



# Explore the Lessee Accounting Treatment When Utilizing the Islamic Financial Leasing

## A Comparative Analysis of IFRS and AAI OFI Accounting Standards for the Financial Leasing

Amer MORSHED,<sup>1</sup> Zsuzsanna SZÉLES<sup>2</sup>

<sup>1</sup> University of Sopron, Hungary, Alexandre Lamfalussy Faculty of Economics  
e-mail: amer.morshed@phd.uni-sopron.hu

<sup>2</sup> Budapest Metropolitan University, Hungary, Institute of Business Sciences  
e-mail: szeles.zsuzsanna@gmail.com

**Abstract.** This study aims to discuss the effects of the AAI OFI accounting standards of financial leased assets on the accounting treatment of the lessee in the case of using the Islamic finance lease. The importance of this study became evident when AAI OFI announced Islamic accounting standards with a significant difference between the IFRSs about the recognition of leased financial assets. Islamic financial institutions recognize the financial leased assets following AAI OFI accounting under long-term assets in the statement of financial position. This study used the interviews as a qualitative research method with financial managers of Jordanian companies using Islamic financial leasing. This study reached the conclusion that both Islamic financial leasing parties recognize the assets in the long-term asset side. The recommendations to avoid the inflation of the Islamic financial leased assets will be by applying a reasonable accountancy treatment by the lessee and consider it as operational leasing with proper justification for the non-compliance with the IFRS.

**Keywords:** financial lease, IFRSs (IFRS 16), Islamic accounting standards

**JEL Classification:** M4 – Accounting and Auditing

## 1. Introduction

Islamic finance has been utilized as an alternative and supportive financial tool in the market since the 1975 establishment of the first Islamic bank for commercial purposes, which is Dubai Islamic Bank (Baker, 2015). Since Islamic finance started out as an initial financial model, it was forced to work in a dual banking system, which is still being ruled by conventional banks (Khattak, 2010). During the first

stage of Islamic finance development, Islamic banks provided many financial products similar to the conventionally offered ones. These new products, called Shariah compliance products, complied with Islamic Shariah rules and included Islamic personal loans and Islamic credit cards (Baker, 2015). After almost a decade, these banks started to provide independent products based on Shariah rules, called “Sharia-based products”: for example, Mudarabah deposits, “partnership investment deposits”, and Ijarah Muntahia Bittamleek “Islamic Financial leasing” (Cebeci, 2012).

However, Islamic financial leasing and Murabaha commodity (buy and resale of products) are considered the most frequently used Islamic financial products (Mnif Sellami and Tahari, 2017). Recently, many organizations have been established to develop and govern Islamic finance. The most important of them is the Islamic Financial Services Board (IFSB), which considered issuing the Islamic financial risk management standards (Aydın, 2017), and AAOIFI, which is an international Islamic organization that issued standards relating to Islamic financing practices from the legal and professional aspects of Islamic financial institutions (Mnif Sellami and Tahari, 2017). This study will analyse and try to resolve the problem created when the AAOIFI issued the Islamic accounting standards to cover the differences of Islamic finance, which are related to Islamic rules from conventional banking. Notably, the standard (No. 8) Ijarah Muntahia Bittamleek (leasing) is issued with due regard to the principal compliance with the leased financial assets, from which the ownership of the asset is not transferred directly to the lessee following the IFRSs. This criterion of financial leased assets recognition may affect the debtor (lessee) accounting treatment when utilizing the Islamic financial leasing.

Moreover, the study focuses on the lessee financial reports side of the Islamic financial lease instead of the IFIs, but it also focuses on the practical side by reviewing real financial statements of the lessees and analysing many interviews with financial managers in addition to the theoretical comparison between the Islamic and the international accounting standards.

Section 2 presents a literary review in a chronological order, illustrating Islamic finance and what its products are. This situation is due to the lack of circulation of Islamic finance in Eastern Europe, which leads the researcher to expect that knowledge of this type of financing in this region will be limited.

The study then presents the reasons for the emergence of Islamic accounting standards and explains what is related to accounting for Islamic finance leasing, which interprets Islamic financial leasing.

Section 3 discusses the research methodology, Section 4 discusses the findings, and, finally, Section 5 provides the conclusions and recommendations.

## **2. Literature Review**

### **2.1. What Is Islamic Finance**

Gheeraert and Weill (2015) defined Islamic finance as a type of finance which follows the Islamic Shariah standards that follow from the Qur'an and Prophet Muhammad Sona'h. Under Islamic Shariah, interest is prohibited for everyone. Alternatively, interest is compensated by the mechanism of profit and loss sharing, meaning that the parties share the financial transaction in profit or loss. Another advantage of Islamic finance is the compulsion of contractual inevitability, in which the parties must clearly define the pillars of the contract and neutralize ambiguity. Furthermore, Islamic finance does not deal with finance activities that consider a violation of Islamic Shariah standard.

According to the Islamic Financial Services Board report (2016), Islamic banking market share has increased in more than half of the 31 examined jurisdictions and in a number of countries where Islamic banking is systemically essential (Cham, 2018). The majority of Islamic banking assets are in the Middle East, including Iran, Saudi Arabia, and the United Arab Emirates, which have an enormous volume of assets. Further, Malaysia is considered the leading country in Islamic finance. Here are some data on the Islamic banking asset totals in 2013, expressed in billion US dollars, of Islamic countries: Iran – 94.3, UAE – 96.7, Saudi Arabia – 90.4, Kuwait – 80.6, Bahrain – 46.2, Qatar – 59.0, Malaysia – 156.7, Indonesia – 13.0, Bangladesh – 17.0, Pakistan – 6.2, Sudan – 6.5, Egypt – 5.0, Tunis – 0.76, and Turkey – 44.8. As a further example, the United Kingdom has 3.3 billion US dollars of Islamic Banking Asset. Hoggarth (2016) found that Russia, Kazakhstan, and the entire central Asian region have engagement with Islamic finance to produce an additional source of income and utilize the unique features of Islamic finance (Levine, 2005).

Furthermore, the development of Islamic banking has the same level of importance as conventional banking and can add benefits to economic productivity and growth at the same level of convenience. Furthermore, Islamic banking provides a unique contribution to macroeconomics for two reasons. First, since the Islamic financial system depends on sharing the loss and profit of the financed projects, the IFIs increase the conservation of its credit policies by evaluation of the investment projects before they provide the loan to the debtor.

For that reason, these IFIs provide more significant contribution than conventional banks, by putting at disposal reliable analytical information about the project's risks and because the Islamic finance methodology is based on the entire economic cycle, is using partnership financing, and is sharing the overall risk with the other parties, not only using the loan agreement.

This depends on generating money from money without the other factors of the economic cycle as in conventional banking; the Islamic financial system is considered more valuable to the economy (Belanès, Ftiti, and Regaïeg, 2015). However, Islamic banks have succeeded in surviving the financial crisis impact in 2008 by keeping large amounts of deposits. On the other hand, conventional banks have lost the confidence of their clients. However, there is another factor to be explained besides the performance of the financial banks. Muslim depositors who are Shariah-compliant have tried to increase the deposit volumes. Furthermore, Islamic banks provide Shariah-compliant banking products and services, these types of products having been put aside due to the crisis of Islamic financial products.

These products can be classified under three groups depending on the type of the h-compliant contracts, as follows: trading contracts such as Murabaha (buy and resell), Salam (forward contract), and Istisna'a (build and sell). Further types are profit- and loss-sharing contracts (partnership contract), such as Musharakah and Mudarabah, and leasing contracts such as Ijarah, which is rent charged against the usufruct of assets (similar to the operating lease). Another form of Ijarah is Ijarah Muntahia Bittamleek, a leasing that ends by transferring the title of the asset to the lessee (identical to commercial rental in conventional finance).

Furthermore, some other services provided by Islamic banks are based on the Shariah-compliant contracts of Wakalah, Kafalah. In these contracts, Islamic banks perform business transactions for their customers against predetermined service charges (Ali and Hussain, 2017). Murabaha is the most common Islamic financing product that is used by most clients. Murabaha is a type of sales transaction between two parties, the seller and the buyer, where the seller has to expressly disclose to the buyer both the original cost and the mark-up, as according to the radical Shariah standards.

By using Murabaha, Islamic financial institutions determine the price – which consists of the original cost and the mark-up (an interest-based loan) – for the underlying assets to sell them to the client (buyer) in advance, and then the client (buyer) has to settle the price of the underlying assets by postponed instalments.

Islamic financial institutions do not have to own the underlying assets before starting the Murabaha process; they can buy the underlying assets to the buyer's order and then resell it to the buyer. By both options, the Islamic financial institution assumes the risks of the underlying assets. However, the underlying assets have to comply with the Islamic Shariah standards (AAOIFI, 2015). Musharakah (partnership contract) is an agreement between several parties to achieve profit by merging the assets, services, or obligations. Mudarabah is a partnership in profit, whereby one party provides capital (Rab al-Mal) and the other party offers labour (Mudarib). Islamic financial leasing involves the conventional financial leasing with the same target, which transfers the title of the underlying assets to the lessee

(Baker, 2015). However, Razi (2014) identified certain aspects of the Islamic system that make the Islamic financial leasing different. The most significant difference consists in that the title of the underlying assets remains in the financial statement of the lessor (the Islamic financial institution) until the real transfer of the title of the underlying assets to the lessee takes place, meaning that it is just a contract for renting the usufruct of the assets, and then there are other contracts to transfer the title. On the other hand, conventional financial leasing requires the lessee to recognize the underlying assets in his/her financial statements. (As there are four optional contracts for transferring Islamic financial assets, the title of the asset will be clarified in the Islamic financial leasing accounting section.) This difference generates other differences such as: the lessor has to bear the insurance cost and the maintenance cost of the underlying asset; the underlying assets need to comply with the Islamic Shariah standards (Lateef, Abdurrazzaq, Shukor, and Tajudin, 2017). However, a detailed description of the Islamic financial leasing will be provided by illustrating its accounting requirements in the section on Islamic accounting.

## **2.2. Islamic Accounting Standards**

Mohammed et al. (2015) argued that since Islamic finance began to develop, accounting standards for Islamic financial institutions have not been provided. Designing such standards governing this type of finance needs to be both in line with the Islamic law and governed by Shariah contracts, which constitute the roots of Islamic finance. Accordingly, the Accounting and Auditing Organization for Islamic Financial Organizations (AAOIFI) was established in Bahrain in 1991. The AAOIFI published a substantial body of accounting and governance standards for the Islamic accounting institutions (AAOIFI, 2015). However, compliance with AAOIFI standards in the Kingdom of Bahrain was investigated by Sarea (2012) and Vinnicombe (2012), and they found a high level of compliance on the part of the Islamic financial intuitions with AAOIFI accounting standards. Zyadat (2011) found that the IFIs in Jordan are in compliance with both accounting and Shariah AAOIFI standards since the Shariah supervisory bodies of the Jordanian IFIs are entirely independent. This leads us to realize that most IFIs apply the AAOIFI accounting standard.

Hijazi and Tayyebi (2010) found KPMG and ACCA. They pointed out that there is a misunderstanding in the application of international and even local standards in Islamic banks as well as a lack of standardization of accounting practices in Islamic banks, such as the adoption of international accounting standards. This article will compare IFRS 16 leases, the financial leasing section, with the AAOIFI accounting standard (FAS 8) with a view to explain the differences and the possible practical problems for the lessee.

**Table 1.** *Comparison between IFRS 16 and FAS 8 regarding the criteria to be considered in the leasing process as a financial lease*

| Under IFRS 16  | Under FAS 8   |
|--|---|
| <p>The IFRS 16 set specific standards to determine the financial lease as follows:</p> <ul style="list-style-type: none"> <li>– “the lease transfers ownership of the asset to the lessee by the end of the lease term;</li> <li>– the lessee has the option to purchase the asset at a price which is expected to be sufficiently lower than the fair value at the date the option becomes exercisable that, at the inception of the lease, it is reasonably certain that the option will be exercised;</li> <li>– the lease term is for the major part of the economic life of the asset, even if the title is not transferred;</li> <li>– at the inception of the lease, the present value of the minimum lease payments amounts to at least substantially all of the fair value of the leased asset;</li> <li>– the lease assets are specialized such that only the lessee can use them without major modifications being made.”</li> <li>– “if the lessee is entitled to cancel the lease, the lessor’s losses associated with the cancellation are borne by the lessee;</li> <li>– gains or losses from fluctuations in the fair value of the residual fall to the lessee (for example, using a rebate of lease payments);</li> <li>– the lessee can continue to lease for a subsequent period at a rent that is substantially lower than the market rent.”</li> </ul> | <p>The Islamic accounting standard considers any leasing process as an operating lease unless there is another combined contract to transfer the ownership of the assets to the lessee; it will be a financial lease. In Islamic finance, this is called Ijarah Muntahia Bittamleek (AAOIFI, 2015). However, FAS 8 mentions four contracts that can be combined with the operating lease to make it a financial lease.</p> <ul style="list-style-type: none"> <li>– Gift contract<br/>The lessor includes in the combined agreement a promise to give the leased assets as a gift (for no consideration) to the lessee after repayment of all leasing instalments mentioned in the combined leasing contract.</li> <li>– Declining partnership<br/>According to this type of combined contract, the lessor concludes an off-balance partnership contract with the lessee, and the ownership of the leased assets is gradually transferred to the lessee regarding the leasing instalments since leasing instalments are divided into two portions, the first portion being considered as a revenue for the lessor and the second as part of the leased assets’ value.<br/>Moreover, both parties share the leased assets’ risk and the expenses regarding their share of ownership of the assets.</li> <li>– Nominal price contracts<br/>In this method, the ownership of the leased assets will be transferred to the lessee at any time if the lessee pays all leasing instalments and the nominal price, which are mentioned in the combined leasing contract.</li> <li>– Sales contract<br/>In this method, the ownership of the leased assets will be transferred to the lessee at any time if the lessee pays the actual price of the leased assets, which is mentioned in the combined leasing contract, and the leasing instalments paid by the lessee will be deducted from the total amount.</li> </ul> |

Sources : IASB, n.d.; AAOIFI, 2015)

**Table 2.** Comparison between IFRS 16 and FAS 8 regarding the recognition of the financial leased assets

| Under IFRS 16  | Under FAS 8   |
|--|---|
| <ul style="list-style-type: none"> <li>– “A lease is classified as a finance lease if it transfers all the risks and rewards incident substantially to ownership.”</li> <li>– “at the commencement of the lease term, the lessor should record a finance lease in the balance sheet as a receivable, at an amount equal to the net investment in the lease;”</li> <li>– “at the commencement of the lease term, the lessees should record finance leases as an asset and a liability at the lower of the fair value of the asset and the present value of the minimum lease payments (discounted at the interest rate implicit in the lease, if practicable, or else at the entity’s incremental borrowing rate);”</li> <li>“The depreciation policy for assets held under finance leases should be consistent with that for owned assets.”</li> </ul> | <ul style="list-style-type: none"> <li>– The IFI must recognize the leased asset under the non-current assets “items held for financial leasing”, and it must contain the whole risk of the financial leased assets.</li> <li>– The standard obliges the IFI as a lessor to apply all instructions of the operating leasing with regard to depreciation and maintenance expenses.</li> <li>– If the IFI is a lessee, it will also apply the instructions of the operational leasing for the recognition and the expenses.</li> <li>The standard does not mention any accounting treatment when the lessor or lessee is not an IFI.</li> </ul> |

Sources : IASB, n.d.; AAOIFI, 2015)

By comparing the differences between the standards, a problem may arise when a firm applying the IFRS 16 utilizes the Islamic financial leasing, since the FAS 8 enforces the IFI as a lessor to recognize the leased assets in its statement of financial position as assets held to financial leasing under the non-current assets section and does not mention any accounting treatment when the lessor or lessee is not IFI. On the other hand, under the IFRS 16, a firm that utilizes Islamic financial leasing as a lessee must recognize the leased assets in its statement of financial position as a right-of-use asset, and the lessor must derecognize the leased assets from his financial statements. IFRS 16 does not mention any special accounting treatment for Islamic financial leased assets. The effects of this phenomenon lead to the duplication of the assets since both the lessee, which is an IFI in most of the situations, and the lessor will recognize the assets in their statement of financial position. Moreover, in this case, both parties will bear the risk of the assets and do the depreciation and handling of other expenses, and this situation will severely affect the statement of profit or loss, especially on the lessee’s side. This conflict should be resolved to provide better financial information.

*Accordingly, the hypothesis of this article will be:*

HP: the lessee recognizes the Islamic financial leased assets among the long-term assets in the statement of financial position.

### **3. Methodology**

The methodology that is used to test the hypothesis is qualitative interviews with five financial managers of Jordanian firms utilizing Islamic financial lease and a theoretical comparison between the IFRS 16 and FAS 8. Transcripts differ in several characteristics from organized questionnaires. First, the relationship between the counterparty and the participant is not restricted. There is no list of questions that must be fully implemented. The researcher will have an intellectual framework for the study questions, drawing on his professional experience and qualifications in Islamic finance and accounting for conducting the interviews (Cassell, 2015). In particular, the questions raised will be distinguished according to the context of the interview and its preparation. Second, the qualitative researcher must diversify the styles applied in his interviews. The interview questions are developed through participants' answers and actions (Cassell, 2015).

### **4. Findings**

After the analysis of the interviews with five financial managers of various firms utilizing Islamic financial leasing, using the coding system, findings are connected with the comparative analysis between the IFRS16 and FAS 8. They responded to the question: "Do you recognize the Islamic financial leasing assets under the non-current assets?" with "Sure, yes, this is the only method I use." Their answers were similar concerning the importance of compliance with the IFRSs – "I do not need a qualified opinion audit report for the financial statements." Most of their responses to the question "Why does your company utilize the Islamic financial lease?" was "to avoid interest" and "to comply with the Shariah rules", one of them also mentioning the relationship between the general manager and an Islamic bank. The answers for the question "Do you know what the accounting treatment of the IFI for the leased assets is?" were as follows: "the IFI still owns the assets" or "I do not know." Responses to the item "It will be an accounting problem since you and the IFI recognize the leased assets under the non-current assets. Can you not recognize it as non-current assets?" were: "I have to follow the IFRS" or "It would be a violation of IFRS."

The most relevant response to the question "Has AAIOFI mentioned any accounting treatment for the lessee?" was "no", and the direct response was: "It should be."



## 5. Conclusion and Recommendations

This study has focused on the accounting treatments of firms that fully comply with IFRSs and utilize Islamic financial leasing. We found that these firms apply the IFRS 16 guidelines because they care about the external audit report, and the AAOIFI did not mention any accounting treatment for these firms when utilizing Islamic financial leasing. On the other hand, the literature review provided evidence that the IFIs complied with the AAOIFI accounting standards.

According to the above mentioned, it is clear that both parties of the Islamic financial leasing process recognize the leased assets in their statements of financial position under the non-current items, although in accordance with the IFIs designation. This recognition of the Islamic financial leased assets causes a problem of dual depreciation and of other expenses recognized by the two parties, who bear the risk of the Islamic financial leased assets. Accordingly, this leads to inaccurate financial information.

Therefore, the recommendations are as follows:

1. Propose this case to the International Accounting Standard Board to allow these firms utilizing Islamic financial leasing to not recognize Islamic financial leased assets in their statements of financial position and only make a disclosure about it in the footnotes.
2. Propose this case to the Accounting and Auditing Organization for Islamic Financial Institutions to include an accounting treatment of these firms utilizing Islamic financial leasing.

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