



The Premier Islamic Bank

Islamic Financial Accounting Standard-2 IJARAH

Interpretation and Implementation



Ahmed Ali Siddiqui

Vice President & Manager

Product Development & Shariah Compliance

Meezan Bank Limited



The Premier Islamic Bank

Scope of Presentation

The scope of this presentation comprises of the following;

- Definition and Salient feature of Ijarah
- Application of the Standard
- Major difference Between Accounting of Finance Lease and Ijarah (Operating Lease)
- Accounting Policies and Recording Procedures of Ijarah transaction as per the requirements and guidelines of IFAS-2
 - Accounting Policies for Ijarah
 - Recording procedure and disclosure requirements of Ijarah transaction as per IFAS-2
- Points for discussion



The Premier Islamic Bank

Concept of Ijarah

Definition and salient Feature of Ijarah



The Premier Islamic Bank

- Ijarah is an Islamic alternative of Leasing.
- Leasing backed by an acceptable contract is an acceptable transaction under Shariah.

“Ijarah is a contract whereby the owner of an asset, other than consumable, transfers its usufruct to another person for an agreed period at an agreed consideration.”

Salient Feature of Ijarah



The Premier Islamic Bank

- Contrary to Finance Lease, in Ijarah the ownership of the assets remains with Lessor (the bank) and only its right of usage is transferred to the lessee.
- Until the assets to be leased are delivered to the lessee, no lease rental become due and payable. (i.e. Ijarah cannot be recorded until the subjected asset is delivered to the lessee.)
- The title of the assets remains with the Lessor during the entire lease term.
- The Lessor bears all the risk and reward associated with the ownership to the asset.
- All cost associated with the asset to bring it into usable form and condition should be borne by the lessor.



The Premier Islamic Bank

Types/Classification of Ijarah

1. Operating Ijarah_

Operating Ijarah is a lease that does not include a promise that the legal title in the leased asset will pass to the lessee at the end of the lease

Types/Classification of Ijarah



The Premier Islamic Bank

1. Ijarah Muntahia Bittamleek (Ijarah wa Iqtina)

It is a lease that concludes with the legal title in the asset passing to the lessee after Ijarah. Ijarah Muntahia Bittamleek includes:

- Ijarah through gift
- Ijarah & transfer of legal title at the end of the lease for a token consideration or other amount as specified in the lease
- Ijarah through transfer of title prior to the end of lease at a price pre-decided

Types/Classification of Ijarah



The Premier Islamic Bank

3. Ijarah tul Musha or Joint ownership Ijarah

It is a lease where Bank & customer jointly owned the leased asset. Bank gives its share to the customer on lease.

After the term of Ijarah, the treatment is similar to Ijarah Muntahia Bittamleek



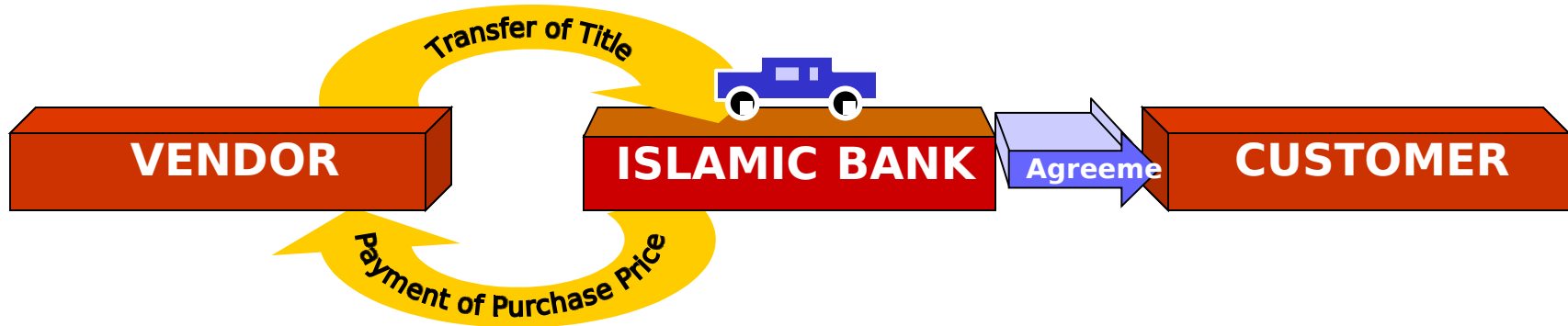
The Premier Islamic Bank

Process of Ijarah (Muntahia Bittamleek)

Process of Ijarah



The Premier Islamic Bank

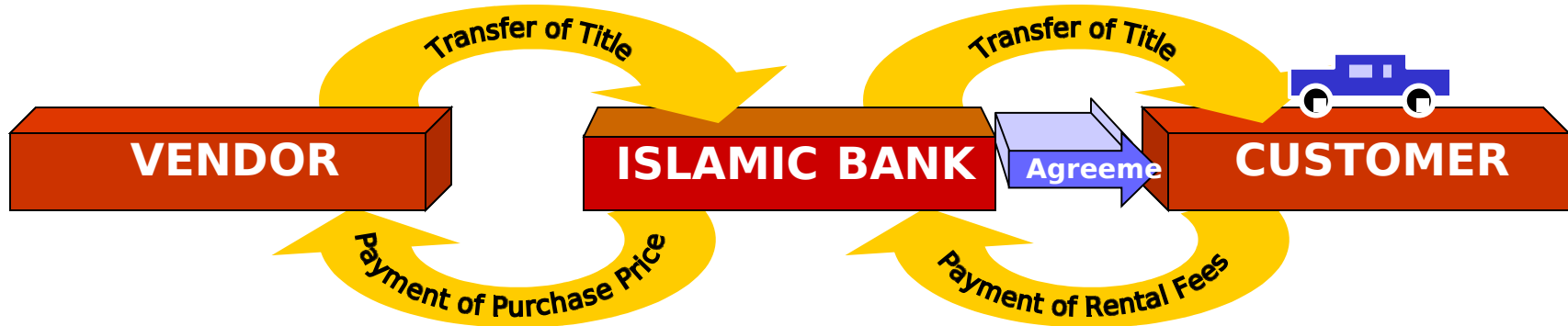


- The customer approaches the Bank with the request for Ijarah financing and enters into a promise to lease agreement.
- The Bank purchases the item required for leasing and receives title of ownership from the vendor
- The Bank makes payment to the vendor

Process of Ijarah



The Premier Islamic Bank



- The Bank leases the asset to the customer after execution of lease agreement.
- The customer makes periodic payments as per the contract.
- At the end of the tenure customer can purchase the asset from the bank with the help of separate Sale agreement.

Accounting Standard for Ijarah

IFAS 2 - Ijarah

Application of Standard



The Premier Islamic Bank

The Islamic Financial Accounting Standard (IFAS)-2 “IJARAH” was issued by the Institute of Chartered Accountants of Pakistan and was adopted by the Securities and Exchange Commission of Pakistan vide its notification S.R.O 431 (i)/2007 dated May 22,2007.

Effective date

IFAS-2 becomes operative for financial statements covering periods beginning on or after July 01, 2007.

Retrospective application of this IFAS is not mandatory. i.e. the IFAS is applicable for Ijarah commencing on or after July 01, 2007.

Major difference between accounting of Finance Lease and Ijarah



The Premier Islamic Bank

Finance Lease (pre-adoption method)

- Leases are recorded as **financing** in the books of **Lessor** (the bank).
- 2) Un-earned income i.e ‘excess of aggregate rentals over cost of the asset’ are recorded at the inception of lease and amortized over the lease term.
- Provision against Doubtful debts is calculated according to the criteria given in Prudential Regulations for banks.
- Leases are disclosed net of provision, income suspense and unearned income.
- Revenue is recorded to the extent of income portion of the rentals based on the manner which produce a constant rate of return.

Ijarah (post-adoption method)

- 1) Ijarah assets are recorded at cost less accumulated depreciation and impairment.
- 2) **Rental** from Ijarah is recognized as income on accrual basis.
- 3) Costs, including depreciation is charged to income statement.
- 4) Assets leased out should be classified according to its nature, distinguished from the assets in own use. (i.e. Plant & Machinery, Vehicle etc.)
- 5) Lessor should make an impairment testing for the asset on a regular basis. Any impairment should be dealt in according to the requirements of **IAS 36 “Impairment of assets.”**

Accounting Policy for Ijarah



The Premier Islamic Bank

Ijarah Asset Recognition

- All Ijarah transactions are to be recorded as “Asset Acquired for Ijarah” at sum of all Cost incurred by the bank in acquiring the asset..
- Assets are to be stated at their cost less accumulated depreciation and impairment if any.
- Depreciation is to be charged to income applying the method which reflects the pattern in which the asset’s future economic benefits are expected to be consumed by the bank.
- In respect of addition and disposal of assets, depreciation will be charged from the month of acquisition till the month of disposal.

Accounting Policy for Ijarah



The Premier Islamic Bank

Revenue Recognition.

Ijarah rentals are to be recognized as income on accrual basis in a systematic manner over the lease period

Expense Recognition

Carrying costs, including depreciation, incurred in earning the Ijarah income are recognized as an expense in the Income statement.



The Premier Islamic Bank

Case Study for Ijarah

Below is the case study for the understanding of suggested Ijarah accounting:

Example	Amount in Rs./%
Asset Price	100,000
Monthly rentals	5,000
Tenure	3 years
Security Deposit	10,000
Delivery Time	1 month

Recording Procedures and Disclosure requirements



The Premier Islamic Bank

Following are the scheme of accounting entries to be recorded in the book of Lessor (the bank)

Jan 1, 2007

1) At the time of payment to the client for the purchase of asset on behalf of bank or directly to the supplier by the bank ;

<i>Dr Advance against Ijarah</i>	<i>100,000</i>	
<i>Cr Pay Order / Party Account</i>		<i>100,000</i>

<i>Dr Cash</i>	<i>10,000</i>	
<i>Cr Security deposit</i>		<i>10,000</i>

Feb 1, 2007

2) When the asset is deliver to the lessee

<i>Dr Asset acquired for Ijarah</i>	<i>100,000</i>	
<i>Cr Advance against Ijarah</i>		<i>100,000</i>

Recording Procedures and Disclosure requirements



The Premier Islamic Bank

Feb 28, 07

3) Accrual of income when it is due(Ijarah rentals are considered as income)

<i>Dr Rental receivable</i>	<i>5,000</i>	
<i>Cr Rental Income</i>		<i>5,000</i>

Feb 28, 07

4) Recording of depreciation on Ijarah Asset

<i>Dr Depreciation expense</i>	<i>2,500</i>	
<i>Cr Accumulated depreciation</i>		<i>2,500</i>

{(100,000-10000)/36}

Recording Procedures and Disclosure requirements-continued



The Premier Islamic Bank

Disclosure in Balance Sheet at month end (Feb 28,07)

<i>Assets at cost</i>	100,000	
<i>Less:</i>		
<i>Accumulated Depreciation</i>		(2,500)
<i>Provision for Impairment</i>		()
<i>Net book value</i>		97,500

5) At the time of receiving of Rental following entry would be passed:

<i>Dr</i>	<i>Party Bank A/c</i>	5,000	
<i>Cr</i>	<i>Ijarah rental receivable</i>		5,000

6) At the time of maturity of Ijarah Contract

<i>Dr</i>	<i>Security Deposit</i>	10,000	
<i>Cr</i>	<i>Party Bank A/c</i>		10,000
<i>Dr</i>	<i>Party Bank A/c</i>	10,000	
<i>Cr</i>	<i>Asset acquired for Ijarah at wdv</i>		10,000

Recording Procedures and Disclosure requirements-continued



The Premier Islamic Bank

7) In case of default in payment of rental

<i>Dr</i>	<i>Provision for doubtful debt (expense)</i>	<i>XXX</i>	
<i>Cr</i>	<i>Provision for doubtful debt (accumulated)</i>		<i>XXX</i>
<i>(with the amount of rental receivable previously accrued and taken to income)</i>			

8) Provision for Impairment of Ijarah assets

<i>Dr</i>	<i>Provision for impairment (expense)</i>	<i>XXX</i>	
<i>Cr</i>	<i>Provision for impairment (accumulated)</i>		<i>XXX</i>

Recording Procedures and Disclosure requirements-continued



The Premier Islamic Bank

Disclosure in Balance Sheet at period end

<i>Assets at cost</i>	<i>XXX</i>
<i>Less:</i>	
<i>Accumulated Depreciation</i>	<i>(XXX)</i>
<i>Provision for Impairment</i>	<i>(XXX)</i>
<i>Net book value</i>	<i>XXXX</i>

Rental Receivable

<i>Rental receivable</i>	<i>XXXX</i>
<i>Less:</i>	
<i>Provision for doubtful debt</i>	<i>(XXX)</i>
<i>Net rental receivable</i>	<i>XXXX</i>

Common Questions Raised



The Premier Islamic Bank

- Where Asset acquired for Ijarah will be reported in the Balance Sheet (Under the classification of financing)
- Does Ijarah will be consider for ADR.
- What will be the guidelines for provision for doubtful debt and Income suspense in case Ijarah is consider as financing under prudential regulations for banks.
- In case Ijarah does not fall under the definition of financing, what will be the guidelines for general provisions for consumer finance..



The Premier Islamic Bank

THANK YOU

