1. Introduction: Understanding Ijarah

Ijarah is an Islamic finance contract that refers to a lease or rental agreement. In essence, it is the transfer of the usufruct (right to use) of a specific asset for an agreed-upon period in return for an agreed-upon consideration (rent). The ownership of the asset remains with the lessor (Mu'jir), while the lessee (Musta'jir) only receives the right to use the asset.

Ijarah Muntahia Bittamleek (IMBTM) is a form of Ijarah that concludes with the transfer of ownership of the leased asset to the lessee at the end of the lease period. This transfer can occur through various mechanisms, such as a gift, a sale at a token price, or a sale at a pre-agreed price.

These standards are crucial for Islamic Financial Institutions (IFIs) in correctly accounting for and reporting such transactions.

2. Financial Accounting Standard (FAS) 32: Ijarah

2.1. Objective and Scope:

- **Objective:** To prescribe the accounting treatment for Ijarah transactions in the books of both the lessor and the lessee. This includes the recognition of assets, liabilities, income, and expenses related to Ijarah contracts.
- **Scope:** This standard applies to all types of Ijarah transactions, including operating Ijarah and Ijarah Muntahia Bittamleek (though SS 9 provides more specific guidance on IMBTM). It covers tangible assets such as property, plant, and equipment.

2.2. Definitions (Key Terms from FAS 32 context):

- **Ijarah:** A contract whereby a lessor (owner) transfers the usufruct of an asset to a lessee for an agreed period at an agreed consideration.
- **Lessor:** The party that leases the asset to the lessee.
- **Lessee:** The party that obtains the right to use the asset under the Ijarah contract.
- **Ijarah Term:** The period for which the asset is leased.
- **Ijarah Rentals:** The payments made by the lessee to the lessor for the use of the asset.
- **Commencement of Ijarah:** The date from which the lessee is entitled to exercise its right to use the leased asset. It is the date from which the Ijarah contract is effective.
- **Residual Value:** The estimated fair value of the leased asset at the end of the

Ijarah term.

2.3. Recognition and Measurement - Lessor Accounting:

- **Asset Recognition:** The lessor continues to recognize the leased asset as its own property (e.g., under Property, Plant, and Equipment).
- **Depreciation:** The lessor depreciates the leased asset over its useful life in accordance with relevant FAS (e.g., FAS on Property, Plant, and Equipment).
- **Ijarah Income Recognition:** Ijarah income (rentals) should be recognized on a time proportion basis over the Ijarah term, unless another systematic basis is more representative of the time pattern in which the benefit from the use of the leased asset is diminished. Typically, this means straight-line recognition.
- **Initial Direct Costs:** Costs incurred by the lessor in arranging an Ijarah (e.g., commissions, legal fees) are added to the carrying amount of the leased asset and recognized as an expense over the lease term on the same basis as the lease income. Alternatively, they may be expensed as incurred if immaterial.
- **Impairment:** The leased asset is subject to impairment testing as per relevant FAS.

2.4. Recognition and Measurement - Lessee Accounting:

- **Ijarah Expense Recognition:** Ijarah rental payments are recognized as an expense in the income statement on a time proportion basis over the Ijarah term (usually straight-line), unless another systematic basis is more representative of the time pattern of the user's benefit.
- **No Asset Recognition (for operating Ijarah):** The lessee does not recognize the leased asset on its balance sheet, as ownership remains with the lessor. The lessee only has the right to use.
- **Leasehold Improvements:** Any improvements made by the lessee to the leased asset that cannot be removed are generally capitalized by the lessee and amortized over the shorter of their useful life or the remaining lease term.

2.5. Presentation and Disclosure (Lessor & Lessee):

- **Lessor:**
  - Gross carrying amount of assets subject to Ijarah and accumulated depreciation.
  - Ijarah income recognized.
  - Future minimum Ijarah rentals receivable under non-cancellable Ijarah contracts in aggregate and for specified future periods.
- **Lessee:**
  - Ijarah expense recognized.
  - Future minimum Ijarah rental commitments under non-cancellable Ijarah

contracts in aggregate and for specified future periods.
    - Significant Ijarah arrangements, restrictions, renewal or purchase options, and contingent rents.

3. Shari’ah Standard (SS) 9: Ijarah and Ijarah Muntahia Bittamleek

(Based on general knowledge of AAOIFI standards. Specific wording may vary based on the exact version of the standard not provided.)

3.1. Objective and Scope:

- **Objective:** To set out the Shari’ah rules for Ijarah and Ijarah Muntahia Bittamleek (IMBTM) contracts, ensuring compliance with Islamic principles. While FAS 32 deals with accounting, SS 9 focuses on the contractual validity and Shari'ah compliance.
- **Scope:** Applies to all Ijarah and IMBTM contracts entered into by Islamic Financial Institutions.

3.2. Key Shari’ah Principles for Ijarah:

- **Asset Existence and Usability:** The subject matter of the Ijarah (the asset) must exist and be usable at the time of contracting or be specifiable in a way that eliminates major uncertainty.
- **Ownership with Lessor:** The lessor must own the asset or have the right to lease it out. The risks and rewards associated with ownership (e.g., major maintenance, insurance against total loss not due to lessee negligence) remain with the lessor.
- **Determinate Usufruct:** The benefit (usufruct) derived from the asset must be clearly defined and permissible (Halal).
- **Determinate Period and Rent:** Both the lease period and the rental amount must be clearly determined at the inception of the contract.
- **Liability for Impairment:** The lessor is responsible for maintaining the asset in a condition that allows the lessee to derive the intended usufruct, unless impairment is due to lessee's misuse or negligence.
- **Subleasing:** The lessee may sublease the asset with the lessor's permission, provided the sub-lessee uses it for permissible purposes and the sublease rent and period do not exceed those of the original lease without lessor consent.

3.3. Key Shari’ah Principles for Ijarah Muntahia Bittamleek (IMBTM):

- **Two Separate Contracts:** The Ijarah (lease) contract and the contract for the transfer of ownership (e.g., sale, gift) must be distinct. The promise to transfer ownership should ideally be unilateral from the lessor or, if bilateral, should not be a condition of the lease itself but rather a separate undertaking.

- **Option to Acquire:** The lessee has an option or a promise is made for the lessee to acquire the asset at the end of the lease term.
- **Transfer Mechanisms:** The transfer of ownership can be through:
    - A gift (Hiba) from the lessor.
    - A sale at a token price.
    - A sale at a pre-agreed price at the end of the lease term.
    - A sale before the end of the lease term at a price equivalent to the remaining Ijarah installments (if agreed upon).
- **No Obligation to Purchase (in some views):** Ideally, the lessee should not be obligated to purchase the asset from the beginning; it should be an option. However, variations exist in practice.
- **Rentals vs. Purchase Price:** Rentals paid during the Ijarah period are for the use of the asset and are not considered installments towards the purchase price until the separate sale contract is executed.

3.4. Relationship with FAS 32:

- SS 9 provides the Shari'ah framework that underpins the transactions accounted for under FAS 32.
- For IMBTM, while FAS 32 would outline the accounting for the lease phase, the eventual transfer of ownership would also have accounting implications (e.g., derecognition of the asset by the lessor, recognition by the lessee) that must align with the Shari'ah-compliant structure defined in SS 9. If an IMBTM is structured in a way that substantively transfers risks and rewards of ownership from the outset (akin to a finance lease), its accounting treatment might differ and lean towards recognizing an asset by the lessee, though this is a complex area in Islamic finance accounting. AAOIFI standards generally treat IMBTM as an operating lease during the lease period, with the transfer of ownership accounted for when it occurs.

4. Use Case Scenarios

Scenario 1: Standard Operating Ijarah (Lessor Perspective)

- **Scenario:** Bank Al-Ameen (Lessor) purchases equipment for $100,000 and leases it to ABC Corp (Lessee) for 3 years. Annual rental is $30,000, payable at the beginning of each year. The equipment has a useful life of 5 years and a salvage value of $10,000. Bank Al-Ameen incurred $2,000 in initial direct costs to arrange the lease.
- **Question:** How should Bank Al-Ameen account for this Ijarah transaction in the first year according to FAS 32?
- **Provided Correct Answer (AI Learning Goal):**

1. **Asset Recognition:** Bank Al-Ameen recognizes the equipment as "Assets for Ijarah" at $100,000. The $2,000 initial direct costs are typically recorded as deferred costs or added to the carrying amount and amortized with income. (Revised from previous: For clarity, asset cost is $100,000; IDC $2,000 treated separately or as part of net income calculation).
2. **Depreciation:** Annual depreciation = ($100,000 - $10,000) / 5 years = $18,000.
   - Depreciation Expense (Year 1): $18,000.
3. **Ijarah Income:** Total Ijarah income over 3 years = $30,000 * 3 = $90,000. Income recognized in Year 1 = $30,000 (straight-line).
4. **Amortization of Initial Direct Costs:** Amortized over 3 years = $2,000 / 3 = $666.67 per year.
5. **Net effect on Ijarah Income (Year 1):** $30,000 (Rental Income) - $666.67 (Amortized Initial Direct Costs) = $29,333.33. (Assuming IDC reduces income).
6. **Journal Entries (Simplified for Year 1):**
   - *To record purchase of equipment:*
     - Dr. Assets for Ijarah $100,000
     - Cr. Cash/Payable $100,000
   - *To record initial direct costs:*
     - Dr. Deferred Ijarah Costs $2,000
     - Cr. Cash $2,000
   - *To record receipt of first year's rent:*
     - Dr. Cash $30,000
     - Cr. Unearned Ijarah Income $30,000
   - *To recognize Ijarah income for the year:*
     - Dr. Unearned Ijarah Income $30,000
     - Cr. Ijarah Income $30,000
   - *To record depreciation expense:*
     - Dr. Depreciation Expense $18,000
     - Cr. Accumulated Depreciation - Assets for Ijarah $18,000
   - *To record amortization of initial direct costs:*
     - Dr. Ijarah Related Expenses (Amortization of IDC) $666.67
     - Cr. Deferred Ijarah Costs $666.67
7. **Balance Sheet (End of Year 1):** Assets for Ijarah (Net) = ($100,000 - $18,000) = $82,000. Deferred Ijarah Costs (Net) = $2,000 - $666.67 = $1,333.33.
8. **Disclosure:** Bank Al-Ameen would disclose future minimum lease payments receivable.

Scenario 2: Ijarah Muntahia Bittamleek (IMBTM) - Lessee Perspective (Token Price Purchase)

- **Scenario:** XYZ Company (Lessee) enters into an IMBTM agreement with Baraka Islamic Bank (Lessor) for a specialized machine. The lease term is 5 years, with annual rental payments of $20,000. At the end of the 5 years, XYZ Company has the option to purchase the machine for a token price of $1,000. The machine's fair value at the inception of the lease is $85,000.
- **Question:** How should XYZ Company account for the annual rental payments during the lease term, and what is the key consideration from SS 9 regarding the purchase option?
- **Provided Correct Answer (AI Learning Goal):**
  1. **Rental Expense:** XYZ Company should recognize an Ijarah expense of $20,000 each year for the 5-year lease term.
     - *Journal Entry (Each Year):*
       - Dr. Ijarah Rental Expense $20,000
       - Cr. Cash/Payable $20,000
  2. **Asset Recognition (During Lease Term):** XYZ Company does not recognize the machine as its asset on its balance sheet during the lease term. It only has the right of use.
  3. **SS 9 Consideration:** According to SS 9, the Ijarah contract and the promise/option to transfer ownership must be distinct. The rentals are for the usufruct, not installments of the purchase price. The option to purchase for $1,000 at the end is a valid mechanism for IMBTM.
  4. **Accounting at Purchase:** If XYZ Company exercises the option, it will then recognize the machine as an asset at the purchase price of $1,000 (plus any directly attributable costs of acquisition at that point).
     - *Journal Entry (At time of purchase):*
       - Dr. Machinery $1,000
       - Cr. Cash $1,000

Scenario 3: Early Termination of Ijarah with Penalty

- **Scenario:** A company leases equipment under an Ijarah contract for 4 years. After 2.5 years, due to unforeseen circumstances, the lessee requests early termination. The contract stipulates a penalty for early termination amounting to $1,500. Unamortized initial direct costs for the lessor are $500. Accrued but unpaid rent by lessee is $800.
- **Question:** What are the accounting implications for the lessor and lessee under FAS 32, and what Shari'ah considerations from SS 9 might apply to the penalty?
- **Provided Correct Answer (AI Learning Goal):**

1. **Lessor Accounting (FAS 32):**
   - Recognize Ijarah income for the accrued rent: Dr. Ijarah Receivable $800, Cr. Ijarah Income $800.
   - Write off unamortized initial direct costs: Dr. Ijarah Related Expense (Loss on termination) $500, Cr. Deferred Ijarah Costs $500.
   - Recognize penalty payment received: Dr. Cash $1,500, Cr. Other Income (Penalty) $1,500. (Assuming payment of accrued rent and penalty are made).
   - The asset remains on the lessor's books.
2. **Lessee Accounting (FAS 32):**
   - Recognize accrued Ijarah expense: Dr. Ijarah Rental Expense $800, Cr. Ijarah Payable $800.
   - Recognize penalty payment as an expense: Dr. Penalty Expense $1,500, Cr. Cash $1,500.
3. **Shari'ah Consideration (SS 9):**
   - Penalties for early termination (Ta'widh) should compensate for actual damages. The $1,500 must be justifiable as actual loss incurred by the lessor (e.g., costs of finding a new lessee, difference in rental rates). It should not be a pre-determined interest-like charge on remaining rentals.

Scenario 4: IMBTM with Ownership Transfer via Gift (Lessor Perspective)

- **Scenario:** Amanah Bank (Lessor) leases a property to a client for 10 years under an IMBTM agreement. Annual rental is $50,000. The property's cost to the bank was $400,000, and its useful life is 20 years (no salvage value for simplicity in this part). At the end of the 10-year lease, the bank will transfer the property to the lessee as a gift (Hiba), as per the IMBTM agreement.
- **Question:** How should Amanah Bank account for the Ijarah and the eventual transfer of the property?
- **Provided Correct Answer (AI Learning Goal):**
  1. **During Lease Term (Annually for 10 years):**
     - Recognize Ijarah Income: Dr. Cash/Receivable $50,000, Cr. Ijarah Income $50,000.
     - Recognize Depreciation Expense: ($400,000 / 20 years) = $20,000. Dr. Depreciation Expense $20,000, Cr. Accumulated Depreciation - Ijarah Property $20,000.
  2. **At the End of Lease Term (Year 10) - Transfer as Gift:**
     - Ensure all income and depreciation up to the date of transfer are recorded.
     - Carrying value of property at end of Year 10 = $400,000 - ($20,000 * 10)

= $200,000.

- Derecognize the property and recognize the gift:
  - Dr. Accumulated Depreciation - Ijarah Property $200,000
  - Dr. Expense from IMBTM - Gift (or Loss on Disposal of Ijarah Asset) $200,000
  - Cr. Ijarah Property (at cost) $400,000

3. **SS 9 Consideration:** The promise to gift the asset at the end of the lease is a valid mechanism for IMBTM, provided it is a separate undertaking from the lease contract itself. The rentals are for usufruct only.

Scenario 5: Subleasing by Lessee

- **Scenario:** Alpha Corp leases an office floor from Beta Islamic Bank for $10,000 per month for 3 years. After 1 year, Alpha Corp, with Beta Bank's permission, subleases 40% of the office space to Gamma Ltd for $5,000 per month for the remaining 2 years.
- **Question:** How should Alpha Corp (original lessee/sub-lessor) account for the original lease and the sublease? What are the Shari'ah considerations?
- **Provided Correct Answer (AI Learning Goal):**
  1. **Alpha Corp - Original Lease with Beta Bank (Lessee accounting):**
     - Recognize Ijarah Rental Expense: Dr. Ijarah Rental Expense $10,000, Cr. Cash/Payable $10,000 (monthly).
  2. **Alpha Corp - Sublease to Gamma Ltd (Sub-lessor accounting):**
     - Recognize Sublease Income: Dr. Cash/Sublease Receivable $5,000, Cr. Sublease Income $5,000 (monthly).
     - The original lease expense continues. The sublease income is recognized separately.
  3. **FAS 32 Consideration:** Alpha Corp continues to account for its head lease as a lessee. The sublease is treated as a separate income stream. If the sublease were to transfer substantially all risks and rewards of the *head lease* (unlikely in most Ijarah contexts for subleases), further analysis might be needed, but generally, it's income.
  4. **SS 9 Consideration:** Subleasing is permissible if:
     - The head lessor (Beta Bank) grants permission.
     - The sub-lessee (Gamma Ltd) uses the asset for permissible (Halal) purposes.
     - The sublease terms (rent, period) do not exploit the original lessee's position without justification or consent if they exceed original terms (e.g., charging significantly more rent for the same portion without added value). Here, 40% space for 50% of total rent seems reasonable if market

rates support it.

Scenario 6: Ijarah on an Asset Under Construction (Istisna’ parallel with Ijarah)

- **Scenario:** An Islamic Bank agrees to finance the construction of a specialized warehouse for a client (Lessee) through a combination of Istisna’ (to construct) and a forward Ijarah (to lease upon completion). The construction cost is $1,000,000. The Ijarah will commence upon completion for 10 years at an annual rental of $150,000.
- **Question:** What are the key accounting phases for the Islamic Bank (Lessor) and the Shari'ah considerations for structuring this?
- **Provided Correct Answer (AI Learning Goal):**
  1. **Phase 1: Construction (Istisna’ for the Bank as Purchaser/Future Lessor):**
     - The Bank pays the contractor. These payments are capitalized as "Assets Under Construction for Ijarah" or similar.
     - Dr. Assets Under Construction for Ijarah $X, Cr. Cash/Payable $X (as payments are made).
  2. **Phase 2: Completion and Commencement of Ijarah:**
     - Upon completion, the total cost ($1,000,000) is transferred from "Assets Under Construction for Ijarah" to "Assets for Ijarah."
     - Dr. Assets for Ijarah $1,000,000, Cr. Assets Under Construction for Ijarah $1,000,000.
     - Then, Ijarah accounting begins (income recognition, depreciation over warehouse useful life) as per FAS 32.
  3. **SS 9 Consideration:**
     - The Istisna’ (construction) contract and the Ijarah (lease) contract must be separate and distinct.
     - The Ijarah contract can be a forward lease, but rentals should only commence once the asset is delivered to the lessee and is ready for use as per the agreed specifications.
     - The subject matter of Ijarah (the warehouse) must be clearly specified.
     - The bank must take ownership and possession (even if constructive) of the warehouse before leasing it out.

Scenario 7: Destruction of Leased Asset (Not due to Lessee Negligence)

- **Scenario:** A vehicle leased by an Islamic Bank to a customer under a 3-year Ijarah contract is destroyed in a flood (an act of God) at the end of Year 1. The vehicle's carrying amount on the Bank's books is $15,000. The Ijarah contract is terminated. Takaful (Islamic insurance) proceeds received by the bank are $12,000.

- **Question:** How should the Islamic Bank (Lessor) account for this event? What are the Shari'ah implications?
- **Provided Correct Answer (AI Learning Goal):**
  1. **Lessor Accounting (FAS 32):**
     - Recognize any accrued Ijarah income up to the date of destruction.
     - Derecognize the asset:
       - Dr. Accumulated Depreciation [Amount for 1 year]
       - Dr. Loss on Destruction of Ijarah Asset [Balancing figure]
       - Cr. Asset for Ijarah [Original Cost]
     - Recognize Takaful proceeds: Dr. Cash $12,000, Cr. Gain from Takaful Proceeds (or offset against Loss on Destruction) $12,000.
     - The net effect will be a loss of ($15,000 carrying value - $12,000 proceeds) = $3,000, assuming no unamortized IDCs.
  2. **SS 9 Consideration:**
     - If the asset is destroyed through no fault or negligence of the lessee, the Ijarah contract terminates automatically from the date of destruction.
     - The lessee is not liable for rentals from that date onwards.
     - The loss of the asset is borne by the lessor (the owner). Takaful coverage is a risk mitigation measure for the lessor.
     - Any advance rentals paid by the lessee for the period after destruction must be refunded.

Scenario 8: Sale and Leaseback (Ijarah)

- **Scenario:** Company X sells a building to Islamic Bank Y for its fair value of $500,000 (which is also its carrying amount for Company X). Simultaneously, Company X leases the building back from Bank Y under an Ijarah agreement for 5 years, with annual rentals of $60,000. The building has a remaining useful life of 20 years.
- **Question:** How should Company X (Seller-Lessee) and Bank Y (Purchaser-Lessor) account for this transaction, and what are key Shari'ah conditions?
- **Provided Correct Answer (AI Learning Goal):**
  1. **Bank Y (Purchaser-Lessor) Accounting:**
     - Purchase of Asset: Dr. Assets for Ijarah (Building) $500,000, Cr. Cash $500,000.
     - Standard Ijarah accounting follows: Recognize Ijarah income ($60,000 annually), depreciate the building (e.g., $500,000 / 20 years = $25,000 annually).
  2. **Company X (Seller-Lessee) Accounting:**

        - Sale of Asset: Dr. Cash $500,000, Cr. Building (at carrying amount) $500,000. (No gain/loss if sold at carrying amount).
        - Leaseback: Recognize Ijarah rental expense: Dr. Ijarah Rental Expense $60,000, Cr. Cash/Payable $60,000 (annually).
    3. **FAS 32 Consideration:** If the sale price is at fair value, any gain or loss on sale by Company X is recognized immediately. The leaseback is treated as a standard operating Ijarah for Company X. If the sale price is above or below fair value, the accounting treatment for the gain/loss might be deferred and amortized.
    4. **SS 9 Consideration for Sale and Leaseback:**
        - The sale must be a genuine transfer of ownership from Company X to Bank Y. Bank Y must assume the risks and rewards of ownership.
        - The transactions (sale and leaseback) should not be a mere subterfuge for a loan (e.g., if Company X is obligated to repurchase the asset at a pre-determined price that effectively guarantees Bank Y a return equivalent to interest).
        - The rental rate should be based on market rates for similar properties.
        - The bank must actually acquire the asset before leasing it back.

Scenario 9: IMBTM with Ownership Transfer via Sale at Pre-agreed Price (Lessee Perspective)

- **Scenario:** GreenTech Ltd (Lessee) is at the end of a 7-year IMBTM contract for a solar power unit with Nur Islamic Finance (Lessor). Annual rentals were $15,000. The IMBTM agreement included a unilateral promise from Nur Islamic Finance to sell the unit to GreenTech for $10,000 at the end of the lease. GreenTech decides to exercise this option.
- **Question:** How should GreenTech Ltd account for the exercise of this purchase option?
- **Provided Correct Answer (AI Learning Goal):**
    1. **Rental Expense (During Lease):** GreenTech would have recorded $15,000 as Ijarah Rental Expense annually.
    2. **Asset Acquisition (At End of Lease):**
        - When GreenTech exercises the option and pays the agreed price:
            - Dr. Equipment (Solar Power Unit) $10,000
            - Cr. Cash/Payable $10,000
    3. **FAS 32 & SS 9 Consideration:** This is a valid IMBTM transfer mechanism. The lessee recognizes the asset at the actual price paid at the point of transfer. The previous rental payments were for the usufruct and are not capitalized into the asset's cost. The $10,000 is the acquisition cost for GreenTech.

Scenario 10: Impact of Late Shari'ah Compliance Review Finding

- **Scenario:** An Islamic Bank has been leasing equipment to various clients under a standard Ijarah template. Two years into some leases, an internal Shari'ah audit reveals that a clause in the template regarding late payment penalties was not fully Shari'ah compliant (e.g., it was structured as a compounding charge rather than actual compensation). The bank immediately rectifies the template for future contracts and decides to address the non-compliant income from past periods. For a specific lease, $500 of non-compliant penalty income had been recognized in the previous year.
- **Question:** What are the accounting and Shari'ah implications for the bank regarding the previously recognized non-compliant income?
- **Provided Correct Answer (AI Learning Goal):**
  1. **Shari'ah Implication:** Income derived from a non-Shari'ah compliant source or clause is considered impure. It must be identified and disposed of to charity (purified). The bank cannot retain this income.
  2. **Accounting Treatment (FAS 32 and general Islamic accounting principles):**
     - The bank needs to reverse the improperly recognized income if it's from a prior period and still within retained earnings, or make an adjustment in the current period.
     - The $500 non-compliant income should be removed from the bank's distributable profits.
     - Journal Entry to correct (simplified):
       - Dr. Retained Earnings (or Current Year Income if immaterial and relating to current year) $500
       - Cr. Liability for Charitable Disposal (or directly to Charity Expense if paid out) $500
     - When the amount is paid to charity:
       - Dr. Liability for Charitable Disposal $500
       - Cr. Cash $500
  3. **Disclosure:** The bank may need to disclose the nature of the non-compliance, the rectification measures, and the amount purified in its financial statements or Shari'ah Supervisory Board report.
  4. **FAS 32:** While FAS 32 details Ijarah accounting, the purification of non-compliant income falls under broader Shari'ah governance and specific AAOIFI standards or guidance on prohibited income.

5. Reverse Transactions (Inducing FAS)

Transaction Set 1:

- **Financial Entries (Lessor's Books):**
  1. *Initial Transaction:*
     - Dr. Asset for Ijarah (e.g., Vehicle) $50,000
     - Cr. Cash/Payable $50,000
  2. *Receipt of Annual Rental:*
     - Dr. Cash $12,000
     - Cr. Unearned Ijarah Income $12,000
  3. *Monthly Income Recognition:*
     - Dr. Unearned Ijarah Income $1,000
     - Cr. Ijarah Income $1,000
  4. *Monthly Depreciation:*
     - Dr. Depreciation Expense $800
     - Cr. Accumulated Depreciation - Asset for Ijarah $800
- **Question:** Which FAS/SS are primarily relevant to these entries, and what type of contract do they suggest?
- **Provided Correct Answer (AI Learning Goal):**
  - **Relevant FAS/SS:** FAS 32 "Ijarah" and potentially SS 9 "Ijarah and Ijarah Muntahia Bittamleek" (if ownership transfer is an element not shown here but implied by broader context).
  - **Type of Contract:** These entries are consistent with an **Operating Ijarah** from the lessor's perspective. The lessor capitalizes the asset, recognizes rental income over time (by initially deferring it and then amortizing), and depreciates the asset.

Transaction Set 2:

- **Financial Entries (Lessee's Books):**
  1. *Payment of Quarterly Rental:*
     - Dr. Ijarah Rental Expense $5,000
     - Cr. Cash $5,000
  2. *End of Lease - Asset Purchased for Nominal Amount (as per prior agreement):*
     - Dr. Equipment $100
     - Cr. Cash $100
- **Question:** Which FAS/SS are primarily relevant to these entries, and what type of contract do they suggest?
- **Provided Correct Answer (AI Learning Goal):**
  - **Relevant FAS/SS:** FAS 32 "Ijarah" and SS 9 "Ijarah and Ijarah Muntahia Bittamleek."

    - **Type of Contract:** These entries suggest an **Ijarah Muntahia Bittamleek (IMBTM)** from the lessee's perspective. The lessee recognizes rental payments as an expense during the lease term. The subsequent purchase of the asset for a nominal amount at the end of the lease signifies the ownership transfer component of an IMBTM, as guided by SS 9. During the lease period, the accounting follows operating lease principles for the lessee under FAS 32.

Transaction Set 3:

- **Financial Entries (Lessor's Books - upon signing the contract):**
  1. *No entry for the asset itself beyond its initial purchase if already owned.*
  2. *Receipt of security deposit (refundable):*
     - Dr. Cash $3,000
     - Cr. Liability for Security Deposit $3,000
  3. *Receipt of first month's rent in advance:*
     - Dr. Cash $1,500
     - Cr. Unearned Ijarah Income $1,500
- **Question:** What do these initial entries indicate about the nature of the transaction under FAS 32 and SS 9?
- **Provided Correct Answer (AI Learning Goal):**
    - **Relevant FAS/SS:** FAS 32 "Ijarah" and SS 9 "Ijarah and Ijarah Muntahia Bittamleek."
    - **Nature of Transaction Indicated:** These entries are typical for the commencement of an Ijarah contract (either standard Ijarah or IMBTM) from the lessor's side.
        - The security deposit is correctly treated as a liability as it's refundable.
        - The advance rent is correctly treated as unearned income, to be recognized as income over the period the service (use of asset) is provided.
        - This aligns with FAS 32's requirement to recognize income over the lease term. SS 9 would ensure the underlying contract for this Ijarah is Shari'ah compliant (e.g., asset exists, rent is known).

Transaction Set 4:

- **Financial Entries (Lessor's Books - Major Maintenance):**
  1. *Payment for significant overhaul of leased equipment (extending its useful life):*
     - Dr. Asset for Ijarah (or Accumulated Depreciation if it reverses previous depreciation) $10,000
     - Cr. Cash/Payable $10,000

- **Question:** Which FAS/SS are relevant, and what principle does this entry reflect regarding lessor responsibilities?
- **Provided Correct Answer (AI Learning Goal):**
  - **Relevant FAS/SS:** FAS 32 "Ijarah" and SS 9 "Ijarah and Ijarah Muntahia Bittamleek."
  - **Principle Reflected:** This reflects the lessor's responsibility for major maintenance (capital expenditure) that enhances or restores the service potential of the asset or extends its useful life. Under SS 9, the lessor bears ownership risks, including significant maintenance. FAS 32 would guide the capitalization of such expenditure to the asset's carrying amount.

Transaction Set 5:

- **Financial Entries (Lessee's Books - Leasehold Improvements):**
  1. *Payment for installation of non-removable fixtures in a leased office space:*
     - Dr. Leasehold Improvements $7,000
     - Cr. Cash/Payable $7,000
  2. *Monthly Amortization of Leasehold Improvements (Lease term 5 years, improvement life 10 years):*
     - Dr. Amortization Expense - Leasehold Improvements $116.67 ($7,000 / (5*12) months)
     - Cr. Accumulated Amortization - Leasehold Improvements $116.67
- **Question:** Which FAS is primarily relevant, and why is the amortization period chosen as such?
- **Provided Correct Answer (AI Learning Goal):**
  - **Relevant FAS:** FAS 32 "Ijarah" (specifically, its guidance on lessee accounting, though general principles of accounting for leasehold improvements also apply).
  - **Amortization Period:** The leasehold improvements are amortized over the shorter of their useful life (10 years) or the lease term (5 years). In this case, 5 years is shorter. This is a standard accounting practice.

Transaction Set 6:

- **Financial Entries (Lessor's Books - Asset Impairment):**
  1. *Recognition of impairment loss on a leased asset due to market decline:*
     - Dr. Impairment Loss on Ijarah Asset $15,000
     - Cr. Accumulated Impairment Loss - Asset for Ijarah (or directly to Asset for Ijarah) $15,000
- **Question:** Which FAS/SS are relevant, and what does this entry signify?
- **Provided Correct Answer (AI Learning Goal):**

    - **Relevant FAS/SS:** FAS 32 "Ijarah" and the general FAS on Impairment of Assets. SS 9 reinforces that ownership risks (like impairment) reside with the lessor.
    - **Significance:** This entry shows the lessor recognizing a reduction in the carrying value of the leased asset because its recoverable amount is less than its carrying amount. This is part of the lessor's responsibility as the owner.

Transaction Set 7:

- **Financial Entries (Lessee's Books - Variable Lease Payment):**
    1. *Payment of base monthly rent:*
        - Dr. Ijarah Rental Expense $2,000
        - Cr. Cash $2,000
    2. *Payment of additional rent based on 1% of lessee's sales for the month (as per Ijarah contract):*
        - Dr. Ijarah Rental Expense (Variable) $500
        - Cr. Cash $500
- **Question:** How does FAS 32 address such variable payments, and what is the Shari'ah consideration?
- **Provided Correct Answer (AI Learning Goal):**
    - **FAS 32:** FAS 32 requires fixed rental payments to be expensed on a systematic basis (e.g., straight-line). Variable lease payments that are contingent on factors other than the mere passage of time (like sales, usage) are generally expensed in the period in which they are incurred.
    - **Shari'ah Consideration (SS 9):** While the base rent must be fixed and known, variable components are permissible if the basis of calculation is clearly defined and agreed upon in advance, removing major uncertainty (Gharar). The variability should not be tied to prohibited elements.

Transaction Set 8:

- **Financial Entries (Lessor's Books - IMBTM, Asset Transfer via Gift at End of Lease):**
    1. *Final rental income recognition and depreciation for the last period are already done.*
    2. *Asset has a carrying amount (Cost - Accumulated Depreciation) of $1,000.*
    3. *Transfer of asset to lessee as a gift:*
        - Dr. Accumulated Depreciation - Asset for Ijarah [Full Accumulated Amount]
        - Dr. Loss on Disposal/Gift of Ijarah Asset (or expense related to IMBTM promise fulfillment) $1,000

        - Cr. Asset for Ijarah [Original Cost]
- **Question:** Which FAS/SS are relevant, and what does this transaction represent in an IMBTM context?
- **Provided Correct Answer (AI Learning Goal):**
    - **Relevant FAS/SS:** FAS 32 "Ijarah" and SS 9 "Ijarah and Ijarah Muntahia Bittamleek."
    - **Representation:** This represents the culmination of an IMBTM contract where the ownership of the asset is transferred to the lessee via a gift (Hiba), as permitted by SS 9. The lessor derecognizes the asset from its books. The "Loss on Disposal" represents the carrying value of the asset being gifted. (Note: The exact account name for the charge upon gifting can vary, e.g., "Expense from IMBTM - Gift").

Transaction Set 9:

- **Financial Entries (Lessee's Books - IMBTM, Asset Purchase at Pre-agreed Price):**
    1. *Final rental expense for the lease term is already recorded.*
    2. *Purchase of asset at the end of Ijarah term for a pre-agreed price of $5,000 (which is not nominal):*
        - Dr. Equipment $5,000
        - Cr. Cash/Payable $5,000
- **Question:** Which FAS/SS are relevant, and how does this differ from a nominal price purchase in IMBTM?
- **Provided Correct Answer (AI Learning Goal):**
    - **Relevant FAS/SS:** FAS 32 "Ijarah" and SS 9 "Ijarah and Ijarah Muntahia Bittamleek."
    - **Difference:** This is one of the valid mechanisms for ownership transfer under IMBTM as per SS 9 – sale at a pre-agreed price. The lessee recognizes the asset at the actual purchase price paid. Unlike a nominal price (which is akin to a gift), this involves a substantive payment reflecting an agreed valuation for the transfer. FAS 32 guides the accounting for the lease phase, and then the asset acquisition is a separate event.

Transaction Set 10:

- **Financial Entries (Lessor's Books - Insurance Costs):**
    1. *Lessor pays annual insurance premium (Takaful) for the leased asset:*
        - Dr. Insurance Expense (or Ijarah Operating Expense) $1,200
        - Cr. Cash/Payable $1,200
    2. *If a portion of Takaful is contractually recoverable from the lessee (as a*

service fee, not as rent):
        - Dr. Cash/Receivable from Lessee $300
        - Cr. Recovery of Expenses (or reduction of Insurance Expense) $300
- **Question:** Which FAS/SS are relevant, and what Shari'ah principle does the primary insurance cost reflect?
- **Provided Correct Answer (AI Learning Goal):**
    - **Relevant FAS/SS:** FAS 32 "Ijarah" and SS 9 "Ijarah and Ijarah Muntahia Bittamleek."
    - **Shari'ah Principle:** The primary responsibility for insuring the asset (basic Takaful against major risks not due to lessee negligence) lies with the lessor, as the owner of the asset (SS 9). This is an ownership-related expense. While the lessor bears this cost, agreements may allow for charging the lessee a separate, clearly defined service fee for arranging such coverage, but it shouldn't be part of the Ijarah rental itself if the responsibility remains with the lessor. FAS 32 would guide the accounting for these expenses and any recoveries.

6. Further Learning Points for AI

- **Distinction between Operating and Finance Leases (Conventional vs. Islamic):** While conventional accounting has clear distinctions (e.g., IFRS 16), Islamic finance, particularly under AAOIFI, generally treats Ijarah as an operating lease for the lessor (asset on books, depreciation) and lessee (rent as expense), even in IMBTM cases, until ownership transfer. The AI should understand this nuance.
- **Variable Lease Payments:** How to account for Ijarah contracts with variable payments (e.g., tied to an index, subject to review). Generally, the fixed portion is accounted for as per standard Ijarah, and variable portions are recognized when incurred or accrued based on the mechanism.
- **Subleases:** Accounting for subleases by both the original lessor, the original lessee (now sub-lessor), and the sub-lessee.
- **Impairment of Ijarah Assets:** How impairment is assessed and accounted for by the lessor.
- **Sale and Leaseback (Ijarah):** Specific conditions and accounting treatment if an entity sells an asset and leases it back under an Ijarah contract.
- **Purification of Non-Compliant Income:** Understanding the Shari'ah requirement and basic accounting for handling income earned through means not fully compliant with Shari'ah principles.