

AN EXPLORATORY STUDY OF IJARAH ACCOUNTING PRACTICES IN MALAYSIAN FINANCIAL INSTITUTIONS

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Prior studies on Ijarah were mainly focusing on the economics, legal and financial aspects, there was, however, so far no in-depth study on accounting for Ijarah. The main objective of this study is to explore the nature of accounting for Ijarah financial instruments as practiced by Malaysian financial institutions. First, the study makes a comparison between the International Accounting Standard on leasing (IAS 17); the accounting standard for Ijarah (FAS 8) as developed by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI); and the Malaysian Accounting Standard on leasing (MASB 10). The study found that there are major differences as to the nature of leasing and Ijarah, and as a result accounting principles that have driven all the three standards as well as accounting techniques developed for leasing and Ijarah are significantly different. Secondly, the study examines the level of acceptability of the AAOIFI's FAS 8 among the Malaysian financial institutions. The result of the questionnaire survey shows a low level of acceptability of FAS 8 and thus, it indicates that, first, the effort to harmonise the accounting practices on Islamic financing practices by financial institutions internationally may be a difficult task. Secondly, until and unless the AAOIFI standard is adopted by the regulatory agency as in the case of Malaysia, Bank Negara Malaysia, AAOIFI standards will remain only as a reference but do not have the legal authority. Consequently, the quality and comparability of accounting information of Islamic financing such as Ijarah will be seriously at a stake.

Introduction

Ijarah has been conceptually understood as a contract of exchange where one party enjoys the benefit arising from employment by another party in return for a consideration for the services rendered and from the use of an asset. Scholars of the four schools of Islamic jurisprudence (Shafi'ie, Maliki, Hanbali and Hanafi) have cited various definitions of the contract of *Ijarah*. In brief, these definitions agree on the fact that the contract of *Ijarah* is a contract on using the benefits or services in return for compensation (Kharofa, 1997).

There is a considerable body of research on the Islamic financial system in general. However, literature that specifically discusses the *Ijarah* contract is limited. The study is motivated to explore accounting issues in *Ijarah* due to the lack of studies on *Ijarah*. The scarce availability of literature written on the topic of *Ijarah* is due to several possible reasons. The most fundamental reason is the infancy stage of Islamic banking and finance as compared to conventional finance. The idea of Islamic finance was inspired by the first conference on Islamic economics in 1976. Obviously, *Ijarah*, which is part of Islamic finance, is very much in its early stages of development.

The first objective of this study is to examine the nature of *Ijarah* financing and its differences with conventional lease financing from the legal and accounting perspectives.

This is considered as important because without a proper understanding on the nature of *Ijarah* and the differences compared to conventional leasing, the conceptualization of the accounting implications for *Ijarah* may not be complete. Consequently, the second objective of this study is to determine the level of acceptability of Accounting and Auditing Organization of Islamic Financial Institution's (AAOIFI) accounting standard on *Ijarah* in Malaysia using questionnaire and interview survey among Malaysian's commercial banks. This is important to explore the current practices in Malaysia vis-à-vis AAOIFI standard. The findings will hopefully provide some insights into the nature and issues of accounting practices of an Islamic financial instrument.

Basic Principles of Islamic Financing and Ijarah

Islamic finance is an ethical, indigenous and equitable mode of finance, which derives its principles from the *Qu'ran* (The revealed book of Muslims), the traditions of the Prophet Muhammad (peace be upon him), and the *Shari'ah Islami'ah* (Islamic law), which is based on the *Qu'ran* and *Sunnah*. There are clear distinctions between Islamic finance and 'conventional' finance (Qureshi and Millet, 1999). These differences are derived from three main prohibitions by the *Shari'ah Islami'ah*. The first prohibition is against *riba'* (usury) that is intended to prevent exploitation and to maximize social benefits. Secondly, Islam prohibits *gharar* (uncertainty) in activities. *Gharar* is considered as not Islamic because it can cause injustice to another party. The third prohibition is against *maisir* (gambling).

One of the most important principles of Islamic finance is the scriptural injunction against *riba'* and there is now a general consensus among Muslim economists that *riba'* is not restricted to usury but encompasses interest as well. The prohibition of usury is ordained in Islam in all forms and intent. This prohibition is strict, absolute and unambiguous. The Holy *Qur'an* in verse 278 of Surah Al-Baqarah states: "*O ye who believe! Fear Allah and give up what remains of your demand for riba, if ye are indeed believers*", and verse 2: 279 says "*If you do it not, take notice of war from Allah and His Messenger, but if ye turn back, ye shall have your capital sums. Deal not unjustly and you shall not be dealt with unjustly*".

Riba' can be defined as predetermined payment over and above the actual amount of the principal. It is prohibited because while profit is legitimately allowed, the parties cannot predetermine a guaranteed profit. This is based on the principle of "uncertain gains" which, on a strict interpretation, does not even allow an undertaking from the customer to repay the borrowed principal plus an amount to take into account inflation.

Riba is also prohibited as it leads to injustice (*zulm*) and Islam is against all forms of injustice and exploitation and pleads for an economic system, which aims at securing extensive socio-economic justice. The Islamic law of prohibition of *riba*, which includes interest, was originally not based on economic theory but on Divine Authority, which considers the charging of usury is as an act of injustice.¹

Gharar is from the Arabic word which means risk, peril and uncertainty. It is a kind of sale, which involves giving an undertaking, which the seller is not certain to fulfill such as the sale of fish before they are caught. The prohibition of *gharar* is because it affects both the subject-matter and the price, which can generate unearned profit or an unacceptably

¹Siddiqui, S. H. Islamic Banking: True Modes of Financing. http://www.islamic-banking.com/ibanking/ibanking_aom/sh_siddiqui.php

huge loss. Hence, the motive behind the prohibition of *gharar* is the avoidance of risk in sale. Another rationale behind the prohibition of *gharar* is that, it depends not on the existence or non-existence of the goods, but on the vendor's obligation to deliver the subject-matter of the sale. If he is not in a position to do so, because, for example the contract contains an element of *gharar* risk, the transaction will be void according to the degree of *gharar* involved.

Literally, *Ijarah* means to give something on rent. As a term of Islamic *fiqh*, *Ijarah* can also refer to wages paid to a person in consideration of the services rendered by him. In the context of Islamic banking, *Ijarah* can be defined as a process by which the "usufruct of a particular property is transferred to another person in exchange for a rent claimed from him/her" (Hairetdinov, 1998). *Ijarah* has been conceptually understood as a contract of exchange in which one party enjoys the benefit arising from employment by another party in return for a consideration for the services rendered and from the use of an asset. This classical definition was the basis of many of the contracts of exchange even before the times of the Prophet and was popular amongst the *fuqaha* as documented in much of the literature. Since that time, the operation of these contracts developed to a higher level of sophistication during the period of the companions of the Prophet. However, the basis of operation remained confined to simple *Ijarah* contracts.

The basic feature of the *Ijarah* contract has been that it is a contract of exchange between one to another party (hereinafter called one-to-one *Ijarah*). For example, one party is given the right to use the services of a person or of a given asset from another party for a consideration. This contract has not involved the transfer of ownership to the other party as there has been no intention to purchase or to own the *Ijarah* object by the interested party. Over time, however, this concept has developed into transactions with more complex features that give rise to variations from the basic structure of the *Ijarah* transactions.

The distinguishing feature of this mode is that the assets remain the property of the Islamic bank to put them up for rent every time the lease period terminates so that they do not remain unutilized for long periods of time. Furthermore, there are some conditions that *Ijarah* transactions need to follow in order to be in consonance with the principles of Islamic finance. These conditions are mainly concerned with the object leased, the contract and the maintenance of the leased assets.

Basically, the lease contract must state the lease period clearly. Renewal terms must also be stated clearly, and things like the rentals for all subsequent years, after the first year, should not contain clauses like "left to the sole discretion of the lessor" and the like. It is also a condition that the subject of the contract must actually and legally be attainable. It is not permissible to lease something that cannot be delivered. Furthermore, it is permissible for the two parties to agree during the lease period to review the lease period or the rental or both. That is because the lease contract occurs periodically unlike the sale contract where the transfer of ownership is immediate. Part of the conditions also state that the lessor bears the liabilities when leasing the asset such as damage, payment of premium cost and basic maintenance. There is no objection to authorizing the lessee to undertake all the above but the costs thereof must be borne by the lessor or owner.

The Need for Harmonisation of Accounting Practices of Islamic Financial Instruments

The need for an accounting standard is not very different from the need for any other kind of standards, whether standards for weights and measures, or standards for clothing sizes, grades of beef, or baseball statistics (Mirza and Baydoun, 2000). The goal or objective of

an Islamic accounting standard is to facilitate comparisons and thereby minimize the social and economic costs of assessing the alternatives with which one is faced in making rational decisions.

Unless a proper disclosure with regard to the financial reporting, the underlying *Shari'ah* principles and the accounting methods adopted is made, the information contained in the financial statement will not be useful for a comparison of the performance of different Islamic banks (Hamat, 1994). Inadequate disclosure of the underlying *Shari'ah* principles will subject the Islamic banks' activities to a lot of questions with regard to their Islamicity. Thus, the need for standard accounting practices in the reporting of Islamic banks' operations is very clear.

The emergence of Islamic banks and financial institutions as relatively new organizations and the great challenge they face to successfully serve the societies in which they operate, have led them, together with specialists in Islamic *Shari'ah* and accounting, to seek the most appropriate means through which accounting standards could be developed and implemented in order to present adequate, reliable, and relevant information to users of the financial statements of such organizations. The presentation of such information is critical to the economic decision making process by parties who deal with Islamic banks and would also have a significant effect on the distribution of economic resources for the benefit of society.²

The structure and processes of Islamic banks do not readily fit in with those of conventional universal banking, which combines both commercial and investment businesses. This seems to have resulted in supervisory bodies adopting different approaches to regulate Islamic banking. Such variations in the regulation of Islamic banking appear, in turn, to have resulted in Islamic banks adopting different accounting treatments for the same transaction. This rendered the financial statements of Islamic banks non-comparable (Karim, n.d.).

Another major problem in the accounting and operation of Islamic banks is the lack of precision in the application of the *Shari'ah* principle to Islamic banking. The *Shari'ah* does not refer directly to banking or its accounting, but to broad issues relating to the prohibition of the paying and receiving of *riba*, transactions relating to pork, gambling, speculation, etc. Therefore, for Islamic countries to operate, in a practical manner, the application of *Shari'ah* principles to the accounting and operations of Islamic banks is important (Naser and Pendlebury, 1997.)

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is an organization that seeks to support the faith of Islam by developing accounting standards for Islamic investment vehicles. In 1991, several parties including practicing accountants and *Shari'ah* scholars helped set up the AAOIFI- a private sector standard-setting body in Bahrain with the aim of producing international accounting standards based on the *Shari'ah* precepts for Islamic banks and financial institutions.

In regulating the financial reporting of Islamic banks, the AAOIFI claims that financial accounting plays an important role in providing the information which the users of the financial statements of Islamic banks depend on in assessing the bank's compliance with the precepts of the *Shari'ah*. However, to perform this role effectively, accounting standards need to be developed and complied with by Islamic banks. The development of

² Concepts of Financial Accounting For Islamic Banks and Financial Institutions, AAOIFI, Para 1.

such standards must be based on clear objectives of financial accounting and agreed upon definitions of its concepts (Karim, 1995).

The growing need for accounting standards and the AAOIFI's regulatory effort have been focusing on certain of the Islamic investment vehicles (Pomeranz, 1997). The AAOIFI also expected to strengthen the effectiveness of *Shari'ah* committees by facilitating the evaluation of emerging financing instruments and by aiding in the implementation of Islamic ethics. Nonetheless, the AAOIFI seeks the implementation of its rules partly by getting central banks to adopt them and partly by trying to persuade Islamic institutions of their usefulness.

Furthermore, at present, the AAOIFI has neither the consent of regulatory bodies (e.g. central banks) nor the power to force Islamic banks to implement its proposed standards (Karim, 1995). Hence, in order to ensure compliance with its standards, the AAOIFI may have no choice but to obtain the support of the regulatory bodies concerned or to try to secure the cooperation of at least the major Islamic banks and their auditors.

Research Questions and Methodology

A review of the literature has shown the lack of studies undertaken to understand accounting practices for *Ijarah*. Most of the literature looked at the description of *Ijarah* financing (Qureshi and Millet, 1999; Hairetdinov, 1998; Al-Hathal, 1997; Cunningham, 1994; De Belder et al, 1993;). Some of the literature touched on the beefing up by Islamic financial institutions of their *Ijarah* (leasing) capacity in expectation of unprecedented future demand. It is also rapidly becoming the most popular form of Islamic finance (Collett, 1996; Collet, 1995). This creates a need to study the dynamics of this type of financing in order to address the lack of awareness and understanding of the accounting treatment of *Ijarah* financing.

There are two research questions in this study. The first is: "What are the differences between *Ijarah* and conventional leasing from accounting perspectives?" The second research question is: "To what extent the AAOIFI's accounting standard on *Ijarah* (FAS 8) is adopted in and acceptable to the Malaysian financial institutions?"

The data collection for the first question involves the review of the accounting standards. Thus, in order to have a better comparison between the *Ijarah* standard and conventional leasing even though conceptually leasing and *Ijarah* are different, it is necessary to study the standard of *Ijarah* recommended by the AAOIFI and compare it with the conventional leasing standard set by the International Accounting Standard (IAS 17) and the Malaysian Accounting Standard Board (MASB 10). This is due to the need to evaluate the similarities and differences of the concepts as well as the accounting requirements.

For the second research question, a survey research method is chosen to measure the level of acceptability of the AAOIFI's standard on *Ijarah*. Since the AAOIFI is the only standard setter for Islamic financial products, this research hopes to find evidence of its level of acceptability in Malaysia. This survey attempts to explore the nature of accounting practices on *Ijarah*. The questionnaire for this research was sent to the Islamic Banking Division of the financial institutions. The questionnaires were sent to a total of 14 financial institutions operating in Malaysia and the questionnaires were addressed to the manager or head of the Islamic Banking Division. Out of the 14 questionnaires, 13 replies were received and covering almost all of the financial institutions that were involved in *Ijarah* financing.

In Malaysia, there is a dual banking system whereby the Islamic banking system and the conventional banking system exist side-by-side. The legal basis for the establishment of Islamic banks was the Islamic Banking Act (IBA), which came into effect on 7 April 1983. The IBA provides Bank Negara Malaysia with powers to supervise and regulate Islamic banks, similar to the case of other licensed banks. The Government Investment Act 1983 was also enacted at the same time to empower the Government of Malaysia to issue government securities issued based on *Shari'ah* principles. The first Islamic bank to be established in the country was Bank Islam Malaysia Berhad (BIMB), which commenced operations on 1 July 1983.

In contrast, other institutions come under the jurisdiction of the Banking and Financial Institutions Act 1989 (BAFIA). The BAFIA, which came into force on October 1, 1989, provides for the licensing and regulation of institutions carrying on banking, finance companies, merchant banks, discount houses and money-broking businesses. However, the Islamic banks are not the only financial institutions involved in Islamic banking. In 1993, other financial institutions can also offer Islamic banking services through the "Islamic Banking Scheme".

A Comparative Study of AAOIFI FAS 8, IAS 17 and MASB 10

This section discusses the descriptive analysis of the comparative study between the AAOIFI's standard on *Ijarah* (FAS 8) and the leasing standards set by the International Accounting Standard (IAS 17) and the Malaysian Accounting Standard Board (MASB 10). The AAOIFI defines *Ijarah* as "ownership of the right to the benefit of using an asset in return for consideration" (please refer to appendix (B) Juristic Rules, FAS 8, Paragraph 1/1). Some *Islamic scholars* have included the duration of the benefit in the definition. As for leasing, the IAS 17 defined a lease as "an agreement whereby the lessor conveys to the lessee in return for rent the right to use an asset for an agreed period of time". The definition given by the MASB 10 is quite similar to the definition given by the IAS 17. The MASB 10 defined lease 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".

All the above definitions capture the element of exchange of usufruct for money transactions. Nevertheless, the definition given by the AAOIFI is furnished with extra conditions, which will distinguish *Ijarah* from conventional leasing. AAOIFI FAS 8 Juristic Rule 1/3/3/2 in the AAOIFI's standard (FAS 8) states that the fulfillment of the benefit should be of a permissible nature and the benefit should be in accordance with the *Shari'ah*. Thus, the AAOIFI's standard gives more detail with respect to the lawfulness of both usufruct and the rent. This is to ensure that *Ijarah* only signifies such an arrangement where both the usufruct and the return are permissible by the *Shari'ah*.

In contrast, the IAS 17 and the MASB 10 adopt a broader aspect of usufruct and return since religion is never an element to be observed by the standard-setters. Thus, strictly speaking, *Ijarah* cannot be equated to conventional leasing. The second aspect to be scrutinized is the types and principles of *Ijarah* and leasing. The AAOIFI's standard classifies *Ijarah* as Operating *Ijarah* and *Ijarah Muntahia Bittamleek*. The main criterion used in the classification is whether the lease includes a promise that the legal title in the leased asset will pass to the lessee at the end of the lease term.

The AAOIFI's standard on *Ijarah* states that when a lease does not include a promise that a legal title will pass to the lessee, it is classified as Operating *Ijarah* and if there is a promise it is *Ijarah Muntahia Bittamleek*. In essence, the subtle difference between *Ijarah* and

Ijarah Muntahia Bittamleek lies in the pre-existence of that promise whereby a lease concludes with the legal title passing to the lessee through either: (i) gift (transfer of legal title for no consideration); (ii) token consideration or other amount as specified in the lease; (iii) transfer prior to the end of a lease for a price equivalent to the remaining *Ijarah* installments; or (iv) a gradual transfer of the legal title (sale) of the leased asset.

In the IAS 17 and the MASB 10, a lease is classified as a finance lease if it transfers substantially all the risks and rewards incident to ownership of the asset from the lessor to the lessee. Title may or may not eventually be transferred. All other leases, which do not meet this criterion, are to be classified as operating leases.

A hire purchase contract for the hire of an asset would also fall within the definition of a finance lease. Hire purchase contracts in Malaysia contain provisions, which transfer the title of the asset to the hirer upon payment of all the hire purchase installments. *Al-Ijarah Thumma Al-Bai'* is the Islamic alternative to conventional hire purchase in Malaysia. It is a leasing ending with sale and consists of two different contracts i.e. the contract of lease and the contract of sale.

However, the standard does not elaborate the meaning of "transfer substantially all risks and rewards incident to ownership". It relies on the consideration of substance over form (IAS 1) in deciding whether a lease should be classified as a finance lease or an operating lease. The promise of the lessor to transfer the ownership of the leased asset to the lessee in the *Ijarah Muntahia Bittamleek* is not the same as the substance over form rule as in the IAS 17 and the MASB 10.

In the conventional lease, the referred component relates to the risk and reward incidental to ownership of the leased asset. In *Ijarah*, the lessor holds the ownership rights and obligations from the very beginning till the end of the contract. The lessor must accept responsibility for any defects of the leased asset, which impair the intended use of the asset, and may not exclude his liability for any impairment that the leased property may sustain.

Note that impairment caused by the lessee's misconduct is not borne by the lessor but by the lessee himself. However, maintenance costs should be taken from the lessor's pocket since it is his duty to maintain the asset. Juristic Rules 1/6 sums up the above principles where it states, "the lease property is the responsibility of the lessor throughout the duration of the *Ijarah*, unless the lessee commits misconduct or negligence".

As for the right of the lessor, AAOIFI FAS 8 Juristic Rule 1/5/2 outlines that "the lessee must use the leased asset in a suitable manner or in conformity with common practice and comply with conditions which are acceptable in the *Shari'ah*. He must also avoid causing damage to the leased asset by misuse through misconduct or negligence".

Therefore, in the *Ijarah* agreement, the ownership rights and usufructary rights are treated differently as they are detachable according to Islamic commercial law. In contrast, there seems to be no distinction made between ownership rights and usufructary rights by the IAS 17 and the MASB 10. In other words, there can never be a transfer of ownership risk in the *Ijarah* contract as it deals only with the transfer of usufruct. In the case of *Ijarah Muntahia Bittamleek*, transfer of ownership only takes place when both parties enter into a contract separate from the *Ijarah* contract (see AAOIFI FAS 8 Juristic Rule 2/3). The second contract is drawn up when the promise is fulfilled.

Between the AAOIFI FAS 8, the IAS 17 and the MASB 10, the major differences are the revenue recognition and the effect of residual value since the contracts of *Ijarah* and lease

are different in their substance. In addition, the IAS 17 reminds the lessor to record the uncertainties of collectability of lease rentals income and the future level of interest rates. As for the AAOIFI, no provision is recorded on interest rate uncertainty because the rental is fixed throughout the *Ijarah* term or the terms of payment are determined up front and the lessor cannot increase the rent unilaterally.

Furthermore, the AAOIFI does not mention the provision for doubtful debt in the case of *Ijarah*, as it might be understood that the provision is commonly practiced but the AAOIFI recommends the financial institutions to establish a provision for the repair of leased assets if the repair expenses differ from year to year over the lease term. This provision is significant under the *Ijarah* contract because ownership risk is borne by the lessor. Not recording the provision would underestimate the lessor's obligation.

Nevertheless, the AAOIFI is also concerned about the recording of the transaction of permanent impairment of the leased asset before the legal title is passed to the lessee. If that was due to the lessee's actions and the installment paid was more than the fair rental amount, then the lessor has to record the transaction as his liability and recognize it as a loss, which will be posted to the income statement. No such emphasis was given in the IAS 17 or the MASB 10.

On the issue of disclosure, all standards require the major class of assets of accumulated depreciation to be stated. In the IAS 17 as well as in the MASB 10, the method for income recognition and future minimum lease payment to be received for specified future payment must be disclosed. However, in the AAOIFI, since only one method of income recognition is recommended, no such disclosure is needed. In addition, a unique requirement in the AAOIFI disclosure is that lease assets for operating *Ijarah* and *Ijarah Muntahia Bittamleek* are to be distinguishable whereby assets for operating *Ijarah* are recorded as investment in *Ijarah* assets while assets for *Ijarah Muntahia Bittamleek* are recorded as *Ijarah Muntahia Bittamleek* assets.

The Extent of Acceptability of AAOIFI FAS 8 among Malaysian Islamic Financial Institutions

Most of the financial institutions in Malaysia adopted the MASB rather than the IAS and AAOIFI standards. A total of 11 out of the 13 institutions adopted the MASB in their practice. The reason that may cause this situation is that the MASB is the only standard setter in Malaysia. Therefore, financial institutions in Malaysia are supposed to conform to the MASB, as it is one of the regulatory bodies. Prior to the existence of the MASB, most of the financial institutions followed the IAS requirements. Hence, the IAS still enjoys a higher popularity than the AAOIFI standard. This is shown in that 4 financial institutions still use the IAS.

As for the AAOIFI, it is a new organization compared to the IAS. In addition, the AAOIFI is aimed at Islamic financial institutions. The conventional financial institutions may not be aware of the existence of the AAOIFI standard. Furthermore, this organization is based in Bahrain. Of the three standards, the AAOIFI gained the least number of adoptions by the financial institutions. Out of 13, only 2 institutions had adopted the AAOIFI. Only one institution uses all the three standards. The institution is Bank Islam Malaysia Berhad. As mentioned earlier, the AAOIFI standards are targeted at Islamic banks. Thus, Bank Islam should be aware of the existence of the AAOIFI's standard. As for the IAS, it had been there long before the MASB was established. Therefore, perhaps for this reason, Bank Islam still adopts the IAS. The MASB is mandatory for financial institutions in Malaysia; hence, Bank Islam is not excluded from conforming to the MASB.

Eight financial institutions were found to only use the MASB standard only. This is as expected as most of the financial institutions are conventional in nature. Therefore, they would not be aware of the AAOIFI's standard. In addition, it is only mandatory for financial institutions in Malaysia to adopt the MASB. However, one financial institution only adopts the IAS. The researcher finds this situation is rather peculiar. Even though the contents of the IAS and MASB are quite similar, as a local financial institution, one should not ignore the importance of the MASB.

This study attempts to provide evidence of the level of acceptability of the AAOIFI's standard on *Ijarah* in Malaysia. Although this research attempted to measure the level of acceptability of the AAOIFI's standard on *Ijarah*, it should be noted that the list of items used in the questionnaire does not comprise the second part of *Ijarah*, which is the *Ijarah Muntahia Bittamleek* (Financing Lease). It only comprises normal *Ijarah* or operating leases. Since the AAOIFI is the only standard setter for Islamic financial products, this research hopes to find evidence of its level of acceptability in Malaysia.

As for the level of acceptability of the AAOIFI's standard on *Ijarah*, the average score or mean is adopted. It is expected to give a clear understanding of *Ijarah* financing practices in Malaysia. The respondents were asked to indicate the extent to which each item has been implemented in their organization on a five-point Likert scale from 1 to 5. A one (1) was to be assigned if it was totally not applicable for the item to be implemented in their organization and five (5) was to be assigned if it was totally applicable to be implemented in their organization. The points 2 to 4 were to be used to indicate varying degrees of intermediate applicability.

Table 1: Mean 3 and above (relatively strong support for the AAOIFI's standard)

Item	Attributes	Mean
1.	<i>Ijarah</i> revenue shall be allocated proportionately to the financial periods in the lease term.	4.33
2.	<i>Ijarah</i> revenue shall be presented in the income statements as <i>Ijarah</i> revenue.	3.67
3.	Initial direct cost, if material, be allocated to periods in the lease term.	3.36
4.	Initial direct cost, if immaterial, charged directly in the income statement as an expense.	3.09
5.	Asset acquired for <i>Ijarah</i> shall be recognized at historical cost.	3.00
6.	Reduction in estimated residual value shall be recognized as a loss.	3.00
7.	Leased assets shall be depreciated consistent with lessor's normal depreciation policy.	3.00

Out of 15 items that have been analyzed, 7 have a mean score of 3 and above. The range of the mean is from 1 to 5, therefore, a score of 3 and above is considered a strong support for the AAOIFI's standard on *Ijarah*.

The highest score is of the level of acceptability for statement that *Ijarah* revenue shall be allocated proportionately to the financial periods in the lease term. Most of the financial institutions that were involved in this survey agreed on this statement. It is quite similar to the accounting standard set by the IAS and MASB. In Paragraph 52 of the IAS 17 mentions that rental income should be recognized on a straight-line basis over the lease term. In addition, Paragraph 49 in the MASB 10 also mentions the same thing. Both the IAS 17 and MASB 10 use the phrase "recognized on a straight-line basis over the lease term". In other words, the rental revenues should be allocated proportionately over the lease term. Hence, it has been a common practice in Malaysia that *Ijarah* revenues are allocated proportionately over the lease period.

The second highest score is for the statement that *Ijarah* revenue shall be presented in the income statement as *Ijarah* revenue. Most of the *Ijarah* practitioners in Malaysia also agreed with this standard. Therefore, it is clear that what has been practiced in this matter conforms to the AAOIFI's standard. Nevertheless, Paragraph 49 in the MASB 10 states that lease income from operating leases should be recognized in income on a straight-line basis over the lease term. While, in Paragraph 27 of the IAS 17, under operating leases, it states that rentals receivable are included in income over the lease term. Both the IAS 17 and MASB 10 agree that the lease income or the rental receivable is recognized as income or revenue. Hence, the standard set by the AAOIFI in this particular matter does not contradict the standards set by the IAS and the MASB.

The statements by the AAOIFI on initial direct cost also fall under the category that has a mean of 3 and above. The first statement mentions that if the initial direct cost is material, it shall be allocated to periods in the lease term. In this matter, the study assumes that what has been practiced in Malaysia regarding the initial direct cost is by chance is a common sense. If the cost is material, it should be allocated to periods in the lease term and if it is immaterial, it should be charged as an expense. In addition, the IAS 17 and MASB 10 also have the same standard, which applies to the initial direct cost. Paragraph 30 of the IAS 17 states that initial direct costs incurred specifically to earn revenues from an operating lease are either deferred and allocated to income over the lease term in proportion to the recognition of rental income or are written off in the period in which they are incurred. The MASB 10 also states the same thing about initial direct cost under the operating leases (please refer to Paragraph 51 of the MASB 10).

However, both standards set by the MASB 10 and the IAS 17 did not mention the level of materiality of the initial direct cost. It is only mentioned that initial direct costs are either allocated to income over the lease term or are recognized as an expense. This is different from the AAOIFI's standard, which has segregated the treatment of the initial direct cost according to its level of materiality.

The AAOIFI's standard also states that the acquiring of assets for *Ijarah* shall be recognized at historical cost. However, the IAS 17 and the MASB 10 are silent on the acquiring of assets under operating leases. Nevertheless, Paragraph 8 of the IAS 17 did mention that the rights and obligations arising from a finance lease are recorded at the beginning of the lease term at the fair value of the leased property. In addition, Paragraph 15 of the MASB 10 also states the same thing. As for the case of operating leases, there is no statement regarding the recognition of the asset.

The AAOIFI standard on *Ijarah* also states that a reduction in the estimated residual value should be recognized as a loss. Nevertheless, the IAS 17 and MASB 10 are also silent on the case of reduction in estimated residual value under operating *Ijarah*. The treatment for a reduction in estimated residual value is only stated under the finance lease. For example, Paragraph 17 of the IAS 17 states that if there has been a permanent reduction in the estimated un-guaranteed residual value, the income allocation over the lease term is revised and any reduction in respect of amounts already accrued is charged to income immediately. The same treatment is used under the MASB 10. Paragraph 39 of the MASB 10 states that any reduction in the estimated un-guaranteed residual value in respect of amount already accrued is recognized immediately.

The last statement by the AAOIFI that falls within this category is related to depreciation of leased assets. The statement states that leased assets shall be depreciated consistent with the lessor's normal depreciation policy.

Table 2: Relatively medium support for the AAOIFI's Standard (Mean of 2.5 to 2.99).

Item	Attributes	Mean
1.	Leased asset shall be depreciated according to lessor's normal depreciation policy.	2.83
2.	At the end of a financial period, amortization of initial direct cost, if material, shall be recognized as an expense.	2.83
3.	At the end of financial period, <i>Ijarah</i> installments receivable shall be measured at their cash equivalent value.	2.83
4.	Repair of leased assets, if material, shall be recognized in the financial period.	2.75
5.	Leased assets shall be presented in the financial statement under Investment in <i>Ijarah</i> Asset.	2.73

Table 2 shows the AAOIFI statements that have a mean of between 2.5 to 2.99. This category of mean is considered as medium support for the AAOIFI's standard. There are 5 statements that fall within this category.

The highest mean score from this category is for the statement asserts that a leased asset shall be depreciated according to the lessor's normal depreciation policy. It is assumed that if a statement in the AAOIFI standard is similar to one in the IAS 17 and MASB 10, then the mean should be higher or at least 3.00. This assumption is based on Paragraphs 29 and 53 of the IAS 17 and Paragraph 54 of the MASB 10. These paragraphs clearly state that under operating leases, the depreciation of leased assets should be on a basis consistent with the lessor's normal depreciation policy for similar assets. Therefore, the researcher feels surprised that the above statement made by the AAOIFI has a mean below 3.00 although the IAS 17 and MASB 10 have proposed the same treatment.

The AAOIFI's standard also states that at the end of the financial period, the amortization of initial direct cost, if material, shall be recognized as an expense. At the end of the financial period also, the AAOIFI's standard states that *Ijarah* installments receivable shall

be measured at their cash equivalent value. Another statement that also falls within this category is related to the repair of a leased asset. The statement asserts that if the repair of a leased asset is material, it shall be recognized in the financial period.

The above results are not unexpected as neither the IAS 17 nor the MASB 10 mentioned anything about the amortization of initial direct cost, or the measurement of *Ijarah* (operating leases) installment receivable, or the treatment of repair of leased assets. These treatments only exist in the AAOIFI's standard on *Ijarah*. Therefore, it is assumed that the treatments are not popular with most of the *Ijarah* practitioners in Malaysia; thus, they have a lower mean score. This assumption is based on the fact that most of the *Ijarah* practitioners follow the IAS and MASB because they are more familiar with these two standards than the AAOIFI's standard.

The last statement that falls within this category is the statement that leased assets shall be presented in the financial statement under investment in *Ijarah* assets. On the other hand, Paragraph 49 of the MASB 10 and Paragraph 43 and 51 of the IAS 17 have a different opinion on this matter. Both the IAS 17 and MASB 10 agree that the lessors should present assets subject to operating leases in their balance sheet according to the nature of the asset and usually as property, plant and equipment. It can be rationalized that the different treatment by the IAS 17 and MASB 10 has led to a lower mean score for the statement set by the AAOIFI on the matter of asset presentation in the financial statement.

It can be concluded here that the main reason some of the statements set by the AAOIFI have a score lower than 3 (in this case from 2.5 to 2.99) is that they are treated differently compared with the IAS 17 and MASB 10 and some of the treatments only exist in the AAOIFI's standard and not in the IAS 17 and MASB 10. Furthermore, most of the *Ijarah* practitioners in Malaysia are still using the IAS 17 and MASB 10 as their main guidelines for *Ijarah*. This can be verified by the survey conducted on the adoption of accounting standards by financial institutions (please refer to Table 1).

Table 3: Relatively weak support for the AAOIFI's Standard (Mean less than 2.5).

Item	Attributes	Mean
1.	Repair of leased asset, if material and differing in amount from year to year, a provision for repairs shall be established.	2.25
2.	If a provision for repairs has been established, cost of repairs shall be charged against the provision.	2.08
3.	If lessee undertakes repairs with the lessor's consent and the costs are chargeable to the lessor, then the lessor shall recognize these repairs as an expense.	2.00

Table 3 shows a list of the AAOIFI's statements that have a mean of less than 2.5. This category is considered as weak support for the AAOIFI standard. There are 3 statements that are included in this category.

All three of the statements are related to the repair of leased assets. The first statement is that a provision for repairs shall be established if the repair is material and differing in amount from year to year. The second statement by the AAOIFI is that if a provision for repairs has been established, cost of repairs shall be charged against the provision. The third statement highlights that if the lessee undertakes repairs with the lessor's consent and

the costs are chargeable to the lessor, then the lessor shall recognize these repairs as an expense.

Most of the *Ijarah* practitioners give a low score to these statements. The reason behind this scenario is that most of them agreed that the repair of the leased asset is totally under the lessee's responsibility. Therefore, the financial institutions that act as a lessor do not have any concern about matters that relate to the repair of the leased asset. Furthermore, the IAS 17 and MASB 10 are also silent on the repair of leased assets. Thus, it gives a low mean score to these statements.

Nevertheless, the lessee should bear the maintenance expenses to keep the leased assets in good working order and be responsible for replacing any worn or damaged parts (Abdullah, 2000; Hairetdinov, 1998). But in other examples, the parties to the lease agreement agree that the main maintenance work must be the responsibility of the lessor and the periodical and partial maintenance is to be assigned to the lessee as it is considered regular and may be considered part of the rental.

Another possible reason that these statements have a low mean score is perhaps that the *Ijarah* practitioners themselves are uncertain how to tackle *Ijarah* issues as most of them are following the IAS 17 and MASB standards for leasing, whereas what they are actually doing is *Ijarah* financing. In addition, Paragraph 4 of the MASB 10 states that this standard does not deal with Islamic leases as these will be dealt with under separate Islamic Accounting Standards.

Furthermore, they may not be aware of the existence of the AAOIFI's standard on *Ijarah*. Therefore, they still use the MASB 10 and IAS 17 as guidelines. This situation may be due to the lack of promotion or concern given by the higher authorities responsible for Islamic banking products in Malaysia to the adoption of the AAOIFI's standard. In other words, the AAOIFI's standard is not mandatory to be implemented in Malaysia. Hence, not many of the financial institutions are adopting the standard.

Conclusion

The findings on the comparison between *Ijarah* and conventional leasing from the legal and accounting aspects showed that there are significant differences between these two contracts. Hence, *Ijarah* should not be seen as an imitation of conventional leasing since the definitions, types, principles, objectives, presentation, measurement methods, disclosure and substance of *Ijarah* are dissimilar to those of conventional leasing.

It can be concluded here that the main reason why some of the statements set by the AAOIFI have a score lower than 3 is that AAOIFI treats them differently compared with the IAS 17 and MASB 10 and some of the treatments only exist in the AAOIFI's standard and not in the IAS 17 or the MASB 10. Furthermore, most of the *Ijarah* practitioners in Malaysia still use the IAS 17 and MASB 10 as their main guidelines for *Ijarah*. Another reason why these statements have a low mean score is perhaps that, the *Ijarah* practitioners themselves are uncertain how to tackle *Ijarah* issues as most of them are following the IAS 17 and MASB standards for leasing, whereas what they are actually doing is *Ijarah* financing.

Furthermore, they may not be aware of the existence of the AAOIFI's standard for *Ijarah*. Therefore, they are still using the MASB 10 and IAS 17 as guidelines. This situation may be because of the lack of promotion or concern given by the higher authorities responsible for Islamic banking products in Malaysia to the adoption of the AAOIFI's standard. In

other words, the AAOIFI's standard is not mandatory to be implemented in Malaysia. Hence, not many of the financial institutions are adopting the standard.

This study highlights the divergence of accounting practices on *Ijarah*. From the questionnaire survey, it is discovered that most financial institutions used Malaysian accounting standards on leasing (MASB 10) as a guide for accounting practices on *Ijarah*. This low level of acceptability of AAOIFI FAS 8 is not unexpected due to the fact that AAOIFI's standard was initially designed for Islamic financial institutions and not financial institutions that undertake Islamic financing transactions. However with the introduction of FAS No.18, Islamic Financial Services offered by Conventional Financial Institution to be effective January 2003, non-Islamic financial institutions are expected to comply. In Malaysia GP8 (Malaysian Central Bank's rules and guidelines on financial reporting) is the regulatory device that influences financial reporting of financial institutions. A small sample size of 13 responses would be indicative rather than conclusive as to indicate the level of acceptability. Future research may try to include a profile analysis developed through focus group survey. Hence, it may be able to capture more useful information for the study.

This study also indicates, subject to further study on other Islamic financial instruments and other Islamic countries, the effort to harmonise the accounting practices on Islamic financial instruments offered by financial institutions internationally may be difficult task. Until and unless it is adopted by the respective countries regulatory agencies, AAOIFI standards will remain only as a reference but do not have the legal authority. Significant efforts are required from the AAOIFI through publicity negotiation, and lobbying process to "market" its accounting standards to further enhance the credibility and comparability of accounting information of Islamic financing such as *Ijarah*.

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