AAOIFI Financial Accounting Standard 32

Ijarah

Contents

AAOIFI Financial Accounting Standard (FAS) 32 "*Ijarah*" is set out in paragraphs 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 principles and rules and key considerations provided by AAOIFI Shari'ah Standards (SS) in respect of such products and matters.

Preface

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

PR2 AAOIFI Accounting Board (AAB / the board), in its strive for improvements of the existing financial reporting standards, decided to revise the existing Financial Accounting Standard (FAS) 8 "Ijarah and Ijarah Muntahia Bittamleek" in order to address the issues faced by the market and observations noted over the 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 its 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 (FAS) 8 "Ijarah and Ijarah Muntahia Bittamleek" originally issued in 1997. 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 an institution, in both the capacities of lessor and lessee.

Rationale for issuing this standard

IN2 The AAOIFI Accounting Board (AAB/ the board), after its constitution in 2015, approved a strategy and plan for improvement in and revision of a significant number of existing FASs. 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 expected changes, at that time, in the generally accepted accounting principles with regard to lease accounting[1], it was decided that the 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 adversely impact the reputation of the Islamic finance industry.

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 32) brings significant changes from its predecessor standard (FAS 8), inter-alia, in the following aspects:

a. changes in the classification. Ijarah transactions under in this standard are classified into the following:

   i. operating Ijarah;

   ii. Ijarah MBT with expected transfer of ownership after the end of the Ijarah term – either through a sale or gift; and

[1] Both the International Accounting Standards Board (IASB) and US 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 bodies revising their respective standards, principally on the same lines although they still maintain differences in respect of certain accounting issues.

iii. Ijarah MBT with gradual transfer – with gradual transfer ownership during the Ijarah term including Diminishing Musharaka Ijarah;

b. new recognition and measurement principles for initial recognition for right-of-use asset, Ijarah liability and advance payments for lessee and lessor accounting;

c. requirement to identify and separate Ijarah and non-Ijarah components, if needed;

d. new recognition and measurement principles for an Ijarah MBT through gradual transfer / Diminishing Musharaka Ijarah, whereby the lessee shall recognise the 'combined asset' (including the right-of-use asset and the proportionate asset already owned by the lessee) whereas the lessor shall recognise the proportionate asset owned. FAS 8 requirements of recording monthly depreciation and gain and loss for such transactions are done away with;

e. allowing effective rate of return/ profit rate method for accounting for rental income, in the hand of the lessor;

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

g. 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.

AAOIFI Financial Accounting Standard 32
Ijarah

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 the Islamic financial institutions (the institutions) on both ends of the transaction i.e., as a lessor and lessee. An institution shall consider the terms and conditions of the 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 transactions for exploration, extraction, harvesting and otherwise use and sale of natural resources; and

   c. service Ijarah transactions including employment / labour contracts and hiring of professional services and other service based contracts (not involving tangible assets), including intellectual property and detachable rights.

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

ii. 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 Jiddiyyah (security deposit) – is the amount deposited as a security against fulfilment10 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 an agreed 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) – represent 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 incurred solely and necessarily for the purpose of execution of the Ijarah transaction e.g., costs borne by the lessor on feasibility study, credit assessment or documentation etc. These do include any regulatory costs borne by a manufacturer or dealer lessor for entering an Ijarah MBT transaction;

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 but do not include any conditions against sale or transfer of ownership of the underlying asset;

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

t. Lessor – is a party in Ijarah contract that transfers the usufruct of an underlying asset for a period of time in exchange for an agreed 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 right-of-use assets (for lessee) – is the amount, if any, expected to be recovered for these assets computed in accordance with paragraph 37;

x. Residual value of underlying assets (for lessor) – 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;

y. Right-of-use asset (usufruct asset) – is a kind of intangible assets 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 transferred on an independent Ijarah basis by a lessee ('intermediary lessor') to a third party, and the original Ijarah contract ('head-Ijarah') between the head-lessor 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;

cc. Useful economic life – is the period over which an asset is expected to be available for use or the number of production units or usage units etc. expected to be obtained/ utilized from an asset;

dd. Usufruct – is a legally enforceable limited right related to an asset including the two property interests of (i) usus (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; and

ee. 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 lapse of time (see paragraph 26).

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 an agreed 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 rentals for the Ijarah in any optional period;

        ii. the amount of any variable rentals 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 of 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 recognise:

    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[2].

Initial recognition of Ijarah liability

24. The gross Ijarah liability shall be initially recognised 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 (see paragraphs 4(ee) and 26) including the supplementary rentals (duly measured at best estimates applying the index rates and other assumptions as of the commencement date; 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 rentals are the Ijarah rentals that depend on an index or a rate. These 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. These also include supplementary rentals which are contingent on certain items e.g., rentals additionally charged after providing certain additional services or after incurring major repair and maintenance.

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

[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.

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

30. Deferred Ijarah cost account shall be presented as a contra-liability (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:

        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 amortisation;

c. less – any accumulated impairment losses;

d. add / less – adjustment for any effect of Ijarah modification or reassessment specified in paragraphs 44-46.

Amortisation 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 37l; 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 requirements of 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 rentals made;

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

c. re-measuring the carrying amount to reflect any reassessment, changes or Ijarah contract modifications or to reflect revised Ijarah rentals.

41. The effect of re-measuring of the carrying amount of Ijarah liability (in line with paragraph 40(c)) shall be recognised as a change in the deferred Ijarah cost unless a specified requirement of paragraphs 44, 45 or 46 applies.

42. Deferred Ijarah cost shall be amortised 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 proportion basis shall be the effective rate of return method.

43. After the commencement date, a lessee shall recognise 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. amortisation of deferred Ijarah cost; and

b. variable Ijarah rentals (not already included in the measurement of the Ijarah liability) – as and when remeasured i.e., when the triggering event or condition occurs.

Ijarah contract modifications

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 without a change in the right-of-use asset (except for change in its useful economic life), 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 only (e.g., 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.

Change in right-of use asset: new Ijarah component

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

a. the modification additionally transfers the right to use of an identifiable underlying asset(s); and

b. the Ijarah rentals are increased corresponding to the additional right-of-use asset.

Change in right-of use asset: derecognition of earlier Ijarah and recognition of a new Ijarah

46. For an Ijarah modification that does not meet the criteria provided in paragraphs 44 and 45, the lessee shall consider the Ijarah as a modified Ijarah as of the effective date and shall account for the

same as a new Ijarah transaction. 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 recognised 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 recognise the Ijarah rentals as an expense on either:

    a. a straight-line basis over the Ijarah term; or

    b. a systematic basis, if considered better representative of the pattern of the lessee's use benefit of the underlying asset.

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 exemption under paragraph 49, shall be applied to a whole class of underlying assets, that have similar characteristics and operational utility.

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 but not on a group / combination basis. The value of an underlying asset shall be considered as of when it is / was new, irrespective of when the Ijarah transaction is executed.

54. The choice provided for in paragraph 53 shall be available if, and only if, the asset is usable for lessee on its own basis, without needing other resources which are not already available with the lessee or being dependent or 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. amortisation of right-of-use asset;

    b. amortisation of deferred Ijarah cost;

    c. variable Ijarah rentals; and

    d. gain or loss on Ijarah modifications and other adjustments.

Disclosures

[Explanation: if the Ijarah cost is attributable to construction / development of an asset then such disclosures shall be provided while disclosing such attributions]

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 amortisation 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 / potential cash outflows not already accounted for as Ijarah liabilities, e.g.,

   i. ijarah not yet commenced to which the lessee is committed including prospective/ forward Ijarah;

   ii. variable Ijarah rentals;

   iii. ijarah extension options;

   iv. ijarah termination options;

   v. 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);

f. future cash outflows as required to be disclosed under paragraph 58I, 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 Jiddiyyah 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 37I, 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/ forward Ijarah), shall be recorded and reported as obligation against advance rentals.

Timing of recognition of underlying asset

61. Underlying asset shall be recognised in the books of the lessor 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 recognised 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 recognised 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 recognised and deferred as initial direct costs.

65. Initial direct costs shall be allocated to income statement through amortisation 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".

Ijarah revenue and costs

Ijarah revenue

74. Ijarah revenue shall be recognised 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 maybe 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 amortisation); 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 recognised over the Ijarah rentals due shall be recognised 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 recognise 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 recognised as an expense in the income statement of a lessor. These include:

    a. depreciation of the underlying asset;

    b. amortisation 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 recognised 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 recognised 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. amortisation 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 Jiddiyyah 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 constitute 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 recognised 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 amortisation (now classified as depreciation), less accumulated impairment, if any).

Derecognition 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), the underlying asset shall be de-recognised and any gain or loss arising on the same being the difference between the carrying value and the consideration received or receivable, shall be recognised 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 recognised 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 recognised 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 derecognised from the books of the seller / transferor (earlier, the lessor) and following shall be recognised, 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-lessor) and duly fulfilling the Shari'ah requirements in this respect, the buyer-lessor unconditionally executes an Ijarah transaction on the same asset back to the same seller-lessee, both the seller-lessee and the buyer-lessor 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-lessor takes place when the control of the underlying asset duly entailing the risks and rewards incidental to ownership are transferred to the buyer-lessor.

100. The seller-lessee is case of a proportionate transfer of asset for Ijarah-back, shall measure the right-of-use asset proportion after transfer and acquired-back and recognise any gain or loss accordingly.

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 transfer/ sale of an asset does not approximate the fair value of the asset transferred, any gain or loss arising on the same shall be:

a. immediately recognised 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-lessor

104. A buyer-lessor shall account for a sale and Ijarah-back transaction in line with this standard as a normal lessor 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)(i). A forward Ijarah transaction shall be subject to other provisions of the standard, on the commencement of Ijarah.

Hamish Jiddiyyah (security deposit)

106. Subject to the terms of the contract, the Hamish Jiddiyyah paid by the lessee shall be recognised 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 recognise a corresponding liability for the same.

107. Adjustment of, or forfeiture of, Hamish Jiddiyyah, 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 recognised as an income of the seller and shall be taken directly to charity payable, when received.

Effective date

110. This standard shall be effective for the financial periods beginning on or after 01 January 2021. Early adoption is permitted.

Transitional provisions

111. The institution may opt to apply this standard on a prospective basis for transactions 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 AAOIFI FAS 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 16th meeting held on 2-3 Rabi I 1441H, corresponding to 31 October 2019 and 1 November 2019 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 Nusratkhujaev
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. Muhammad Jusuf Wibisana
4. Mr. Saqib Mustafa
5. Mr. Syed Najmul Hussain
6. 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" while developing its revised plan in 2016, after its reconstitution. It was also noted that a limited scope revision project for FAS 8 had already been initiated by the predecessor board. FAS 8 originally issued in 1997 catered and responded to the need to distinguish a Shari'ah compliant lease from a conventional lease and to prescribe the correct accounting treatments in line with its true nature in line with Shari'ah. However, considering the fact that there had been significant evolution of the product and its new and innovative variants had become more common, it was eminent to review and revise the standard duly catering to such needs. Accordingly, the oard decided that there is a need to improve the existing FAS 8.

BC2 The board also considered that globally there have been significant changes in 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 other (initially planned as convergence standards). In line with the new AAOIFI 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 and the specific structure of Ijarah transactions which is not considered by such global standards.

Scope exclusion – service Ijarah

BC3 From Shari'ah standpoint Ijarah has two basic types i.e., asset Ijarah and service Ijarah. Whether or not this standard shall include service Ijarah in its scope was a key question addressed by the working group as well as the board, and was raised during public hearing sessions as well. The board considered that the service Ijarah can be segregated into two types, being human based or technology and equipment based such as, bandwidth, telecommunication minutes etc. Considering the significant differences in nature of the two types of Ijarah, the board decided that this standard shall cover the asset Ijarah only. However, the service Ijarah which involves equipment as well, the same shall be subject to this standard as such contracts will have an Ijarah element subject to the requirements of this standard. For such type of transactions, the measurement of usufruct can be performed by unit of output or other such measures.

Key distinguishing factors between an Ijarah MBT and conventional finance lease

BC4 An Ijarah is principally a lease transaction. The issue of difference with conventional transactions arise 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.

BC5 The board considered that in an Ijarah MBT, it is a primary condition by Shari'ah that the risks and rewards incidental to ownership are with the lessor throughout the lease term. Whereas, in a finance lease, according to its definition, substantially all risk and rewards incidental to ownership are transferred to the lessee at inception of lease i.e., in substance it is considered to be a sale. It is worth noting that if substantially all risk and rewards in a lease transaction are transferred at inception, the same cannot be termed as Shari'ah compliant. This is because, as per Shari'ah an Ijarah is separate from the sale or gift transaction, as 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. Considering these factors, the oard reiterated that the option of accounting for Ijarah MBT similar to conventional finance lease is not acceptable.

BC6 The same issue was discussed in detail at the working group and the board as well as public hearings and was also specifically referred to the Shari'ah board's committee for review of financial accounting and governance standards. After due deliberations, it was decided that fundamentally there shall be no difference in accounting for the Ijarah or Ijarah MBT as an Ijarah MBT is essentially an Ijarah transaction and any future commitment for sale or gift cannot be combined with the Ijarah contract.

BC7 It is also worth noting that from the economic substance perspective, the subject matter of an Ijarah transaction is the usufruct whereas the subject matter of a conventional finance lease is the financing. This is the reason that the conventional accounting standards focus on recognition of liability, as the primary requirement. The board also took a considered view that the concept of minimum lease payment 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, duly considering the Ijarah and sale / gift as separate transactions.

BC8 The board also considered the nature of a promise for sale and / or gift executable at a future date. Considering various factors including in particular, (i) the nature of a unilateral promise / undertaking as per Shari'ah, and (ii) the prohibition of combing two transactions in one, the board reiterated its view taken earlier at multiple occasions with regard to such transactions, and decided that they do not combine with the Ijarah transaction and do not change the nature of the Ijarah transaction.

Key distinguishing factors - Shari'ah perspective

BC9 The above decisions of the board were based on a thorough analysis of the key distinguishing factors between an Ijarah MBT transaction and conventional finance lease transactions. Certain key distinguishing factors are listed below:

a. in Ijarah MBT, during the lease term, the lessor carries the operational risks related to ownership e.g., theft, destruction, technical obsolescence, unavailability for a period due to major maintenance / repairs etc., as well as, the Takaful / insurance cost and taxes related to ownership of asset;

b. in Ijarah MBT, during the lease term, the lessor carries the market risk related to the ownership of the asset i.e., if for any reason the promise is not executed at the future date, the gain or loss in value of asset relates to the lessor;

c. in Ijarah MBT, the rentals commence from the time the asset is delivered to the lessee in condition good enough for intended use, and not from the time when the funds are disbursed;

d. in Ijarah MBT, no rental is chargeable during the period when asset is not available for the intended use for any reason; and

e. in Ijarah MBT the ownership transfer takes place against a unilateral promise which is not binding on either of the parties and there are situations when such transfer never takes place e.g., destruction or theft of the asset before completion of Ijarah term.

BC10 The board also considered the philosophical foundations of Islamic finance. The fundamentals are based on the prohibition of Riba and permission of trade which means that the time value of money is not acceptable, but the time value of economic resources such as goods, assets, labour and entrepreneurship is acceptable. Accordingly, the board took a considered view that in Ijarah MBT, the price (Ijarah rental) is calculated and charged on the use benefit of asset rather than time value of money (i.e., disbursed financing). As an example, Ijarah rental cannot be charged and recorded until the underlying asset is in possession of the lessee or if the asset is not available for intended use for any reason. In conventional finance lease, on the contrary, 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.

Operating Ijarah

BC11 The board also noted that there are no significant differences between an operating Ijarah and an operating lease. The distinguishing factor being 'risks and rewards' incidental to ownership belongs 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.

BC12 There are however 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.

Accounting for usufruct / right-of-use asset

BC13 The global accounting standard setters while revising their accounting standard for leasing took a fundamental shift, whereby the concept of recognition of right-of-use asset was introduced, even in case of operating leases. 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).

BC14 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.

BC15 It must be noted that the transfer of control of the right-of-use asset to the lessee is not the transfer of control of the physical asset.

Acceptability of usufruct / right-of-use asset from Shari'ah perspective

BC16 In Ijarah, a lessee acquires the usufruct of 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.

BC17 The preliminary study phase for the standard 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. It was important to note that the Shari’ah views usufruct as an intangible asset (being actually a right and not a physical asset).

BC18 The board considered the pros and cons of this accounting approach, including Shari'ah issues applicable thereto after due consideration with the Shari’ah board’s committee for review of financial accounting and governance standards and decided that usufruct meets the definition of an asset under Shari'ah and under AAOIFI Framework.

Recognition of right-of-use asset, its amortisation and residual value

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 recognised, rather than recording the present value of minimum lease payments.

BC20 The oard, considering the Shari’ah requirements and the specific characteristics of Ijarah transactions, concluded that right-of-use is a kind of intangible asset and amortised accordingly. Amortisation will be from commencement date (and not the inception date – see also paragraph BC30) to the end of useful economic life of the right-of-use asset which will coincide with the end of the Ijarah term. Amortisation over and above the Ijarah term, if allowed, means that the two transactions are combined for the purpose of accounting.

BC21 Accordingly, the board rejected the idea, even though certain experts during the public hearings suggested to allow amortisation of the right-of-use asset over a period over and above the Ijarah term.

BC22 However, the board considered that keeping a residual value of the right-of-use asset at the end of the Ijarah term is an accounting estimate and may be kept if there are additional economic benefits expected. 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, once it is transferred to the owned assets.

BC23 The board considered that through this option the benefit can be passed on to the future periods whereby the residual value is to be kept at a value close to the value of the asset at that time. This is also in line with requirement in the Shari’ah standards, whereby in the case of an early termination of an Ijarah the lessor is required to compensate the lessee with the additional rentals paid (in an Ijarah MBT) as compared to market norms.

Subsequent measurement – use of fair valuation for right-of-use asset

BC24 The subsequent measurement of the right-of-use asset was discussed at the working group and the issue was also raised at the public hearings, whereby the generally accepted accounting principles normally allow for fair valuation of the right-of-use asset. The board initially considered the proposal, but considering the specific nature of an Ijarah right-of-use asset, took a considered view that it might not be the right approach to allow fair valuation for an asset which has a limited life and which does not reflect the underlying asset, but only the right-of-use of the same. This was also reaffirmed after discussions on the public hearing comments and the working group comments of the same.

BC25 The board considered that if the right-of-use asset is revalued and the value has increased, there is a risk that the periodic financial reports and the income statement will be distorted due to the high amounts of amortisation, as this standard does not allow the amortisation of right-of-use asset beyond the period of the Ijarah term i.e., during the Ijarah term, there will be a higher charge of amortisation which may result in distortion of financial reporting for the period. The release of additional effect of amortisation will be done directly through equity so it will not be reflected in the income statement. Considering these factors, the board decided to not allow the fair valuation of right-of-use asset.

BC26 The board evaluated the costs and expenses related to the right-of-use asset. There were two issues highlighted in related to expenses of the underlying asset – an accounting issue and Shari'ah issue. The current market practices are generally to record the expense directly by the lessee. However, 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 as a revenue).

Ijarah MBT through gradual transfer / Diminishing Musharaka Ijarah

BC27 The Board after taking into account industry comments agreed that the accounting for Ijarah MBT through gradual transfer under FAS 8 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.

BC28 It is also considered that if the units are sold at cost (to lessee) depreciation at the end by the lessor is not required, as the residual value is equal to the cost. This shall significantly reduce the accounting complications.

BC29 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.

Ijarah commencement date vs. inception date – issue of future Ijarah

BC30 The board discussed at length the issue of the commencement date vs. inception date accounting. The board, in particular, noted that as per Shari'ah, 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 (irrespective of the pricing mechanism involved, which may take into consideration such period), and this is one of the distinguishing factor between Ijarah MBT and conventional finance leases. The similar issue in related to future Ijarah i.e., Ijarah Mawsufah fi al-Dhimma was also raised and discussed during the public hearings and was duly considered by the board. However, after due deliberations, it was decided that any Ijarah rentals charged and / or received before the commencement date shall be recorded as an advance which shall remain non-remunerative.

Accounting and financial reporting by the Lessor

BC31 Without any principal change from FAS 8, this standard requires that the leased asset shall be recognised at cost and depreciated over the useful life by the lessor and gross rentals shall be recognised as income.

BC32 Generally, it was understood that depreciation shall be based mostly on straight-line method. However, there were situations where certain institutions were using annuity method for depreciation. The board considered if there needs to be change to the depreciation method to allow annuity method as this was further raised during the public hearings of the standard. After due deliberations the board 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.

BC33 The board concluded 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. This was based on the fact 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.

Deposits and Hamish Jiddiyah

BC34 The board considered that 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 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 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.

Lease term and extension options

BC35 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 amortisation 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 C: Brief history of the preparation of the standard

H1 The newly formed AAOIFI Accounting Board (AAB / the board) held its 1st meeting 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 were presented at the 2nd AAB meeting 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 1st 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 2nd meeting on 7 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 2nd working group held on 12 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 10th meeting 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 11th AAB meeting on 21-22 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 3rd 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 The public hearing for the exposure draft was conducted in multiple jurisdictions during 2019. The first public hearing event for the exposure draft was conducted in February of 2019 in United Arab Emirates (hosted by Abu Dhabi Islamic Bank - ADIB) and Pakistan (hosted by ICAP). Additionally, public hearings were conducted in Egypt (hosted by Egyptian Islamic finance Association – EIFA) and Turkey (hosted by KGK and TKBB) in June of 2019.

H10 A roundtable event on the exposure draft was held on 13 Muharram 1441H, corresponding to 12 September 2019. The event was hosted by Al-Baraka Banking Group, at its headquarters, Bahrain

Bay in the kingdom of Bahrain. A select group of finance and banking leaders, representatives of central banks, CEOs and CFOs of leading banking and financial institutions, leading scholars and experts, and representatives of regional and international organizations, among others participated in the event and contributed their valuable insights.

H11 All comments received from public hearings along with the views and comments from different industry participants on the exposure draft was then presented for discussion at two working group meetings held on 10 Safar 1441H, corresponding to 9 October 2019 and 29 Safar 1441H, corresponding to 28 October 2019.

H12 All comments and recommendations received on the final version of the exposure draft was then presented for discussion at the 16th AAB meeting held on 3-4 Rabi' I 1440H, corresponding to 31 October and 1 November 2019 in the Kingdom of Bahrain. The board deliberated on changes suggested by the working group and the standard was approved for final issuance.

H13 The standard was approved for publishing with instructions for making suggested changes. After due process, the standard was issued on 4 Jumada I 1440H, corresponding to 30 December 2019.