IJARAH LEASING

INTRODUCTION

Today, starting a business is not an easy task as there exists stiff competition in all the sectors of the economy. Moreover, the start-up capital requirement for any business is very high.Further, with the expansion of international trade, global economy and the development in the technology has further made it essential for the corporate houses to assess the alternative financial institutions so as to fulfil their financial requirements. Ijarah (leasing) can be considered one of the alternative approaches that companies can work upon in order to meet their requirements. Instead of buying an asset, this method provides an opportunity for the companies to use the asset to meet their goals. This method is best suited for those assets which become outdated very frequent such as technology, which changes every now and then (Shubber, 2011).

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The benefit of using this approach is that, the company doesn’t have to worry about the investment made on the technology as they do not have to incur costs on them. But, this Ijarah (leasing) is bit contradict to international regulations and Islamic principles. This report will discuss the similarity between Ijarah contract and conventional leasing. Further, it will also describe the range of Ijarah-based contracts used by Islamic Financial Institutions. Further, it will also highlight the financial and operating lease by focusing on differences and similarities between leasing and Ijarah. Moreover, it will also discuss the different accounting treatments used by it. The final section of the paper will describe the different accounting standards recommended by the International Financial Reporting Standards (IFRS) and Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). At the end of this work, some suggestions will be made which will help in squaring up the differences in interpretation between these approaches (Ahmad and Luo, 2010).

Ijarah contract is a form of Islamic leasing contract which involves two parties. First is the lessor and the second party is the lessee. Under such contracts the lessor transfers the right of using specific assets for pre decided period of time by both the parties and gets specific amount of rental in against of the use of the asset at a predetermined price. Under this contract, the ownership of the assets remains with the lessor and legally the lessor is responsible for any kind of risk associated with the assets such as maintenance cost, natural wear and tear, costs associated with repairing of the assets, etc. But, if the damages are aroused due to mal handling and negligence of the lesser, in that case the lesser will have to bear the compensation (Taap and et. al., 2011). Apart from this, the term Ijarah is sometimes interchanged with Ijarah Amal. Ijarah Amal means to employ an individual in order to accomplish work on one’s behalf. The best example is the salaries given by the company to its employees. Although, in Ijarah leasing contract, the ownership is not legally transferred to the lessee, but recently a new type of Ijarah contract has been developed and named as Ijarah Muntahia Bittamleek. Under such type of contract, at the end of the contract the ownership of the asset is transferred to the lessee or it can be said that the lease contract ends with the sales of the asset (Shubber, 2010).

On the other hand conventional leasing contract can be defined as a contract in which the lessor gives the right of using the asset to the lessee for a specific period of time and rent determined at the time when both the companies entered into the contract. In such contracts, ownership of the asset is not transferred to the lessee and all it is the liability of the lessor to bore all the expenses associated with the assets if they are aroused due to situations which are not in control of the lessee. At the end of the contract, the asset is transferred back to the lessor (Shubber, 2008).

The range of ijarah based contract used by Islamic Financial Institutions is very wide. Some of the different types of Ijarah contracts are discussed below:

Simple Ijarah: This type of contract is quite similar to that of conventional operating lease contract. Most of the time this Ijarah contract is made for those assets which are costly and the individual or the company has to invest huge capital. Further, it is also made for those assets which are highly profitable in the market. In operating lease contract, the lessor has the ownership of the assets and all the expenses such as maintenance and depreciation of assets, etc. are to be bear by the lessor. Under Ijarah leasing, the lease period if generally short and the lessee do not require to pay the full amount of the asset during the leasing period. Further, the lessee has right to terminate the contract by giving prior notice to the lessor. Finally, when the contract period gets over, the assets are again transferred to the lessor and then if needed he can get into contract with another party if the asset is operating properly, otherwise the asset is considered as scrap. Below are some of the examples of simple Ijarah (Introduction to Islamic Banking & Finance, 2008).

Firstly, the bank can buy the asset from the market and then can lease out to the customers for specific periods and at certain rental. In this case the bank is the vendor. This approach is ideal Ijarah from Islamic point of view.

The second example involves third party vendor. In this, firstly the customer or the lessee chooses the asset which he wants to lease from the financial institute. Then the bank buys that asset from its vendor and forwards it to the customer who is lessee under some lease contract.

Finally, in order to save administrative cost, the bank instead of buying directly from the vendor, appoints customer as its agent and give him right to buy the asset from the vendor and then leases it to the customer. So customer acts as both agency and lessee to the bank (Islamic Finance: A Practical Guide, 2008).

jarah Mausufah Fi Zhimman: This type of lease agreement is similar to that of forward lease contract. Ijarah Mausufah Fi Zhimman contract is considered as an Ijarah based contract and is accepted by the Shariah Advisory Council of the Securities Commission of Malaysia. In such kind of lease agreement, the asset is not owned by the lessor at the time when the agreement is made between the two parties. But during the time of contract, complete information regarding the asset is included in the contract so as to avoid confusions between the parties. Moreover, the cost of the asset and the period of the lease agreement are also mentioned in the agreement. Depending on the agreement made between the parties, lessee can either pay fixed rentals or variable rentals. Further, it also tells when the lessee can use the asset. Ijarah Mausufah Fi Zhimman is similar to that of bai salam (Weir, 2009). The only difference between the two is in the spot payment. In Bai Salam, the lessee has to make payment in the advance whereas in Ijarah Mausufah Fi Zhimman the lessee does not require to pay any instalment during the lease contract. If the assets do not match the specification specified in the contract, the lessee has right to reject the asset and can ask for its replacement. If the lessor is unable to replace the asset before a specific time, in that case lessee holds the right to cancel the agreement and if the contract is cancelled lessor has to refund the entire amount (Zaman, 2010).

Ijarah Muntahia Bittamleek: This type of Islamic lease contract is similar to that of conventional financing lease. The basic difference between this kind of lease and simple Ijarah lease is that in this it is not necessary that at the end of the agreement the asset does not belong to the bank. Ijarah Muntahia Bittamleek is helpful for those individuals and business who do not have enough financial sources to purchase a useful asset. Moreover, as under such kind of the leasing contract, the lessee does not have to borrow the asset cost from the financial institute, thus, their financial statements show a less degree of leverage enjoyed by the company (Open to comparison: Islamic finance and IFRS, 2010).

Under such leasing agreement, based on the demand and needs of the lessee, the lessor or the bank buys the asset and then leases it to the lessee at a pre decided rent and period. Once the contract is matured, the lessee becomes the owner of the underlying asset. Therefore, such lease agreement includes a point that the lessor has to transfer the ownership of the asset to the lessee during or at the maturity of the lease agreement. This can be achieved by either of the following manner:

By selling the asset to the lessee at a predetermined price at the end of the contract

By gifting it to the lessee

Ownership can be transferred gradually

Under this type of contract, during the leasing period the cost of the asset is amortized. This type of contract cannot be cancelled by the lessee before paying the amount incurred on the losses if any. This leasing contract consists of two main agreements. Firstly, to shift the ownership of the asset and secondly, the selling contract. When the contract is matured, the lessor has to keep his promise. But the right of exercising the contract remains with the lessee. As, during the leasing period, the lessor is the legal owner of the asset, thus, it is his responsibility to meet all the expenses associated with the asset during the contract period. The sole responsibility of the customer is to pay timely rentals for using the assets (Rahaman and Zainuddin, n.d).

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Till now the report focused on the different types of Ijarah contracts. Now, in this section the report will focus on the similarities and the differences between the conventional leasing contract and an Ijarah contract. If compared to operating lease, simple Ijarah is quite similar to it in many senses. Firstly, once the asset is received by the lessee, the lease payments are started. Moreover, during the entire lease period, the ownership remains with the lessor and thus he is responsible for all the risks associated with the assets. Until and unless, if the contract does not specify any points about the termination of contract, the lessee can terminate the contract whenever he wants. There exists one difference between simple Ijarah and operating lease and it is that in operating lease if the lessee is not able to make timely payment of rental, the lessor has a right to charge late payment charges at certain percent, but simple Ijarah, the lessee can charge only that much amount which is equal to his loss as penalty (Hidayat, 2011).

Similarly there exist some similarity and differences between Ijarah Muntahia Bittamleek and financial lease. In both the cases, the ownership is transferred to the lessee at the end of the agreement. Further, the lessee has to amortize the entire amount during the leasing period. The difference between the two exist is due to the number of contracts made in the contract. In conventional financing lease, both sale and lease agreement are included in single lease agreement while, in the case of Ijarah Muntahia Bittamleek both the sale and lease agreements are drafted in a separate contract (Ijarah, n.d). Moreover, in conventional financing lease all the loss is borne by the lessee, but in case of Ijarah Muntahia Bittamleek contract, all the losses are to be borne by the lessor. Only those losses which arise because of mal handing of assets are borne by the lessee. Furthermore, in Ijarah, all the costs related insurance of the asset are borne by the lessor under the Takaful or Islamic insurance. Moreover, costs incurred in purchase of assets such as registration fee, customs duty, import cost are determined on the basis of rental amount (Comparisons Between Ijarah and Conventional Operating Lease Contracts, 2011).

The next section of the report will discuss the AAOIFI standards and IFRS recommended accounting treatment of Ijarah (leasing) contract. According to the IAS 17 lease document, a lease contract is considered as financial leasing if all the risk, cost and rewards associated with assets during the lease period transfer to the lessee. On the other hand, if some risk or reward or cost is shared by the lessor, in that case the contract is regarded as operating leases. If the lease contract is financed, in that case the lease is reported as receivable in the financial statement of the lessor and it is equal to the investment made by the lessor on the asset (Causse, 2012). Further, income generated from the lease agreement is reported as revenue in the income statement of the lessor. On the other hand, in the lessee’s financial statement, the lease is reported under assets and liability side. Under asset side the fair value of the asset is reported whereas under liability side the present amount of the remaining lease payments is recorded. Depreciation is also charged on the assets and is recorded in the financial statement. All the payments made by the lessee as rentals are recorded under expenses in the income statement (Choudhury, 2011).

Under Islamic rule, risk must be equally shared by the lessor as Shariah principle focuses on the form of the transaction and not on the substance. Therefore, under this the financial lease is considered as an operating lease and a promise is made by the lessor to the lessee to transfer the asset at the maturity of the contract. That is, there exist both; a lease contract and a sales contract, and because of this, the lessor has to bear all the cost and risk associated with the asset during the entire leasing period. Moreover, at the end of the lease contract, if the asset is gifted to the lessee, the lessor has to charge depreciation so as to make the residual value equals zero (Napier, 2011). But, if the assets are exchanged with some predetermined amount, this amount must be subtracted while determining the depreciation amount. In Ijarah, the rentals or the instalments are reported as income in the income statement of the lessor on an accrual basis, while, lessee reports the rental or assets as expenses on his income statement. The ijarah and conventional leasing differs in certain accounting standards (Ridzwa and Shanmugam and Perumlal, 2005).

For example, if first company goes for financial leasing agreement with Islamic bank and the second goes for financial leasing agreement with conventional bank for a similar asset, then after some time if they want to breach the contract, then the Islamic bank will consider the productive life of the asset in determining the depreciation rather that lease period and then on the basis of the difference between the two amounts, the figure will be recorded as profit or loss in the income statement. In this case, only the prior instalments will be borne by the lessee. But in case of the conventional financial leasing agreement, the lessee is not allowed to cancel the lease agreement as legally he is the owner of the asset and the contract is considered as financial leasing and not the operational leasing (Iqbal and Greuning, 2008).

On the other hand, for operating leasing contract, AAOIFI and AFRS recommend near about same accounting treatment. That is, the owner of the asset is the lessor and it will be reported in its balance sheet under assets side. Further, he has to record depreciation also earned income from the lease instalments will be recorded as income in the income statement while lessee will record only expenses in the income statement arising due to the payment of instalments (Mac Kee, Mac Kee and Garner, 1999).

SUMMARY

Starting any business in the present business environment is very challenging task as start-up capital requirement for any business is huge. Further, it is very difficult for the corporate and business houses to have easy access to the financial institutions from where they can raise the funds. In such situations, companies have to go for some other kind of financial institutions which can easily cater their needs with minimum process and other requirements. For such corporate or business houses, Ijarah (Leasing) is proving to be a good alternative to conventional financial institutions and conventional leasing. Under Ijarah leasing corporate do not have to purchase the machine rather, this leasing technique provides them an opportunity to use the equipment to attain their aims and objectives. Therefore, it is best suitable for all those business houses which frequently require updation in their technology. The most significant advantage of such financing to the companies is that they don’t have to invest much on fixed assets and technology (Shubber, 2011).

Two parties are involved in any Ijarah contract, the first party is the lessor and the second party is the lessee. Although, the ownership of the asset will remain with the lessor and he will have to fulfill all the legal risk associated with the asset, the lessee just has to pay periodic rental for using the asset for pre decided time. Many a times the word Ijarah is interchanged with the word Ijarah Amal, which means a person can employ another person for completing a particular work on his or her behalf. In recent time a new type of contract named Ijarah Muntahia Bittamleek has been developed under which, at the end of the contract period, the contract is sold to the lessee that is, the possession of the property or asset will be transferred to lessee. On the contrary, in a conventional leasing contract, the ownership of the asset is not transferred and the lessee has to make periodic rental payments (Napier, 2011).

The Islamic financial institutes have wide options of Ijarah to choose from, but the most common of them are: Simple Ijarah, Ijarah Mausufah Fi Zhimman and Ijarah Muntahia Bittamleek. In Simple Ijarah contract, contracts for those assets are signed which are very costly and requires huge investment. Under this, the leasing period is comparatively short and the lessee do not have to pay the entire cost associated with the asset. This kind of contracts can be terminated before the maturity date and are considered similar to that of conventional operating lease. In Ijarah Mausufah Fi Zhimman neither the lessor, not the lessee owns the assets at the time of the contract. On the basis of the requirement of the lessee, the lessor purchases the asset and leased it to the lessee. It is bit different from the Bai Salam, as under Bai Salam the lessee has to pay entire amount upfront, but in this the lessee pays regular installments. It is similar to forward lease contract. In Ijarah Muntahia Bittamleek, the lessee does not have to make any take any kind of loan from the financial institutes there for have lower degree of leverage. In this, according to the need of the lessee the purchases the asset and leases it to the lessee. During or at the maturity, the ownership has to be transferred to the lessee (Ijarah, n.d).

Ijarah contract has some similarities and differences as compared to conventional leasing. Features of Ijarah leasing is similar to that of conventional operating lease, that is, no sooner the asset is made available to the lessee, the rental payment starts. Similarly, the ownership of the assets is not transferred to the lessee and is remained with the lessor throughout the contract period. Therefore, it is the responsibility of the lessor to bear all the risk associated with the assets. Moreover, if not specified in the contract, the lessee can terminate the contract at any moment of time. Difference between simple Ijarah and operating lease is that in operating lease if the lessee is not making timely payment of rentals against the use of te property, the lessor has all rights to charge late payment charges. On the other hand, in simple Ijarah, the maximum amount that can be charged by lessor is equal to his loss because of non-payment of late payment. Moreover, in conventional leasing both lease and sale contracts are included in one contract while, in Ijarah Muntahia Bittamleek, separate contracts are drafted. Thus, Islamic leasing is bit different from that of conventional leasing and provides an additional opportunities to the business from where it can raise funds (Ahmad and Luo, 2010).