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IJARAH OR LEASE? A DICHOTOMY IN CONVENTIONAL AND ISLAMIC ACCOUNTING TREATMENT

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INTRODUCTION

Religion (regardless of its origin and type) always had momentous influence on the way human conduct their life -- religion always teaches mankind to undertake their life activities in the righteous path. Islam, a religion founded nearly 1500 years ago, has one of the biggest followers worldwide. Since the days of Prophet Muhammad (p.b.u.), Islam has advocated for a fairand balanced socio-economic development – all activities should be undertaken according to Islamic principles or 'halal' based activities. Failing to do so, Muslims shall face the wrath of Allah. And accounting is not an exception.

The accounting system has been an integral part of the economical functionality of a nation since the late 19th century. Without a proper accounting system, business activities cannot be carried out effectively. For many years, almost all countries worldwide have been using the conventional accounting system or also called as the western-based accounting system, for recording, processing and delivering information to its users. However, the past twenty years or so saw an increase in the callings by Muslim scholars and advocators on the need for Islamic based accounting system. Islamic accounting can be defined as the "accounting process" which provides appropriate information to stakeholders and ensure investors the continuity of the business operation within the limits of the Islamic *Syariah* besides fulfilling its socio-economic objectives (Shanmugam, et al., 2005). Rooting from the question of whether conventional accounting system suits the needs of Muslims, Islamic scholars argued on the irrelevance of conventional accounting system to Muslims due to its economic-complexity and non compliance to social obligations. The application of Islamic based accounting system has been imparted into almost all types of transactions, including leasing activities. In Islamic term, lease is called as Ijarah. This paper highlights the accounting treatment differences for lease or Ijarah transactions from both the conventional and Islamic accounting perspectives.

DICHOTOMY: GENERAL PERSPECTIVES

One of the main differences in the conventional and Islamic accounting system lies in its economic principles. The western economic principles propose for individuals to have unconditional and absolute rights over their wealth with the main objective of maximizing profit and lowering cost (Shafi, 1979). Islamic economics however does not provide absolute power to aMuslim over their wealth – they are merely trustees of the wealth and must abide by Allah's instructions on using them. Sharing of wealth among fellow Muslims is a must in Islamic economics. The underlying Islamic principles govern socio-economic development rather than maximization of profit. As highlighted by Haqiqi and Pomeranz (1987, p.156) "no-man should claim for himself what is creation of Allah, or the product of another man's efforts and skills". This shows heavy reliance towards social justice.

In terms of the regulating standard, the conventional accounting system in Malaysia is regulated by the Malaysian Accounting Standards Board (MASB). Prior to January 2005, lease transactions undertaken in Malaysia were regulated under the MASB 10 standard. This was recently changed to FRS 117. It needs to be highlighted here that the FRS 117 does not deal with Islamic based leases. In the FRS 117, a lease is defined as an agreement whereby the lessor conveys to the lessee in return for a payment or series of payments the right to use an asset for an agreed period of time. The conventional accounting system measures accounting transactions based on its economic events. FRS 117 specify that a lease is classified based on the economic life of the assetto the business rather than its useful life term. Here, the standard assumes and acknowledge thatan asset may have more than one user over its economic life.

Meanwhile, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is the main body that governs Islamic based financial reporting. In Islam, a lease is named as Ijarah and governed by the AAOIFI 8. This standard defines Ijarah as the ownership of the right to the benefit of using an asset in return for consideration. In Islamic accounting, the measurement of accounting transactions is based on the *socio-economic* and *religiou*s events.

Both the conventional (FRS 117) and Islamic standards (AAIOFI 8) define the areas that do not constitute a lease transaction. However, AAIOFI 8 Islamic Ijarah has an extra provision of not covering the professional labour services provided as part of a lease transaction.

In the conventional system, a lease is categorized into two types that are finance lease and operating lease. A finance lease is defined as a lease with condition that the lessor (owner of the asset) has transferred substantially all the risks and rewards related to the ownership of the assetto lessee, eventually the title may or may not transfer. In Malaysia, a hire purchase contract is treated as a finance lease as it fulfills the above condition of transferring the title of the asset to the hirer upon completion of the payment of the hire purchase installment. Meanwhile, anoperating lease is defined as any other lease than a finance lease.
The Islamic system also categorizes an Ijarah into Ijarah Muntahia Bittamleek (finance lease) and Operating Ijarah. This classification is based on the criteria whether the lease includes a promise that the legal title in the leased asset will pass to the lessee at the end of its term. If a lease does not include a promise that a legal title will pass to the lessee (buyer) then it is known as operating Ijarah.

The differences in this context is that the Islamic standards provide clear definition of what constitute an operating Ijarah -- in which it states that operating Ijarah does not constitutes a promise to legally transfer the title of the lease. However in conventional accounting, the definition is rather in the sense that it classifies the operating lease as anything apart from finance lease. The conventional standard also states that the legal title may or may not be transferred.
Nevertheless, FRS 117 considers a lease of land and buildings as two separate elements based on reliability of the lease payment allocation. If the lease payment cannot be allocated reliably, then both land and building are classified as finance lease. Similar differences can also be found for the finance lease. The conventional finance lease stressed that the legal title would not betransferred without any form of consideration (money), but Ijarah Muntahia Bittamleek allows forlegal title transfer to take place without consideration.

DICHOTOMY: ACCOUNTING PERSPECTIVES

Both the conventional and Islamic standard provides the accounting treatment for a lease or Ijarah. These treatments are defined from the lessor and lessee's accounting perspectives. Both standards provide for treatment for the purchase of the lease asset. In the conventional accounting, a finance related lease asset can be bought by the lessee at a lower than the fair value price at the date the option becomes exercisable from the lessor (provided that during its inception, it is reasonably certain that it will be exercised). On contrary, the legal title of theIjarah Muntahia Bittamleek asset can be transferred to the lessee from lessor before the end of thelease term for a price similar to the balance of the Ijarah instalment.

The initial direct costs pertaining to the lease asset -- such as commissions and legal fees, are treated differently in both accounting systems. The FRS 117 stressed that the initial direct costwill be added to the carrying amount of the leased asset and recognised over the lease term on the same basis as the lease income. However, AAIOFI 8 suggests that the initial direct cost be recorded as a deferred cost (which follows the matching concept) **if** the direct cost is significant. This cost can be allocated in proportion to the life term of the lease asset. If the cost is seen as immaterial, then it will be charged as an expense in the income statement as a one time expense.

In terms of the treatment of the lease asset in the balance sheet, the FRS 117 provides a broad view of treating the leased asset in the balance sheet. The standard suggests that a lessor can present a leased asset according to the nature of the asset with normal depreciation policy. But theAAIOFI 8 recommends the lessor to record an Ijarah asset in their balance sheet as an investment with normal depreciation policy.
In term of asset valuation, the conventional accounting is silent about the asset valuation underthe operating lease but for the finance lease, the standard recommends the lessee to recognise it inthe balance sheet at an amount equal at the inception of the lease to the fair value of the leased property or, if lower, at the present value of the minimum lease payments under fair value. The AAIOFI 8 recommend Ijarah assets to be recognized at historical cost which includes net purchasing price and all expenditures necessary to bring the asset to its intended use.

As the conventional accounting is silent on the treatment of repair of leased assets, the AAIOFI 8 suggests the cost of repairs to be borne by both the lessor and lessee. However both AAOIFI 8 and FRS 117 provide similar treatment for revenue receivable on finance lease. For a lessor, the Ijarah should be shown as Ijarah revenue in the income statement over the lease term. However, the FRS 117 provides a different approach in recording the asset amount. The lessor at the date of commencement can record the sales revenue at the asset fair value, or if lower, the present value of the minimum lease payment accruing to the lessor, computed at a commercial rate of interest.

SUMMARY

In summary, the differences in both accounting systems are summarized in the following Tables.

Table 1: General Dichotomy

Definition	The process of identification, recording, classification, interpreting and communicating economic events that allow the users to make informed decisions	The accounting process which provides appropriate information to stakeholders and the continuity of the business operation within the limits of the Islamic *Syariah* besides fulfilling its socio-economic objectives
Objective	Provide efficient information to users for economic decision making	Provide information to users for decision making process with the condition that it complies with the provisions of the *Syariah*
Measurement	Measures transactions based on economic events	Measures transactions based on socio-economic and religious events
Economic principles	Individuals have *unconditional and absolute rights* over their wealth and can use them whenever and however they want to	Islamic economics does not provide absolute power to a Muslim over their wealth – they are merely trustees of the wealth and abide by Allah's instructions on using them. Sharing of wealth among fellow Muslims is must
Standard	Malaysian Accounting Standards Board FRS 117.	Accounting, Auditing Organization for Islamic Financial Institutions (AAOIFI) 8
Scope of Standard	MASB 10 can be used for lease accounting purpose except for two lease contracts related to exploration of natural resources and motion picture licensing agreements	AAOIFI 8 can be used for Ijarah accounting purpose except for three lease contracts related to natural resources, motion picture licensing agreements AND usage of professional labours
Definition of Operating Lease	Operating lease is not clearly defined in FRS 117. It is merely said to be anything apart from finance lease	AAOIFI 8 provide clear definition of what is operating Ijarah -- operating Ijarah is defined as an Ijarah without a promise to legally transfer the title of the lease from lessor to lessee

Table 2: Accounting Dichotomy

	Conventional	**Islamic**
Consideration of the lease	The finance lease provides for the lessee to buy the asset at a lower than the market value at the date of the option becomes exercisable from the lessor (provided that during its inception, it is reasonably certain that it will be exercised).	Ijarah Muntahia Bittamleek allows legal title transferred to lessee from lessor before the end of the lease term for a price similar to the balance of the Ijarah installment.
Initial Direct Cost	FRS 117 recommended that the initial cost to be added to the leased amount.	Treatment for Ijarah's initial direct cost is clearly defined in AAOIFI 8. If the direct cost is significant -- allocated similar to Ijarah Revenue (lessor) and Ijarah expenses (lessee) as deferred cost – MATCHING CONCEPT. If it is immaterial -- charged as an expense in the Income Statement as a one time expense – MATERIALITY CONCEPT.
Balance Sheet Treatment	Standard provides a broad view of treating the lease asset in the balance sheet as an asset in accordance to the nature of the asset using the normal depreciation policy.	In the lessor's Balance Sheet, the Ijarah asset is recorded as an investment with normal depreciation policy.
Repair Cost	FRS 117 is silent on the treatment of the repair of leased assets	The cost of repairs should be borne by both lessor and lessee.
Assets Valuation	FRS 117 is silent about the asset valuation under the operating lease. But for the finance lease, the lessee has to show it in the balance sheet equal to the fair value of the asset.	Ijarah assets should be recognized at historical cost which includes net purchasing price & all expenditures necessary to bring the asset to its intended use
Rental Income	Freedom for lessor to increase the rent based on current market interest rate	Fixed rental amount based on consent from both parties to make long term agreement. CANNOT change

CONCLUSION

In conclusion, the differences that exist in conventional and Islamic accounting pertaining to lease are mixed and favor the conventional accounting in certain extent and vice-versa. The conventional accounting has limited exclusion for what constitutes lease transaction compared to Islamic accounting, which has detailed coverage. The definition of operation lease in the conventional accounting is also not clear vis-à-vis the Islamic accounting. In terms of consideration of the lease, the conventional accounting seems to have the upper hand compared toIslamic accounting. Here, the lessee of the conventional accounting can obtain the asset at much lower price. Finally, the description of the costs (material or immaterial) involved in acquisitionof the lease asset is not clear in conventional accounting. Here, the Islamic accounting approach seems to have better description of the costs.

While this paper may highlight the differences between conventional and Islamic accounting pertaining to lease in a preliminary manner, the general conclusion that can be made is that both conventional and Islamic accounting approaches may have different impact on accounting users, based on which accounting system they have preference to.

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