

**From: AOSSG ISLAMIC FINANCE WORKING GROUP**

**Subject: SURVEY ON IFRS 16 *LEASES* AND *IJARAH***

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## About the Survey

1. Ijarah is one of the most commonly used contracts in Islamic financial transaction. In Islamic banking, ijarah is popular for financing of asset such as vehicle and property. In the capital market space, ijarah contract is used as the underlying contract of sukuk (Islamic bond). This Survey focuses on the application of ijarah in Islamic banking without considering capital market or sukuk.
2. Report by the International Monetary Fund in 2017 evidenced that ijarah accounted for a quite significant portion of the total financing in 31 jurisdictions, i.e. about 20% of total financing from 2013 to 2015<sup>1</sup>.
3. Two WG member-jurisdictions, Indonesia and Pakistan have been applying separate accounting standards for ijarah i.e. SFAS 107 *Accounting for Ijarah* and IFAS 2 *Ijarah*, respectively. In short, these Islamic accounting standards recognise all leases as 'operating lease' even when there is an option to transfer the ijarah asset at the end of the ijarah period. This treatment is said to conform to the Shariah interpretation in their jurisdictions that contracts could not be linked and hence transactions need to be accounted for separately.
4. Additionally, the Islamic accounting standards are also largely tailored to the FAS No.8 *Ijarah and Ijarah Muntahia Bittamleek* issued by AAOIFI<sup>2</sup>. There is no 'finance lease' classification under AAOIFI.
5. Therefore, there is a disparity in the way a contract with features of a finance lease is accounted for under IFRS Standards and the Islamic accounting standards. This issue has been long recognised by the WG as the 'main' reason for departure from IFRS Standards. As such, with IFRS 16's effective date drawing closer, the Survey is developed to understand:
  - a. issues or challenges in applying IFRS 16 to ijarah-based transactions, particularly from a lessor's perspective; and
  - b. whether IFRS 16 will reduce or widen the gap between accounting for ijarah (as leases) under IFRS and Islamic accounting standards.
6. Five WG Member-jurisdictions responded to the Survey, i.e. Indonesia, Malaysia, Pakistan, Saudi Arabia and Syria.

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<sup>1</sup> According to the International Monetary Fund Report, 31 countries responded to its survey: Afghanistan, Algeria, Bahrain, Bosnia and Herzegovina, Botswana, Djibouti, Guinea, Hong Kong, Indonesia, Iraq, Jordan, Kenya, Kazakhstan, Kosovo, Kuwait, Kyrgyzstan, Lebanon, Luxembourg, Malaysia, Morocco, Oman, Pakistan, Palestine, Qatar, Saudi Arabia, South Africa, Sudan, Tunisia, Turkey, United Arab Emirates (U.A.E.), and the United Kingdom (U.K.). Out of the 31 countries, 4 are WG member-jurisdictions, i.e. Indonesia, Malaysia, Pakistan and Saudi Arabia.

<sup>2</sup> Accounting and Auditing Organization for Islamic Financial Institutions, AAOIFI. [www.aaofi.com](http://www.aaofi.com)

## Executive Summary

7. The Survey found that IFRS 16 has been adopted by all WG member-jurisdictions, with mandatory effective date on 1 January 2019, except for Indonesia i.e. on 1 January 2020. SOCPA has prescribed additional disclosure requirements to the adopted IFRS 16. Although IFRS 16 is adopted in Indonesia and Pakistan, SFAS 107 *Accounting for Ijarah* and IFAS 2 *Ijarah* are applied to Islamic leases in Indonesia and Pakistan respectively.
8. Findings suggest that ijarah that transfers ownership at the end of the ijarah term is prevalent. Generally, during the ijarah term, an Islamic financial institution (IFI) as lessor is required to assume risks and rewards incidental to ownership of the ijarah asset. However, there are at least two permutations to this.
  - a. Firstly, despite the general rule, Shariah provides flexibility for the lessor to transfer the risks and rewards of the underlying asset to the lessee; subject to mutual parties' consent. For example, the IFI would require the customer to obtain takaful coverage for the ijarah asset. Such practice is common in Malaysia and Saudi Arabia.

In Saudi Arabia, the staff of Saudi Organization for Certified Public Accountants (SOCPA) explained that the IFI is required by law to insure the asset and this responsibility cannot be passed on to the customer. However, in practice, the IFI incorporates the insurance cost into the ijarah rental and this seems to be the common practice in the jurisdiction.

Additionally, in Malaysia, the transfer of ownership is almost always executed since the customer is obliged to fulfill his promise (*wa'd*<sup>3</sup>) to purchase the asset at the end of the term, failing which, the customer is required to compensate the IFI for any losses incurred.

- b. Secondly, the lessor is required to assume risks associated with the ijarah asset throughout the ijarah period. This may include repair and maintenance costs incurred due to other than the lessee's negligence and is common in Indonesia and Pakistan. The next leg which is the 'sale' of the asset to the customer is treated separately by the IFI. Any gain or loss arising therefrom is recorded in the IFI's profit or loss.

The Survey also noted that Meezan Bank Limited in Pakistan indicated that "*The customer also has the option that instead of paying the Bank and acquiring the car upon completion of the Ijarah period, he can simply return the car to the Bank*<sup>4</sup>".

<sup>3</sup> The Shariah Advisory Council of Bank Negara Malaysia has resolved that *wa'd* as applied in Islamic banking is *wa'd mulzim*, or a binding *wa'd*.

<sup>4</sup> Meezan Bank Limited. <https://www.meezanbank.com/car-ijarah>

9. The Survey signifies that one should not accord the same accounting treatment to all contracts that appear to be ijarah without further examination. It is evident that although in both situations the transaction is structured as 'ijarah muntahia bittamleek (ijarah with an ownership transfer) there were differences in the fact patterns or terms of the ijarah.
10. Survey findings indicated that the gap between accounting for ijarah under IFRS Standards and the Islamic accounting standards continue to exist in these jurisdictions – although respondents believed that applying IFRS 16 to ijarah with characteristics of operating lease would produce similar results.
11. Respondents shared the following reasons for non-application IFRS Standards:
  - a. Staff of the Institute of Chartered Accountants of Pakistan (ICAP) explained that Shariah does not recognise the concept of time value of money and hence the principles in IFRS Standards where measurement of financial assets and liabilities applying the effective interest rate is not acceptable.
  - b. Staff of the Indonesian Institute of Accountants (IAI) explained that ijarah as applied in Indonesia involve more than just leases. It includes for example service contract and leases of intangible asset.
12. However, the WG acknowledged that IFRS 16 can be applied to leases of intangible assets and contains guidance for separating non-lease component, such as service, from a lease contract. For example, paragraph 17 of IFRS 16 states “*For a contract that contains a lease component and one or more additional lease and non-lease components, a lessor shall allocate the consideration in the contract applying paragraphs 73-90 of IFRS 15.*”
13. Survey findings also concluded that non-adoption of IFRS 16 for Islamic finance in Indonesia and Pakistan may result in a wider gap mainly because SFAS 107 and IFAS 2 do not recognise the concept of right-of-use (ROU) asset for lessee accounting.
14. The WG acknowledges the widening gap but at the same time recognises that adoption of accounting standards involves more than just technical discussion, but decision making at the national level and political will of the jurisdictions.

## Survey Results

### Adoption of IFRS 16: Exception for Ijarah in Indonesia and Pakistan

15. Five WG member-jurisdictions – Indonesia, Malaysia, Pakistan, Saudi Arabia and Syria – have adopted IFRS 16 without modification and with similar effective date except for Indonesia whereby the Standard would be mandatorily effective a year later i.e. 1 January 2020.
16. It is important to note that IFRS 16 is not applicable to entities which engage in Islamic finance in Indonesia and Pakistan.
17. Additional disclosures are prescribed by SOCPA in addition to the existing requirements in the Standard, as follows:
  - a. *60A: To fulfil the requirement of paragraph 59(a) which requires disclosure of the nature of the lessee's leasing activities, the contractual terms, for each party to lease contract, at minimum in relation to ownership, basic maintenance, guarantee and insurance of the leased asset, and the ownership transfer arrangements (if any) shall be disclosed.*
  - b. *94A: To fulfil the requirement of paragraph 92(a) which requires the disclosure of the nature of the lessor's leasing activities, (a) contractual terms, for each party to lease contract in relation to ownership, basic maintenance, guarantee, and insurance of the leased asset and the ownership transfer arrangements (if any); and (b) contractual effects of termination of the contract because of the force majeure and whether lessee is required to pay the subsequent lease payments shall be disclosed.*

### Lessor accounting: The gap remains

#### Features of prevalent ijarah in the market

*Ijarah muntahia bittamleek (lease followed by ownership transfer)*

18. All respondents noted that ijarah muntahia bittamleek is prevalent in their jurisdictions and operating ijarah (without ownership transfer) is also prevalent in Saudi Arabia.

#### *Risk and rewards*

19. Survey findings indicated that features of ijarah muntahia bittamleek vary in at least two ways.
  - a. Firstly, IFI as lessor assumes all risks incidental to ownership of the ijarah asset during the ijarah period. This feature is shared by Indonesia and Pakistan.
  - b. Secondly, risks are transferred to the customer, subject to mutual consent by the contracting parties (IFI and customer); as seen in Malaysia, Saudi Arabia and Syria.

In Saudi Arabia, IFI is required by law to insure the asset and is not allowed to pass on the cost of insurance/takaful to the lessee. However, in practice, the IFI incorporates the costs into the ijarah rental amount. The mutual parties' consent for the transfer of risks and rewards only apply to basic maintenance costs of the asset. For example, the IFI and customer may have an arrangement whereby the customer will bear costs incurred that arise from wear and tear of the ijarah asset.

### *Right to direct the use of ijarah asset*

20. Generally, findings indicated that the IFI as lessor does not have the right to direct the use of the ijarah asset during the contract term. Staff of MASB and SOCPA indicated that ijarah contract include sufficient protective right of the IFI as lessor, for example right to repossess the asset from customer upon default. In this case, IFIs in Malaysia will usually sell the underlying asset and any net gain or loss arising from the sale will be accruing to the customer.

### *Other features*

21. Indonesia – Staff of IAI explained that the transfer of risk and rewards of the ijarah asset occurs at the end or upon termination of the ijarah contract. Subsequently, the asset will be transferred to the lessee via a new separate contract.
22. Malaysia – Shariah Advisory Council of Bank Negara Malaysia has resolved that Shariah recognises both legal and beneficial ownership. In the context of ijarah, although legal title of ijarah asset may not be with the IFI, this is not a violation of Shariah requirement on 'ownership' of asset.
23. Pakistan – the option to purchase the ijarah asset by the lessee is a separate arrangement and until such time the option is exercised, the risks and rewards incidental to ownership of the asset remain with the lessor.
24. Saudi Arabia – IFI as lessor has the responsibility to maintain and repair ijarah asset for faults not caused by the lessee's negligence. The lessee has the right to purchase the leased asset (from the lessor) during the lease term for consideration predetermined in the ijarah contract. The transfer of asset to the lessee/customer at the end of the ijarah period is normally at a predetermined amount. However, if, at the end of the ijarah contract, the customer decides not to purchase the asset, the IFI as lessor will lease or sell it to a third party. Any gain or loss from the sales of the asset will be accruing to the lessor.

### **Reporting of ijarah in the financial statements as lessor**

25. Survey findings noted that ijarah was reported either as:
  - a. Finance lease under IAS 17 and/or financial instrument under IAS 39 – Saudi Arabia and Malaysia
  - b. Operating lease under IAS 17 – Syria
  - c. 'Operating lease' under Islamic accounting standard – Indonesia and Pakistan

26. Indonesia and Pakistan share the same accounting treatment, whereby the IFI as lessor recognises lease rental income and leased asset (fixed asset) is not derecognised because the risks and rewards of the ijarah asset remain with the lessor.
27. In Syria, the respondent indicated that legally, risks and rewards of the ijarah asset remain with the lessor and hence such ijarah was treated as 'operating lease' under IAS 17.
28. The risks and rewards principle in classifying a lease is explained in paragraph 62 of IFRS 16, as follows:

*"A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership of an underlying asset. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset."*

The above is carried forward from the principle in paragraph 8 of IAS 17<sup>5</sup>.

## **Recognition of 'two assets'**

29. Under the Islamic accounting standards as applied in Indonesia and Pakistan; the IFI as lessor will record two types of ijarah assets; namely:
  - a. fixed asset – this represents the corpus of the underlying ijarah asset, such as vehicle or building; and
  - b. receivable – this represents the right for rental payment due from customer during the ijarah term.
30. In Indonesia, ijarah receivable is recognised as financial asset and subject to impairment requirement under SFAS 55; which is similar to the provisioning method under IAS 39 *Financial Instruments: Recognition and Measurement*.
31. It was understood that the ijarah asset is recognised as fixed asset mainly to accentuate the IFI's 'ownership' of the asset which is also the crux of the Shariah ruling on ijarah.

## **Lessee accounting: Possibly another gap**

32. Survey findings noted that ijarah for own-use assets is common among WG member-jurisdictions except for Malaysia whereby 'lease' contracts are usually used instead of ijarah.

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<sup>5</sup> Paragraph 8 of IAS 17 *Leases* states: "A lease is classified as a finance lease if it transfers substantially all the risks and rewards incidental to ownership. A lease is classified as an operating lease if it does not transfer substantially all the risks and rewards incidental to ownership."

- a. In Indonesia, respondent noted that such an ijarah is accounted for under PSAK 107 which requires the IFI as lessee to recognise rental expense during the ijarah term for all types of ijarah.
  - b. Respondent from Pakistan noted that ijarah for own-use is not common in Islamic banks but in other Islamic financial institutions and it is accounted for as 'ijarah rental' under IFAS 2.
  - c. Respondent from Saudi indicated that ijarah for own-use is immaterial among Islamic banks but from their accounting policies disclosed, such ijarah is reported using IFRS Standards.
33. Paragraph 22 of IFRS 16 requires a lessee to recognise right-of-use (ROU) asset<sup>6</sup> and a corresponding lease liability. Recognition of ROU is consistent with *fiqh* (Shariah jurisprudence) texts which expound that in ijarah, right to use an asset in itself is an asset, or *mal'*. Therefore, the rule in the Islamic accounting standards that only permits the lessor to recognise the asset (in all types of ijarah) is arguably flawed.

## Additional observation

34. The respondents from ICAP and Saudi Organization for Certified Public Accountants (SOCPA) made the following observations on applying IFRS 16 to Islamic financial transactions:
- a. *"How to address the key Shariah principles whereby two agreements, e.g. lease and sale, cannot take place within one contract. Further, there are other factors which need due deliberation such as treatment of diminishing Musharaka, Ijaratul Musha (co-ownership), Ijarah Mousufa BilDhimma (which is now becoming common) etc., timing of recognition, sale and lease back, de-recognition, advance rentals and security deposits."* – staff of ICAP.
  - b. *"IASB, in its treatment of lease by the lessee, concentrates on the transfer of the usufruct of the underlying asset rather than transfer of the asset itself. We would like to see the same in the accounting by the lessor, which may solve the concern of Shariah Scholars."* – staff of SOCPA.
35. The issues raised by staff of ICAP require additional details in terms of the specific challenges in applying IFRS. The Shariah principle that a contract should not be made conditional on another contract is rather homogeneous among the WG member-jurisdictions. If, based on the contractual terms of ijarah contract in Pakistan that the IFI as lessor assumes all risks and rewards incidental to ownership

<sup>6</sup> Recognition exemptions: Paragraph 5 of IFRS 16 states that a lessee may elect not to apply the requirements of the Standard to short term leases and leases for which the underlying asset is of low value.

<sup>7</sup> Paragraph 81, Financial Reporting Issues relating to Islamic Finance, AOSSG, 2010. ([www.aossq.org](http://www.aossq.org)).  
*"... The view is consistent with fiqh texts which expound that in Ijarah although the lessor retains ownership of the underlying asset, the usufruct of that asset is transferred to the lessee; and the majority of fuqaha recognise that the right to an asset is in itself an asset, or mal ..."*



of the ijarah asset, such an ijarah may meet the classification of an operating lease – that is similar to the accounting under IFAS 2.

36. The presence of a contract of ‘sale’ to effectively transfer the ownership of the ijarah asset does not automatically result in the ijarah being reported as a finance lease (in which case is not acceptable in Pakistan). Paragraph 65 of IFRS 16 states:

*“If it is clear from other features that the lease does not transfer substantially all the risks and rewards incidental to ownership of an underlying asset, the lease is classified as an operating lease. For example, this may be the case if ownership of the underlying asset transfers at the end of the lease for a variable payment equal to its then fair value, or if there are variable lease payments, as a result of which the lessor does not transfer substantially all such risks and rewards.”* [Emphasis added]

37. The observation by the staff of SOCPA on asymmetrical between lessor and lessee accounting was shared by some other respondents to the IASB earlier exposure drafts on IFRS 16 and finally the IASB decided it is not essential that the lessee and lessor accounting models are symmetrical (BC60-66 of IFRS 16). The IASB has also decided to carry forward substantially all of the wording in IAS 17 with respect to lessor accounting.
38. Shariah-concern users may appreciate that ‘ownership’ as defined by Shariah may not always translate into an ‘asset’ for accounting purpose.

## Conclusion

39. Survey findings indicated that the gap between IFRS Standards and Islamic accounting standards on leases remains. This is mainly because of ‘one size fits all’ accounting for ijarah under the Islamic accounting standards versus the different approaches for lessor and lessee under IFRS Standards. Furthermore, the gap may be wider with the capitalisation of ROU under IFRS 16; which is not applicable under the Islamic accounting standards.
40. Ijarah encompasses a broad range of transactions and when it is used to economically replicate conventional transactions, the accounting would vary. For example, an IFI that uses ijarah contract to finance a customer’s purchase of an underlying asset is likely to be reporting the ijarah under IAS 39 or IFRS 9 as opposed to using the ijarah contract as a lease facility for the customer.

## Moving forward

41. Islamic accounting standards for ijarah – SFAS 107 and IFAS 2 – as adopted in Indonesia and Pakistan show substantial replication of the AAOIFI’s FAS No. 8 *Ijarah and Ijarah Muntahia Bittamleek*. AAOIFI’s plan to revise its FAS No.8<sup>8</sup> may have a trickle-down effect to the Islamic accounting standards seen in Indonesia and Pakistan. Such an effect may harmonise the gap as mentioned earlier but until then,

<sup>8</sup> Source: <http://aaofii.com/standards-under-review-2/?lang=en>

the WG acknowledges the differences which stem mainly from factors other than technicality of the IFRS Standards.

42. On a separate note, with the increase in the number of countries with systemic importance of Islamic finance<sup>9</sup>, applying a single set of accounting principles for ijarah (and for other Islamic financial transactions) will enhance comparability and understandability of financial statements among users and potential investors.
43. Therefore, effort and collaboration between WG member-jurisdictions and the IASB are pivotal to ensure that IFRS Standards can be applied to Islamic financial transactions.

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<sup>9</sup> The Islamic Financial Services Board's survey reported that there are 12 jurisdictions where Islamic finance has achieved domestic systemic importance i.e., they represent at least 15% of domestic banking sector assets. See Appendix 2 for details of the 12 jurisdictions.

## Appendix 1: Comparison of lessor accounting under IFRS 16, FAS 8, IFAS 2 and SFAS 107

IFRS 16 Leases	AAOIFI FAS 8 Ijarah and Ijarah Muntahia Bittamleek	IFAS 2 Ijarah (Pakistan)	SFAS 107 Ijarah Accounting (Indonesia)
<p><b><u>Operating lease:</u></b> <b>Recognition</b> Para 81: A lessor shall recognise lease payments from operating leases as income on either a straight-line basis or another systematic basis.</p> <p><b>Presentation</b> Para 88: A lessor shall present underlying assets subject to operating leases in its statement of financial position according to the nature of the underlying asset.</p> <p><b><u>Finance lease:</u></b> <b>Recognition</b> Para 67: At the commencement date, a lessor shall recognise assets held under a finance lease in its statement of financial position and present them as a receivable at an amount equal to the net investment in the lease. Para 75: A lessor shall recognise finance income over the lease term, based on a pattern reflecting a constant periodic rate of return on the lessor's net investment in the lease.</p> <p><b>Presentation</b> Para 67: At the commencement date, a lessor shall recognise assets held under a finance lease in its statement of financial position and present them as a receivable at an amount equal to the net investment in the lease.</p>	<p><b><u>Operating ijarah:</u></b> <b>Recognition</b> Para.5: Asset acquired for ijarah shall be recognized upon acquisition at historical cost.  Para.9: Ijarah revenue shall be allocated proportionately to the financial periods in the lease term.</p> <p><b>Presentation</b> Para.8: Leased asset shall be presented in the lessor's statement of financial position under Investments in Ijarah Assets.</p> <p><b><u>Ijarah muntahia bittamleek:</u></b> <b>Recognition</b> Para. 21: Assets acquired for Ijarah to be accounted for as in item para.5.  Para. 24: Ijarah revenue To be accounted for as in item para.9  Para 28: legal title of the leased asset shall pass to the lessee, provided that all Ijarah instalments are settled.</p> <p><b>Presentation</b> Para.22: Leased assets shall be presented in the lessor's statement of financial position lessor's statement of financial position under Ijarah Muntahia Bittamleek assets and shall be measured at their book value.</p>	<p><b>Ijarah in the financial statements of lessor</b> <b>Recognition</b> Para 6: Assets acquired for Ijarah shall be recognized upon acquisition at historical cost. Historical cost of assets acquired for Ijarah includes net purchasing price plus wherever applicable all expenditures necessary to bring the asset to its intended use, such as custom duties, taxes, freight, insurance, installation, testing, etc.  Para 10.4: Ijarah income from Ijarah should be recognized in income on accrual basis as and when the rental becomes due, unless another ~ systematic basis is more representative of the time pattern in which benefit of use derived from the leased asset is diminished.</p> <p><b>Presentation</b> Muj'ir (Lessors) should present assets subject to Ijarah in their balance sheet according to the nature of the asset, distinguished from the assets in own use. (para. 10.1)</p>	<p><b>Lessor accounting:</b> <b>Recognition</b> Para 9: The object of ijarah is recognized when the ijarah object is obtained at the cost of acquisition (para 9)  Para 11: The ijarah object is depreciated or amortized, if in the form of assets that can be depreciated or amortized, in accordance with the depreciation policy or amortization for similar assets over their useful life (economic life).  Para 14: Rental income over the contract period is recognized when the benefits of the assets have been transferred to the lessee.  Para 15: Receivables from rental income are measured at the value that can be realized at the end of the reporting period.</p> <p><b>Presentation</b> Para 31: Ijarah income is presented net after deducting related expenses, for example depreciation expenses, maintenance and repair expenses and so on.</p>

**Appendix 2 – Jurisdictions with systemic Islamic finance importance in domestic banking asset<sup>10</sup>**

No	Jurisdiction	AOSSG Member-jurisdiction?	IFRS Standards or others?	Information based on IFRS jurisdictional profile <sup>11</sup>
1	Iran	No	IFRS	The AOI (Audit Organization of Iran) requires large listed companies to apply IFRS Standards (with two optional modifications) starting with Iranian year 1395, which is the financial year beginning 20 March 2016 according to the Gregorian calendar.
2	Sudan	No	N/A	Not applicable (N/A)
3	Brunei	Yes	IFRS	Brunei Darussalam adopted full IFRS Standards for publicly accountable entities effective 1 January 2014.
4	Saudi Arabia	Yes	IFRS	IFRS Standards are required for all banks, insurance companies, and listed companies.
5	Kuwait	No	IFRS	Kuwait has adopted IFRS.
6	Yemen	No	IFRS	IFRS Standards are required for some companies and are permitted for all other companies in Yemen.
7	Qatar	No	IFRS	Qatar has adopted IFRS Standards.
8	Malaysia	Yes	IFRS	Malaysia has already adopted IFRS Standards and the IFRS for SMEs Standard for all companies.
9	UAE	No	IFRS	The UAE has adopted IFRS Standards and the IFRS for SMEs Standard.
10	Bangladesh	No	IFRS	Bangladesh has adopted IFRS Standards and the IFRS for SMEs Standard.
11	Djibouti	No	N/A	Not applicable
12	Jordan	No	IFRS	IFRS Standards are required for the financial statements of all companies whose securities are traded in a public market.

<sup>10</sup> Islamic Banking Share in Total Banking Assets by Jurisdiction (1H2016), IFSB Islamic Financial Services Industry Stability Report 2017. The Report defines systemically important as those that have more than 15% as a proportion of total domestic banking sector assets.

<sup>11</sup> Source: <https://www.ifrs.org/use-around-the-world/use-of-ifrs-standards-by-jurisdiction/>

### **Appendix 3 – Responses from staff of Institute of Chartered Accountants of Pakistan (ICAP) on non-adoption of IAS 17<sup>12</sup>**

There are the following limitations resulting in non-application of IAS 17 which need to be studied further for IFRS 16:

1. Under the Shariah principles two agreements, e.g. lease and sale, cannot take place within one contract. It is a well settled rule of Islamic jurisprudence that, in specific types of transactions, one transaction cannot be tied up with another transaction so as to make the former a precondition for the other. If lease and sale are included in one contract, this transaction can be viewed as a deferred sale with a deferred payment, which is not acceptable in Shariah principles. These will contain significant Gharar (excessive uncertainty) with regard to which of the risks and rewards are to be taken by which party, applying which contract first.
2. A future sale contract is not allowed by Shari'ah and hence the option of purchase or sale is only a promise / undertaking, binding on neither or one party only, executable at a future date. Putting it all together we believe that neither as per Shariah, nor as per prudent accounting practices, it would be wise and justified to combine the both.
3. According to the Shari'ah principles, in case of Ijarah (which is to be kept separate from promise to sell) the usufruct of the asset is transferred which means that "substantially all risks and rewards incidental to ownership of asset" are not transferred to the lessee at inception of lease, so it does not fall within the strict definition of finance lease (see para 12 of IAS 17).
4. The finance lease accounting fundamentally assumes a liability to have been incurred (which does not happen as per Shariah and legal requirements) and an asset (tangible / physical) to have been acquired (which does not happen as per Shariah and legal requirements).
5. Considering the substance over form issue which is the base for accounting as finance lease under IAS 17, we believe that there is a clear Shariah requirement to keep the execution of the contracts as per their legal form and any departure is considered a Shariah non-compliance. Considering the strict rules applied by the central bank and the respective Shariah boards, we believe that in such transactions, generally speaking, the substance and form are uniform and hence IAS 17 accounting for finance lease would not be justified.
6. The liability accounting involves time value of money which is fundamentally not acceptable in Islamic finance.
7. The lessor, generally being Islamic bank, has to take care of the profit and loss distribution to the PLS depositors / unrestricted investment accounts and the shareholders who are generally Shariah conscious. Applying finance lease accounting would result on numerous accounting issues resulting in distribution of a profit which is not rightfully earned or not rightfully calculated in line with Shariah including the accounting from inception of lease vs. accounting after the delivery of asset and recognition of other income and expenses etc.

Considering the above factors together with the Shariah requirements, Ijarah is accounted for as separate transactions as an operating lease followed by a disposal through another agreement.

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<sup>12</sup> Verbatim from the staff responses to the Survey.

## Appendix 4 – Hypothetical example of an aircraft lease

This question is developed in the Survey to understand whether ijarah that transfers risks and rewards to the lessee will still be recognised as ‘operating lease’ in the lessor’s book; as required by the Islamic accounting standards, or otherwise.

### Hypothesis

**Customer enters into a contract with FlyCo for the use of an aircraft for a 15-year period. The aircraft is worth CU100 million and the term of the contract requires the Customer to make payments amounting to CU200 million during the 15-year period.**

**Customer is responsible for operating the aircraft and ensuring that the aircraft is properly maintained. Customer also bears any risks of damage or malfunction of the aircraft. The contract does not include any substitution clause such that FlyCo is not obliged to substitute the aircraft during the 15-year period if the aircraft is not working (for example due to damage or malfunction).**

**Q14a: Based on your analysis, how likely is it for the above transaction to be arranged using an ijarah contract in your jurisdiction?**

**Indonesia:** Unlikely. The above transaction does not meet the definition of ijarah transaction under PSAK 106 Accounting for Ijarah. The above transaction indicates transfer of risks and rewards from lessor to lessee. Ijarah transaction in Indonesia do not allow transfer of risks and rewards to lessee. Therefore, the risks and rewards of assets ijarah remain in IFI.

**Malaysia:** Likely. In Malaysia, such an ijarah may be arranged whereby Customer assumes the risks and rewards incidental to the ijarah asset during the 15-year period; subject to agreement by the contracting parties, i.e. FlyCo and Customer. If FlyCo is an Islamic financial institution under the purview of Bank Negara Malaysia, on the substitution of asset, Shariah Advisory Council of BNM has ruled that if the damage of the asset is such that it prevents the lessee from enjoying its usufruct of the asset, the ijarah contract could either be: dissolved or continued provided that the asset is repaired or substituted with a new one. The above ruling takes effect on 1 August 2018 prospectively. This is however is not reflective of the current product offerings of IFIs in Malaysia.

**Pakistan:** Unlikely. Though currently not aware of any Ijarah arrangement for air crafts. This would normally be structured as a Diminishing Musharaka transaction, considering the pattern of existing large transactions and Sukuk.

**Saudi Arabia:** Likely

**Syria:** Likely – as operating lease.

**Q14b: Assuming that the above transaction is entered into using an ijarah contract; what is the accounting treatment under the Islamic accounting standards in your jurisdictions?**

**Indonesia:** Not Applicable in Indonesia

**Malaysia:** Not applicable as Malaysia does not have separate accounting standard on ijarah (and for all other Islamic financial transactions). Therefore, the answer is the same as the response in (a) above.

**Pakistan:** Considering the above transaction structure, normally, the transactions would not be approved by Shariah boards as the applicable Shari’ah rules (as per central bank’s requirements) do not allow “the customer to take the risk of major damage or major faults, other than those of operational nature” in the

aircraft. Since the scenario contains this condition, hence we believe that this will not be considered a Shariah compliant Ijarah. However, Islamic banks use Takaful and agency based and supplementary rental based risk hedging instruments, which are acceptable, if being separate from the core contract. If it is determined not to be a Shariah compliant Ijarah, then it will be recorded under IAS 17.

**Saudi Arabia:** IFRS

**Syria:** Operating lease. However, there is no separate Islamic accounting standards in Syria

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**Q14c: [Only for Indonesia and Pakistan who apply Islamic accounting standards for ijarah]**

***If the terms of the ijarah contract in your jurisdictions is such that:***

- ***the customer enjoys the economic benefit and bears risks of the asset during the ijarah period;***
- ***the present value of ijarah rentals at inception forms major part of the asset's fair value; and***
- ***the asset will be transferred to the customer at the end of the ijarah period at a nominal amount***

***would the transaction still be accounted for as an 'operating lease' under the Islamic Accounting Standards applicable in your jurisdiction?***

**Indonesia:** No. Please refer to the explanation in (a) above.

**Pakistan:** Permissible Ijarah contracts in Pakistan, would not meet these factors (at least "substantially all" of them together), as if the 2nd and 3rd condition may meet, but the 1st will not be met. Accordingly, it might be common that such transaction would not be structured as an Ijarah transaction, and will rather take form of a Diminishing Musharaka arrangement.

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**Q14d: Please let us know if you have additional comment.**

**All respondents:** No