related to presentation and disclosure in the books. Such as the assets purchased for Ijarah – these are usually considered an investing activity, but few experts may have a view of classifying the same as ‘financing’ and as a result these may be disclosed under operating activities.
The concept of ‘Present Value of Minimum Lease Payment’ i.e. PV of MLP cannot be applied in line with Shari’ah principles. In Ijarah the ‘gross Ijarah liability’ comprise of the total Ijarah rentals and not total lease payments. In other words, total lease payments under conventional accounting standards include guaranteed residual value and other advanced initial deposits etc. which is not acceptable for Ijarah.

**Accounting for usufruct / right-of-use asset**

The global accounting standard setters while revising their accounting standard for leasing took a fundamental shift. The Board agreed with certain major changes that were brought in by such standards. Particularly, the Board agreed that entering into an Ijarah transaction gives rise to a ‘right-of-use’ asset (which may also be called a usufruct asset).

The Board considered the pros and cons of this accounting approach, including Shari’ah issues applicable thereto and decided that usufruct meets the definition of an asset under Shari’ah and under AAOIFI Framework.

Accordingly, the Board decided that accounting for usufruct or right-of-use asset in the books of the lessee (irrespective of being an Ijarah or Ijarah MBT) would have an even fair and transparent view of the state of affairs. Therefore, the ‘right-of-use’ asset shall be accounted for as well as the corresponding liability.

In Ijarah a lessee purchases the right to use an underlying asset during the Ijarah term and assumes an obligation to make payments to the lessor for granting the right to use that asset. Additionally, the lessee has an obligation to return the underlying asset to the lessor at the end of the Ijarah term. The lessor has a right to receive payments from the lessee for providing the right to use the underlying asset. The lessor also retains rights associated with ownership of the underlying asset. Having identified the rights and obligations that arise from an Ijarah, the Board further considered which of those rights and obligations create assets and liabilities to be accounted for in the books of lessee and lessor. The lessee accounting model better reflects the economics of an Ijarah because, at the commencement date, a lessee obtains the right to use an underlying asset for a period of time, and the lessor has delivered that right by making the asset available for use by the lessee. In Islamic finance, assets are recognized in line with its nature based on the Shari’ah characteristics. Ijarah MBT is a good example of the same in which the IFI being the lessor is required to recognize the physical asset, while under conventional finance lease it is considered to be the net investment in finance lease (which is a financial instrument, not the physical asset).

The preliminary study phase consisted with evaluating all concepts and theories by many accounting bodies. An important topic under discussion was the acceptability and recognition of usufruct as an asset. Shari’ah considers right-of-use / usufruct as Maal i.e. transferable, with certain conditions, and has its own characteristics of Maal. Shari’ah views usufruct as an intangible asset (being actually a right and not a physical asset).

In conventional lease accounting the view is that in a finance lease where substantially all risk and rewards incidental to ownership is transferred to the Lessee, it means in substance it is a sale. However, as per Shari’ah if substantially all risk and rewards is transferred at inception it means the product is not Shari’ah compliant due to the fact that an Ijarah is separate from the sale or gift
transaction. As per Shari’ah two contracts (or one contract and one promise) are to be accounted for separately, duly distinguishing the respective risks, rewards and responsibilities of both parties. Additionally, as per Shari’ah during the term of an Ijarah the risk and rewards incidental to ownership are to be kept with the Lessor. Considering the same, the Board reiterated that the option of accounting for Ijarah MBT similar to conventional finance lease is not acceptable.

Recognition of usufruct and its amortization

BC19  The Board was of the view that from Shari’ah perspective, primarily there is an acquisition of a usufruct by the lessee and for that reason a liability is incurred. Accordingly, the initial recognition of the usufruct is determined as the starting point. Therefore, the standard requires the “prime cost” of the right-of-use asset to be recognized, rather than recording the present value of minimum lease payments.

BC20  Taking into account the Shari’ah views, the usufruct is not seen as a tangible asset, rather an intangible asset. Therefore, the usufruct is treated as intangible asset and accordingly amortized and not depreciated.

BC21  The Board, considering the Shari’ah requirements and the specific characteristics of Ijarah transactions, concluded that right-of-use is an intangible asset and amortized accordingly. Amortization will be from commencement date (and not the inception date) to the end of useful economic life of the right-of-use asset which will coincide with the end of the Ijarah term. Amortization over and above the Ijarah term, if allowed means that the two transactions are combined for the purpose of accounting. Accordingly, once the Ijarah term is complete, there will be a residual value that shall be amortized on a straight-line basis or any other systematic basis.

Charity

BC22  The amount of charity contributed by the lessee shall not be recorded as income of the lessor, as it is an amount received on account of others, which does not give rise to revenue, according to the accounting principles.

Scope exclusions - Service Ijarah

BC23  Service Ijarah can be segregated into two types, being human based or technology and machines based such as, bandwidth, telecommunication minutes etc. The Board considered that this standard covers the technology and machine based service Ijarah, as the measurement of usufruct can be performed by unit of output or other such measures. Additionally, the standard also requires identifying and separating an Ijarah from a complex contract with multiple aspects included in it. These are required to be accounted for separately.

Ijarah MBT through gradual transfer

BC24  The Board after taking into account industry comments agreed that the FAS 8 accounting for Ijarah MBT through gradual transfer was having practical impediments and required improvement. In order to avoid the complexities of accounting for Ijarah MBT with gradual transfer, the standard introduces
the underlying asset to be termed as a ‘combined asset’ which includes the proportionate underlying asset as well as the right-of-use asset owned by the lessee.

BC25 It is also considered that if the units are sold at cost (to lessee) depreciation at the end of the lessor is not required, as the residual value is equal to the cost. This shall significantly reduce the accounting complications.

BC26 The Board also considered that there are transactions in different parts of the world which are very similar in characteristics to Ijarah MBT with gradual transfer of ownership, such as ‘Diminishing Musharaka based on Shirkat-ul-milk with Ijarah’. The Board decided that all such products shall be subject to the same accounting and reporting requirements under this standard.

**Commencement date vs. inception date**

BC27 The Board took into account substance and form together in determining the commencement date vs. inception date accounting. Due to the unique structure of an Ijarah compared to a conventional lease, all Ijarah shall be recognized on commencement date i.e. when the asset is made available to the lessee in a condition capable of being used for the intended purpose. Ijarah rental can only be charged after possession of asset (in usable condition) to the lessee and rental is neither earned nor recorded before possession and delivery of asset. As a result, all transactions (including Ijarah Mawsufa Bil Dhimmah) before the commencement date shall be recorded as an advance which shall remain non-remunerative.

**Advances, deposits and Hamish Jiddiyah**

BC28 There are multiple types of deposits or advance payments in Ijarah transactions. Most commonly in the form of Hamish Jiddiyah or security deposit. As per Shari’ah standards these are a receivable of the lessee and payable of the lessor, and shall continue to be accounted for until the conclusion of the Ijarah term. After the conclusion of the Ijarah term the same can be used as a sale transaction proceed or be refunded, as per the mutual arrangement between the parties.

**Determining the ‘prime cost’ of the right-of-use asset**

BC29 The standard provides two approaches of initial recognition of, and computation of the prime cost of the right-of-use asset. First one approach is the asset side accounting through the asset cost, whereas the second option, which is applied if first option is not practicable, is accounting through the estimation of fair value of the liability. In accordance with Shari’ah the right-of-use asset is recorded first and then the corresponding liability is recognized.

BC30 The estimation based on liability method is provided to cater to the situations whereby cost or fair value of the usufruct is not available to determine the prime cost. This is only allowable as an alternative and not the primary valuation option for prime cost. The liability method does not include a reassessment option (i.e. at subsequent measurement) since the liability method would only be used as an alternative for initial assessment.
Costs and expenses related to the right-of-use asset

BC31 There were two issues related to expenses of underlying asset – an accounting issue and Shari’ah issue. The practices currently prevailing in the market are generally to record the expense directly by the lessee. The Board was of the considered view that these expenses shall be recorded by the lessor, and even if the lessee incurs the same, these shall be recorded as recoverable from lessor (even if lessor has a supplementary rental mechanism to recover the same, which shall be accounted for accordingly).

Accounting and financial reporting by the Lessor

BC32 Without any significant change from FAS 8, this standard requires that the leased asset shall be recognized at cost and depreciated over the useful life by the lessor and gross rentals shall be recognized as income.

BC33 Generally it was understood that depreciation shall be based mostly on straight-line method. However, there were situations where certain IFIs were using annuity method for depreciation which is not an acceptable method of depreciation. The Board also considered if there needs to be change to the depreciation method to allow annuity method. However, after due deliberations it concluded that the annuity method of accounting was not suitable as it does not reflect the pattern of economic benefits, as well as, is against the essence of Shari’ah.

BC34 After due deliberations, the Board decided to keep the straight-line method, as a preferred method of revenue recognition and allowing another systematic basis i.e. using the effective rate of return method. The Board concluded that in certain situations the use of effective rate of return method for recognition of revenue might result in more equitable and fair distribution of profits amongst stakeholders. Residual value – usufruct and underlying asset

BC35 The Board discussed elements of residual value and decided to provide guidance for residual value determination in respect of right-of-use in the hand of the lessee.

BC36 The Board considered that the residual value in respect of a right-of-use asset shall be nil – in case of, an operating Ijarah or an Ijarah MBT through sale at fair value after the end of the Ijarah term or an Ijarah MBT that does not meet the condition specified in paragraph 37(c) – because the benefits acquired under the Ijarah contract are fully diminished during the Ijarah term.

BC37 The Board further concluded that the estimated residual value of the underlying asset at the end of the Ijarah term shall be applied in case of an Ijarah MBT through gradual transfer, as is estimated for any item of property, plant and equipment or investment property.

BC38 In case of Ijarah MBT through sale or gift after the end of the Ijarah term, if it is highly likely that the option of transfer of ownership of the underlying asset to the lessee shall be exercised through purchase or gift, the Board concluded that the residual value shall be equivalent to the estimated residual value of the underlying asset at the end of the Ijarah term less promised purchase price (if any), as this is the eventual economic benefit available to the lessee after the end of the Ijarah term.
Lease term and extension options

BC39 The Board considered and resolved that the Ijarah term shall include extension and termination options as this is relevant due to the fact that the total term must be estimated, and taken into account for depreciation and amortization calculations. The assessment of probability of exercising the extension is also in line with global best practices. There is a rebuttable presumption that expressed intention of the lessee to exercise the extension option(s) provides reasonable certainty with regard to extension of Ijarah term in line with generally accepted accounting principles. Subsequent reassessment is also in line with generally accepted accounting principles.
Appendix D: Brief history of the preparation of the standard

H1 The newly formed AAOIFI Accounting Board (AAB) held its meeting No. 1 on 6-7 of Jumada II 1437H, corresponding to 15-16 of March 2016 at Ramee Grand Hotel, Kingdom of Bahrain. In this meeting it was decided that high priority shall be bestowed on the revision of the standard on Ijarah.

H2 The consultation notes on Ijarah was presented at the AAB meeting No. 2 convened on 25-26 Shawwal 1437H, corresponding to 30-31 July 2016. In this meeting the members reviewed the existing FAS 8 including the scope and the accounting treatment in the books of the lessee. Additionally the members discussed Ijarah definition, types and accounting for the Ijarah assets and liabilities. The members agreed that there shall be attempts to iron out, as much as possible, the differences between AAOIFI standards and generally accepted accounting principles, especially with respect to Ijarah. The members agreed that an accounting working group should be formed immediately to that effect.

H3 The first working group on the Ijarah standard was held on 27 Rajab 1438H, corresponding to 24 April 2017. The members agreed that the definition of an Ijarah would be closer to Shari’ah and the new standard will be from scratch, not an adoption or revision of the existing standard and the standard would include accounting for both lessor and lessee.

H4 The Committee of the Shari’ah Board for Review of Accounting and Governance Standards held its Meeting No. 2 on 6 Muharram 1439H, corresponding to 27 September 2017. This meeting discussed the Shari’ah aspects of recognition of the usufruct of the Ijarah asset and the transfer of risk and reward.

H5 The initial exposure draft was presented at the second working group held on 23 Ramadan 1439H, corresponding to 7 June 2017. The working group deliberated on the draft and it was recommended to the Board.

H6 The AAB held its meeting No. 10 on 7-8 Shawwal 1439H, corresponding to 21-22 of June 2018 in Beirut, Lebanese Republic. In this meeting the contents of the draft standard were discussed and it was decided to be presented at the next Board meeting for further discussion.

H7 After incorporating comments and suggestion from the previous Board meeting, the draft was presented for the second time at the AAB meeting No. 11 on 20-21 Dhul-Hijjah 1439H, corresponding to 1-2 September 2018 at the AAOIFI head-office in the Kingdom of Bahrain. The exposure draft was principally approved in this meeting.

H8 The exposure draft was officially issued on 24 Rabi’ II 1440H, corresponding to 31 December 2018, after a third working group meeting held on 19 Rabi’ II corresponding to 26 December 2018 where members finalized the exposure draft based on instructions from the AAB.

H9 [to be updated]