
Project	Leases
Topic	Shariah-compliant leases – Lessor issues

Introduction

1. Considering the intersection between Islamic, or Shariah-compliant, products and IFRS is one of my assigned tasks as Director of International Activities. The leases project has accelerated one part of that consideration. This is a background paper about issues in lessor accounting and does not include recommendations.
2. To begin, I would like to express my thanks to the Malaysian Accounting Standards Board (MASB) and its staff. They have been invaluable in helping me to develop this paper. Any errors in the paper are mine. I have attached the appendix on Islamic finance issues from the Asia-Oceania Standard Setters Group (AOSSG) comment letter on leasing. I will try not to repeat too much of its content.
3. Most books and articles on Shariah-compliant contracts begin with a lengthy introduction to concepts and prohibitions in Islam and the development of financial transactions that are permitted. I plan to avoid that here, as much as I can. In September of last year, a working group of the AOSSG produced a paper titled, *Financial Reporting Issues relating to Islamic Finance*. That paper is the best available examination of the financial reporting implications of Shariah-compliant finance. I have attached a copy for Board members' reference. Paragraph 4 of the AOSSG paper sums up the problem this way:

This paper has been prepared by the technical staff of the IFRS Foundation and the FASB for discussion at a public meeting of the FASB or the IASB.

The views expressed in this paper are those of the staff preparing the paper. They do not purport to represent the views of any individual members of the FASB or the IASB.

Comments made in relation to the application of U.S. GAAP or IFRSs do not purport to be acceptable or unacceptable application of U.S. GAAP or IFRSs.

The tentative decisions made by the FASB or the IASB at public meetings are reported in FASB *Action Alert* or in IASB *Update*. Official pronouncements of the FASB or the IASB are published only after each board has completed its full due process, including appropriate public consultation and formal voting procedures.

Shariah-Compliant Leases – Lessor Issues

The use of contracts other than lending to achieve financing is not an expedient circumvention of the prohibition on interest. Instead, it serves to make a clear distinction between a social transaction and a business transaction. In Islamic thinking, a loan is an act of benevolence, for which one hopes to receive the grace of Allah in return, and not worldly profits. Conversely, trade-based contracts are explicitly commercial in nature and it would therefore be permitted to expect returns thereon, such as dividend, profit, or rental. Economically, the returns on a trade-based contract may be similar to interest on a conventional loan. The similarity is not lost on Shariah scholars. Nevertheless, the majority-held view that permits the former and prohibits the latter is based on an injunction found in the Quran:

*“...they say, ‘Trade is like riba’, but Allah hath permitted trade and forbidden riba ...”*¹

Ijarah

4. This paper focuses on one trade-based contract – Ijarah. Bank Negara Malaysia (the Malaysian Central Bank) has produced a number of useful documents about Shariah-compliant products. I will use their definitions throughout this paper²:

Ijarah (leasing)

Refers to an arrangement under which the lessor leases equipment, building or other facility to a client at an agreed rental against a fixed charge, as agreed by both parties.

Ijarah Muntahia Bittamleek [IMB]

Refers to a leasing contract which includes a promise by the lessor to transfer the ownership in the leased property to the lessee, either at the end of the term of the Ijarah period or by stages during the term of the contract.

Ijarah Thumma al-Bai' (leasing and subsequent purchase) [AITAB]

Refers to a leasing which subsequently followed by a sale contract whereby the hirer leases the goods from the owner at an agreed rental over a specified period. Upon expiry of the leasing period, the hirer enters into a second contract to purchase the goods from the

¹ Surah Al-Baqarah, verse 275

² *Guidelines on Skim Perbankan Islam*. Bank Negara Malaysia. Kuala Lumpur. Available on: http://www.bnm.gov.my/guidelines/01_banking/04_prudential_stds/28_spi.pdf

Shariah-Compliant Leases – Lessor Issues

owner at an agreed price. This concept is applicable for financing of consumer goods and durables.

5. Ijarah is also a popular technique used in the current generation of Sukuk, Shariah-compliant securities with a growing market in Islamic countries. This paper focuses on the more basic principal-to-principal Ijarah.
6. There are several conditions that must exist in an Ijarah contract, including:
 - (a) The property must be the asset of the lessor;
 - (b) The property cannot be of the sort that is consumed through use, like food or petroleum;
 - (c) The amount of rent must be known in advance, although contingent rents are permitted;
 - (d) The risks associated with owning the asset, both physical and financial, remain with the lessor;
 - (e) The costs associated with owning the asset, like property taxes and insurance, are borne by the lessor, although there may be separate contracts to charge some of those costs to the lessee, and
 - (f) The costs associated with using the asset, like utilities, are borne by the lessee.
7. Shariah scholars recognize the idea that a lease is a transfer of rights to use. Indeed, they were referring to the concept of *usufruct* long before accounting standard setters took up the idea. However, the Shariah scholars draw a line between transferring the right to use, which is permitted, and a purchase financing contract, which is not permitted.
8. If that is so, how can contracts like IMB and AITAB exist? They are defined as leases ending with ownership. The answer lies in prohibitions surrounding linkage of contracts. IMB and AITAB are not embodied in a single contract because a lease and a purchase option cannot be combined in a single contract. Instead, the lease contract and the lessee's option to purchase the asset at the end of the lease are two separate contracts. We should note here that IMB and

Shariah-Compliant Leases – Lessor Issues

AITAB are modern-day innovations that did not exist historically. The arrangement of two classically permitted contracts, i.e. lease and sale, in sequence was developed to address modern financing needs. As I understand the thinking, Shariah scholars reject the idea of linking two contracts, each of which would be permitted on its own, into a single contract that would be prohibited. The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) issues accounting, auditing, and Shariah standards. The basis for conclusions of AAOIFI's Shari'a Standard No. (9), *Ijarah and Ijarah Muntahia Bittamleek*, includes the following discussion:

The basis for the requirement that all the rules prescribed for an ordinary lease are applicable to Ijarah Muntahia Bittamleek is that a mere promise to transfer ownership does [not] exclude the contract from becoming an Ijarah contract or from the applicable rules. This requirement is necessary in order to prevent a linking of contracts (the sale contract and lease contract). The International Islamic Fiqh Academy has issued a resolution in support of this ruling. [page 158]

9. Thus, practitioners are mindful of keeping the contracts of lease and sale in IMB and AITAB conspicuously separate, and the attendant Shariah Boards of their banks often see to it that they do.
10. This thinking suggests the further argument that Ijarah are always operating leases for accounting purposes, and that is my understanding of the AAOIFI accounting standard on the topic (we do not have a copy and it is not available electronically). In our current proposals, a performance-obligation approach seems to be consistent with the scholars' thinking. A derecognition approach or in-effect sale treatment would not be. One author makes the point this way:

According to Islamic principles of finance, there is no difference between operating and finance leases; if all of the four essential elements related to contracting parties, subject matter, consideration and the period in Ijarah are taken care of, Ijarah can be used as the mode of modern business by the financial institutions in the form of Ijarah Muntahia-bi-Tamleek. The deciding factor in this regard is

Shariah-Compliant Leases – Lessor Issues

the risk relating to ownership that must remain with the lessor and the sale should be separate from the lease.³

Current practice

11. To test that preliminary conclusion, I looked at published annual reports. I reviewed the annual reports of 16 banks that assert Shariah compliance. Four of the banks did not appear to have material Ijarah activity, leaving a usable population of 12, summarized below.
 - (a) Asserted compliance with IFRS – 5 banks from Saudi Arabia, Kuwait, and the United Arab Emirates;
 - (b) Asserted compliance with AAOIFI – 3 banks from Bahrain and Qatar;
 - (c) Asserted compliance with national standards – 2 banks from Malaysia, 1 from Pakistan and 1 from Indonesia.
12. The results were not what I expected.
13. In most cases, the accounting policy disclosure was not helpful to answer whether a bank applied finance or operating lease accounting to Ijarah. There were exceptions, but in most cases I had to rely on code words. If a policy note said that Ijarah revenue was recognized on a “constant yield” basis, I concluded that the bank was using finance-lease accounting. If a policy note said that Ijarah revenue was recognized on a “time proportionate” basis, or if the notes discussed depreciation of Ijarah assets, I concluded that the bank was using operating-lease accounting. The results were:
 - (a) Finance lease accounting – 3 of the IFRS banks and 2 that followed national (Malaysian) standards;
 - (b) Operating lease accounting – 1 of the IFRS banks, all 3 of the AAOIFI banks, and 1 that followed national (Indonesian) standards;

³ Ayub, Muhammad. *Understanding Islamic Finance*. John Wiley & Sons, Ltd. Chichester. 2007. (Kindle edition)

Shariah-Compliant Leases – Lessor Issues

- (c) Mixture of finance and operating lease accounting – 1 of the IFRS banks and 1 that followed national (Pakistani) standards.

14. For example, one of the IFRS banks made the following comments in the policy note:

Financing Ijarah: An agreement whereby the Group (lessor) leases an asset to a customer (lessee), for a specific period against certain rent installments. Ijarah could end in transferring the ownership of the asset to the lessee at the end of the lease period. Also, the Group transfers substantially all the risks and returns related to the ownership of the leased asset to the lessee.

Income from Ijarah is recognized on an accrual basis on effective yield method.

15. That description is consistent with finance lease accounting. In contrast, one of the AAOIFI-compliant banks made these disclosures that are clearly consistent with operating-lease accounting:

Ijarah Muntahia Bittamleek assets comprises assets under lease, comprising aircraft, land and buildings, under terms that would transfer ownership of the assets to third parties at the end of the respective lease term.

Depreciation is provided on a straight-line basis on all Ijarah Muntahia Bittamleek assets other than land (which is deemed to have an indefinite life), at rates calculated to write off the cost of each asset over the short of either period of the lease or economic life of the asset.

Ijarah Muntahia Bittamleek income is recognised on a time-proportionate basis over the lease term.

16. One more example, of a correct but not helpful disclosure by an IFRS-compliant bank:

Group as a lessor

Leased assets

This represents net investment in assets leased for periods which either approximate or cover a major part of the economic lives of such assets. The lease agreements provide a purchase option to lessees at a price equal or expected to be equal or lower than fair value of such assets at the time when such option is exercised.

Operating leases

Shariah-Compliant Leases – Lessor Issues

Leases where the lessor retains substantially all the risks and benefits of ownership of the asset are classified as operating leases.

Leased assets are stated at amounts equal to the net investment outstanding in the leases.

17. The more important, and unanswerable, question is what the banks' accounting policies *should* have been under IFRS. A stand-alone Ijarah contract would probably meet the conditions for an operating lease under existing IFRSs. IFRS and Malaysian banks that disclosed information about lease-purchase contracts like IMB and AITAB seem to be applying finance lease accounting to those products.
18. Analysis of the relative volumes of Ijarah activity was also difficult. Most of the banks included Ijarah in a balance sheet category labelled "financing assets." This was true even for those banks that were using operating-lease accounting and were, therefore, combining financial and nonfinancial assets on the same line. For several of the banks, Ijarah represented more than 25% of the category.
19. I have discussed this analysis with practitioners in the field and they agree with my conclusions. Their observations about bankers' motivations are more enlightening. For example, they point out that an asset under an operating lease (an airplane or a building) has a different regulatory capital load than a finance lease receivable. This obviously motivates some bankers toward finance-lease accounting. Others support operating-lease accounting, and are willing to take the capital charge, because they maintain that the accounting should be consistent with the Shariah evaluation of the individual contracts.
20. Consumer preferences can also influence accounting treatment. Some customers may insist on Ijarah as an operating lease to keep the debt off-balance sheet. (One Islamic banker acknowledged that his customers would be indifferent to his bank if he can't offer the advantage of an off-balance sheet effect.) Other customers may want to structure Ijarah as a finance lease because (i) absolving the bank's responsibility for bearing costs related to the asset results in cheaper pricing; and/or (ii) the customer can claim capital allowances on the asset for income tax purposes.

Shariah-Compliant Leases – Lessor Issues

The standard-setting problem

Consistency of assertions

21. Standard setters are accustomed to the conflict that may arise between the assertions in a contract, on the one hand, and someone’s view of the substance of the agreement on the other. Here, we have:
 - (a) A contract that says, “I own this asset and am legally entitled to lease it to you.” Remember, the first rule of Ijarah is that the asset must be the property of the lessor, and
 - (b) A financial statement that says, “I don’t own the underlying asset at all. I’ve transferred it to you. I own a financial instrument.”
22. Before I reviewed the annual reports, I expected that managers of most Shariah-compliant institutions would find that level of cognitive dissonance unacceptable. I still expect that many, like the managers whose institutions follow AAOIFI and some national standards would be unwilling to accept the idea of conflicting assertions. In their view, a derecognition or in-effect sale approach contradicts the first principle of the Ijarah agreement. Managers at the IFRS and MASB-compliant institutions seem to have concluded otherwise. In their view, Shariah compliance and financial reporting do not necessarily demand the same answers.
23. I do not see a solution to this part of the problem within the boundaries of the leasing project.⁴ The possibility for conflicting assertions arises in many areas of Shariah-compliant finance. The Boards should deal with it as a part of a more general consideration of Shariah-compliant finance.

⁴ Personal note – Other, that is, than applying the superior performance obligation approach throughout.

Shariah-Compliant Leases – Lessor Issues

Arbitrage and structuring

24. As I observed earlier, a simple Ijarah contract is probably reported as an operating lease under our current standards and following the performance obligation approach under the Exposure Draft. The requirements outlined in paragraph 6 seem tailor made to that result, although they predate lease accounting by several hundred years. The AOSSG paper raises a series of questions about the accounting approach for the *Ijarah Muntahia Bittamleek* described earlier in the paper. This arrangement is the growth business in Ijarah, and the AOSSG paper raises concerns that different IMB structures might lead to different accounting results, even though the underlying rights and obligations are very similar. I understand their concern and I share it, but this is by no means a problem unique to Shariah-compliant arrangements.