TO BE PUBLISH IN PART II OF THE GAZETTE OF PAKISTAN

Statutory Notification (S.R.O.)

GOVERNMENT OF PAKISTAN
SECURITIES AND EXCHANGE COMMISSION OF PAKISTAN

Islamabad, the May 22, 2007

NOTIFICATION

S.R.O 431(I)/2007.__ In exercise of the power conferred by sub-section(3) of section 234 of the Companies Ordinance, 1984 (XLVII of 1984), the Securities and Exchange Commission of Pakistan is pleased to direct that the Islamic Financial Accounting Standard 2, annexed to this notification, issued by the Institute of Chartered Accountants of Pakistan, shall be followed in regard to the financial statements by companies and modarabas while accounting for Ijarah (Lease) transactions as defined by the said Standard:

Provided that the Commission may grant an exemption to any company or any modaraba, if it is in the public interest so to do, from compliance with all or any of the requirements of the aforesaid Standard.

Annex to Notification

ISLAMIC FINANCIAL ACCOUNTING STANDARD
IFAS 2 IJARAH
Issued By
The Institute of Chartered Accountants of Pakistan

IFAS 2

ISLAMIC FINANCIAL ACCOUNTING STANDARD

IFAS 2 IJARAH

I. The standards, which have been set in bold italic type, should be read in the context of the background material and implementation guidance in this Standard. Islamic Financial Accounting Standards are not intended to apply to immaterial items

Objective

2. The objective of this Standard is to prescribe, for lessees and lessors, the appropriate accounting policies and disclosure to apply in relation to Ijarah

Scope

3. This Standard shall apply in accounting for Ijarah as defined in paragraph 5 but shall not **apply to:**

3.1 lease agreements to explore for or use minerals, oil, natural gas and similar non-regenerative resources;

3.2 licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents and copyrights;

3.3 lessors of investment property leased out under operating leases (see IAS 40 **Investment Property); and**

3.4 lessors of biological assets leased out under operating leases (see IAS 41 Agriculture).

4. This Standard applies to agreements that transfer the right to use assets even though substantial services by the lessor may be called for in connection with the operation or maintenance of such assets. On the other hand, this Standard does not apply to agreements that are contracts for services that do not transfer the right to use assets from one contracting party to the other.

Definitions

5. The following terms are used in this Standard with the meanings specified:

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

Explanation:

The term Ijarah for the purpose of this Standard also includes a contract of sub-lease executed by the lessee with the express permission of the lessor (being the owner).

Whether a transaction is an Ijarah or not depends on its substance rather than the form of the contract provided it complies with the Shariah essentials as may be prescribed from time to time.

5.2 Prescribed means as prescribed by any law or regulations or directives for the time being in force.

5.3 An Ijarah is an Ijarah that is cancelable only:

5.3.1 upon the occurrence of some remote contingency such as force majeure;

5.3.2 with the mutual consent of the muj'ir (lessor) and the musta'jir (lessee); or

5.3.3 If the musta'jir (lessee) enters into a new Ijarah for the same or an equivalent asset with the same muj'ir (lessor).

5.4 The inception of the Ijarah shall be effective from the date the asset leased out is put into musta'jir's (lessee's) possession pursuant to an Ijarah contract.

5.5 The term of the Ijarah is the period for which the mustajir (lessee) has contracted to lease the asset together with any further terms for which the musta'jir (lessee) has the option to continue to lease the asset, with or without further payment, which option at the inception of the Ijarah it is reasonably certain that the musta'jir (lessee) will exercise.

5.6 Ujrah (lease) payments are the payments over the Ijarah term that the musta'jir is, contractually required to pay.

5.7 Fair value is the amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm's length transaction.

5.8 Economic life is either:

5.8.1 the period over which an asset is expected to be economically usable by one or more users; or

5.8.2 the number of production or similar units expected to be obtained from the asset by one or more users.

5.9 Useful life is the estimated period, from the beginning of the Ijarah term, without limitation by the Ijarah term, over which the economic benefits embodied in the asset are expected to be consumed by the enterprise.

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.

Ijarah in the Financial Statements of Musta'jir (Lessees)

7. Ujrah payments under an Ijarah should be recognized as an expense in the income statement on a straight-line basis over the Ijarah term unless another systematic basis is representative of the time pattern of the user's benefit.

8. For Ijarah, ujrah payments are recognized as an expense in the income statement on a straight- line basis unless another systematic basis is representative of the time pattern of the user's benefit, even if the payments are not on that basis.

9. Musta'jir (Lessees) should, in addition to meeting the requirements of IAS 32, Financial Instruments: Disclosure and Presentation, make the following disclosures for Ijarah:

9.1 the total of future ujrah payments under Ijarah, for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years;

(iii) later than five years;

9.2 the total of future sub-ijarah payments expected to be received under sub-ijarah at the balance sheet date;

9.3 Ijarah and sub-ijarah payments recognized in income for the period, with separate amounts for Ijarah payments and sub-ijarah payments;

9.4 a general description of the Musta'jir's (lessee's) significant Ijarah arrangements including, but not limited to restrictions imposed by Ijarah arrangements, such as those concerning dividends, additional debt, and further Ijarah.

Ijarah in the Financial Statements of Muj'ir (Lessors)

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10.1 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.

10.2 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.

10.3 Costs, including depreciation, incurred in earning the Ijarah income are recognized as an expense.

10.4 Ijarah income is 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 use benefit derived from the leased asset is diminished.

11. Initial direct costs incurred specifically to earn revenues from an Ijarah are either deferred and allocated to income over the Ijarah term in proportion to the recognition of Ujrah, or are recognized as an expense in the income statement in the period in which they are incurred.

12. Assets leased out should be depreciated over the period of lease term using depreciation methods set out in lAS 16

However, in the event of an asset expected to be available for re-ijarah after its first term, depreciation should be charged over the economic life of such asset on the basis set out in lAS-I 6.

13. To determine whether a leased asset has become impaired, that is when the expected future economic benefits from that asset are lower than its carrying amount, an enterprise applies the International Accounting Standard dealing with impairment of assets that sets out the requirements for how an enterprise should perform the review of the carrying amount of its assets, how it should determine the recoverable amount of an asset and when it should recognize, or reverse, an impairment loss.

Sale and Leaseback Transactions

14. A sale and leaseback transaction involves the sale of an asset by the vendor and the leasing of the same asset back to the vendor.

15. *When an asset is sold with an intention to enter into an Ijarah arrangement, any profit or loss based on the asset's fair value should be recognised immediately. If the sale price is below fair value, any profit or loss should be recognised immediately except that, if the loss is compensated by future lease payments at below market price, it should be deferred and amortised in proportion to the lease payments over the period for which the asset is expected to be used. If the sale price is above fair value, the excess over fair value should be deferred and amortised over the period for which the asset is expected to be used.*

16. Muj'ir (Lessors) should, in addition to meeting the requirements of IAS 32, Financial Instruments: Disclosure and Presentation, make the following disclosures for Ijarah (Leases):

16.1 the future Ijarah payments in the aggregate and for each of the following periods:

(i) not later than one year;

(ii) later than one year and not later than five years;
(iii) later than five years; and

16.2 a general description of the muj'ir (lessor's) significant leasing arrangements.

17. In addition, the requirements on disclosure under IAS 16, Property, Plant and Equipment, IAS 36, Impairment of Assets, IAS 38, Intangible Assets and IAS 40, Investment Property, apply to assets leased out under Ijarah.

Effective Date

18. This Islamic Financial Accounting Standard becomes operative for financial statements covering periods beginning on or after first day of July 2007.. If an enterprise applies this Standard for financial statements covering periods beginning before first day of July 2007, the enterprise should disclose the fact that it has applied this Standard.

It is also clarified that this Standard will be required to be followed on those Ijarahs which commence after the above-mentioned effective date. However financial institutions who have entered into Ijarah agreements before the effective date of this standard will have the option for early compliance with the requirements of this before the effective date.

Appendix

Essentials and Model Agreements for
Islamic Modes of Financing

Introduction

The Commission for Transformation of Financial System set up in the State Bank of Pakistan pursuant to the Supreme Court Judgment on Riba dated December 23, 1999 approved essentials of Islamic modes of financing including Musharaka, Mudaraba, Murabaha, Musawama, Leasing, Salam and Istisna. The recently established State Bank of Pakistan's Shariah Board has reviewed and approved these essentials of Islamic modes of financing and recommended that the same may be circulated to the banks conducting Islamic banking business in Pakistan as guidelines that would form the basis for Prudential Regulations on Islamic banking in due course. It does not preclude the possibility of developing new modes or instruments of financing, modifications or variants of the modes provided they are Shariah compliant. The Ijarah Essentials are given below:

Ijarah (Leasing)

i) In Ijara/leasing, the corpus of leased commodity remains in the ownership of the lessor and only its usufruct is transferred to the lessee. Any thing, which cannot be used without consuming the same, cannot be leased out like money, edibles, fuel, etc. Only such assets, which are owned by the lessor, can be leased out except that a sub-lease is effected by the lessee with the express permission of the lessor

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ii) Until such time that assets to be leased are delivered to the lessee, lease rentals do not become due and payable.

iii) During the entire term of the lease, the lessor must retain title to the assets, and bear all risks and rewards pertaining to ownership. However, if any damage or loss is caused to the leased assets due to the fault or negligence of the lessee, the consequences thereof shall be borne by the lessee. The consequences arising from non-customary use of the asset without mutual agreement will also be borne by the lessee. The lessee is also responsible for all risks and consequences in relation to third party liability, arising from or incidental to operation or use of the leased assets.

iv) The insurance of the leased asset should be in the name of lessor and the cost of such insurance borne by him.

(It is hoped that arrangement shall soon be made for Islamic Takaful to replace the existing insurance system).

v) A lease can be terminated before expiry of the term of the lease but only with the mutual consent of the parties.

vi) Either party can make a unilateral promise to buy/sell the assets upon expiry of the term of lease, or earlier at a price and at such terms and conditions as are agreed, provided that the lease agreement shall not be conditional upon such sale. Alternatively, the lessor may make a promise to gift the asset to the lessee upon termination of the lease, provided the lessee has fulfilled all his obligations. However, there shall not be any stipulation in the lease agreement purporting to transfer of ownership of the leased assets at a future date.

vii) The amount of rental must be agreed in advance in an unambiguous manner either for the full term of the lease or for a specific period in absolute terms.

viii) Assignment of only the lease rentals is not permissible except at par value.

ix) Contract of lease will be considered terminated if the leased asset ceases to give the service for which it was rented. However, if the leased asset is damaged during the period of the contract but is capable of being repaired, the contract will remain valid.

x) A penalty can be agreed ab initio in the lease agreement for delay in payment of rental by the lessee. In that case, lessee shall be liable to pay penalty calculated at the agreed rate in percent per day/annum. However, that penalty shall be used for the purposes of charity. The banks can also approach competent courts for award of damages, at discretion of the courts, which shall be determined on the basis of direct and indirect costs incurred, other than opportunity cost. Also, security or collateral can be sold by the bank (purchaser) without intervention of the court.

No. DIR(CS)/19/2007

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Advisor/Secretary