

# A COMPARISON OF CONVENTIONAL LEASE AND ISLAMIC LEASE (IJARAH)

Mazni Abdullah

## Abstract

*Leasing arrangement which is widely practiced in the business operation to acquire the physical asset is also permitted in Islam in which the evidence is shown in the Quran and Hadith. It must be noted however that the Islamic lease and conventional lease contract as practices today are different in their underlying principles. In view of this, this paper attempts to compare between the conventional lease and Islamic lease or Ijarah by referring to the guideline prescribes under the conventional accounting standard and Islamic accounting standard. A discussion in this paper might give some insights to the users of the financial statements or the public in understanding the differences between conventional lease and Islamic lease (Ijarah).*

**Keywords:** *Conventional lease, Ijarah, Accounting Standards.*

## Introduction

Leasing arrangement is not something new to the economic environment. The existence of leasing as an economic tool was first noted in the 2010 BC in the ancient Samarian City. The evidence showed that the ancient Egyptians were active in the leasing both real and personal property. The rapid expansion of leasing and the various

forms it has taken began during the post-war period in which the importance of this development was first highlighted by the Securities and Exchange Commission in its Fifteenth Annual Report for the year ended June 30, 1949 (Myers, 1962). Monson (2001) noted that the principal economic reasons for the existence of leasing include:

- To intermediate the risk of owning property;
- To finance the acquisition of property, plant and equipment;
- To enable users of property to conserve working capital as compared to more traditional financing arrangements;
- To intermediate credit risk between sub-prime credits and traditional lending institutions;
- To intermediate the transfer of income tax benefits associated with owning property from low marginal rate tax payers to higher rate tax payers; and
- To outsource significant activities related to the maintenance and administration of property, plant and equipment to specialists.

In Malaysia the use of leasing as a source of finance is only began in the early 1970s (Tan, 2000). A study conducted by Mazni and Ervina (2004) shows that 65% of companies in the sample used the leasing arrangement as a source of financing in their business operation in the year 2003. However the study only investigates the conventional leases employed by the Malaysian companies without covering an Islamic lease employed by the Malaysian companies.

In Islamic finance, an Islamic lease is also known as *Ijarah*. The legitimacy of *Ijarah* contract (Islamic lease) is mentioned in the Financial Accounting Standard No. 8 (FAS 8) - *Ijarah and Ijarah Muntahia Bittamleek* issued by the AAOIFI<sup>1</sup> as follows:

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1. Accounting and Auditing Organisation for Islamic Financial Institution (AAOIFI) based in Bahrain that responsible to issue Islamic accounting standards.

"The basic rule of the Ijarah contract is that it is considered permissible and the supporting evidence for this is in Quran, Sunna, Ijma (consensus) and common sense."<sup>2</sup>

In the Quran, the evidence of lease contract is shown on verses 26-27 in Surah Al Qasas in which it has indicated the payment of wages and the agreed period of service contract as follows:

*"...O my dear farther engage him on wages: truly the of men for thee to employ is the man who is strong and trustworthy..." (Al Qasas: 26)*

*"...I intend to wed one of my daughters to thee on condition that thou serve me for eight years; but if thou complete ten years, it will be (grace) from thee. But I intend not to place thee under a difficulty; thou wilt find me, indeed, if God wills, one of righteous." (Al Qasas: 27)*

In the Sunnah of Prophet Muhammad S.A.W, the evidence of lease contract is shown in the Hadith narrated from Abu Huraira in Musnad i.e. about prompt payment of wages for work done, while the duty to inform the employee on the conditions and reward of the contract of employment are enjoined in the Hadiths narrated from Abu Huraira and Abu Said Al Khudri (Al Zuhaili, 1995). The evidence is also shown in the Hadith narrated by Ahmad, Abu Dawud, and Al-Nasa'y as follows:

*"The farmers during the time of the Prophet (pbuh) used to pay rent for the land in water and seeds. He (pbuh) forbade them from doing that, and ordered them to use gold and silver (money) to pay the rent."*

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2. Al-Mughni, with Asharh Al-Kabeer, Vol. 6; Ibn Rusd, Bedaiyat Al- Mojtahed, Vol.2, p.25.

Thus, the objective of this paper is to provide a general comparison between the conventional lease and Islamic lease (Ijarah) with the references made to the current conventional accounting standards and Islamic accounting standard. For this purpose, the discussion in this paper is structured into five sections. The next section discusses the need of an Islamic accounting standard to specifically deal with the Ijarah transactions. The third section provides the definition of conventional lease and also Islamic lease. The fourth section provides a comparison of conventional lease and Ijarah and the final section is the conclusion of this paper.

### **The Need for Islamic Accounting Standard**

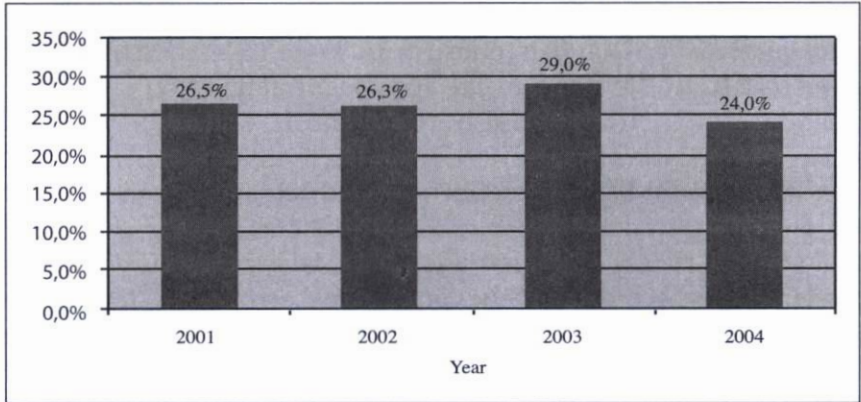
Many Islamic scholars claimed that the assumptions underpinning conventional accounting systems which are based on the Western philosophy is incompatible with Islamic Beliefs and Values. Western accounting approach adopts a narrow marginalist and utilitarian economic principles (Lehman, 1992). While Gray, Owen and Maunders (1992) noted that Western accounting system has created social imbalance among mankind "the rich become richer, while the poor become poorer".

Unlike conventional accounting, Islamic accounting is related to social responsibility and accountability (Khir, 1992). Harahap (2001) argues that Islamic accounting should regulate and establish a harmonious interaction among the various parties. It has been suggested that an Islamic accounting has the characteristics as to report an accurate income determination, to promote efficiency and leadership, to comply with Shariah law and commitment to justice (Harahap, 1992). Islamic accounting also can be defined as the accounting process which provides appropriate information to stakeholders and ensures investors the continuity of the business operation within the limits of the Islamic Shariah besides fulfilling its socio-economic objectives (Shanmugam, Perumal and Ridzwa, 2005). According to Shanmugam et.al (2005) Islamic accounting focuses on identifying socio-economic and religious events and transactions.

Pertaining to the Islamic lease or Ijarah contract, the Islamic accounting standard to deal with the issues has already existed in FAS 8 which is issued by AAOFI. Nevertheless, the FAS 8 is considered inadequate to the Malaysian context because the accounting treatments as prescribed in the standard are specific for application for Islamic Financial Institution only and also in contradiction with regulators, legal and tax provision in Malaysia. In view of this, the Malaysian Accounting Standard Board (MASB) being the standard setting body in Malaysia recognised the need to develop another Islamic accounting standard to deal with the Islamic lease that suit to the Malaysian context which is presently not covered under the conventional accounting standard on lease. Moreover, Ijarah and Ijarah based transactions have become an important part of Malaysian economic activity. A report published by the Bank Negara Malaysia (Central Bank of Malaysia) shows a growth of Ijarah transactions offered by the financial institutions in Malaysia ranging from 24% - 29% or around 26.5% in average (Table 1).

In fact, a comprehensive set of accounting standards to address a specific Islamic based transaction is needed to avoid the different practices among the enterprises and thus the comparability will be compromised. At this stage, the Malaysian Accounting Standard Board has developed the draft of Islamic accounting standard on Ijarah namely MASB EDi-2 with the objective to prescribe the appropriate accounting policies and disclosure to apply in relation to Ijarah. The exposure draft of MASB EDi-2 was released in July 2004 for comments from professional accounting bodies, regulators, Shariah scholars, preparers, users and other interested parties and the MASB EDi-2 Ijarah is expected to be implemented in July 2005. However, as at to date, the MASB EDi-2 remained outstanding pending further review by the board or pending conclusion by the IASB (International Accounting Standards Board). In view of this, the Malaysian Accounting Standard Board has decided that Islamic leases would fall within the ambit of FRS117 until a pronouncement on Islamic leases is issued.

Table 1: The Breakdown of Ijarah Commitment by Year.



Source: Annual Report of Bank Negara Malaysia (year 2001-2004).

### Definition of Conventional lease and Islamic lease (Ijarah)

The definition of conventional lease can be derived from the western based accounting standard, which most of the accounting standards for leases like IAS 17, FASB 13, SSAP 21 and FRS117<sup>3</sup> give almost similar definition of lease. Conventional lease can be defined as an agreement between a lessor and lessee that conveys to the lessee the right to use specific property owned by the lessor for an agreed period of time. In return for this right, the lessee agrees to make periodic cash payments (rents) to the lessor. Further, the conventional accounting standard classified the lease into two types of leasing i.e. operating lease and finance lease, based on the extent to which risks and rewards incident to ownership of leased asset lie with the lessor or the lessee.

Ijarah on the other hand is a term of Islamic fiqh, which means to give something on rent<sup>4</sup>. According to the Islamic jurisprudence, the

3. FRS 117 is the accounting standard on leases issued by the Malaysian Accounting Standard Board. Previously, the standard was known as MASB 10 Leases. Beginning 1 January 2005, the standard was renamed FRS 117 and the standard has been revised and was approved by the Board in August 2005.
4. Mufti Maulana Muhammad Taqi Usmani , *An Introduction to Islamic Finance, Karachi: Idaratul-Ma'rifat, 2000.*

term of Ijarah can be applied into two different situations. In the first situation, it means to employ the services of person on wages given to him as a consideration for his hired services. For this type of Ijarah, the employer is called "*musta'jir*" and the employee is called "*ajir*".

Meanwhile, the second type of Ijarah relates to *usufructs* of assets and properties and not to the services of human beings. In this case, Ijarah means to transfer the *usufruct* of a particular property to another person in exchange for a rent claimed from him. The *usufruct* means the right of using and enjoying the benefits accruing from the Ijarah asset, so long as that use or enjoyment does not alter or diminish the essence of the asset. Thus, the lessee only has the right to benefit from the assets while the assets still belong to the original owner (lessor).

The second meaning of Ijarah here is analogous to the English term "leasing" in which the lessor is called "*mu'jir*", the lessee is called "*musta'jir*" and the rent payable to the lessor is called "*ujrah*". For the purpose of this paper, the second meaning of Ijarah is employed, as it is relevant to the discussion here. Moreover, the Islamic accounting standard on Ijarah (FAS 8) and the proposed standard (MASB EDi-2) clearly mentioned that the following lease contracts do not cover under the standards:

1. Ijarah agreements for exploration or use of natural resources, such as oil, gas, timber, metals, and the like.
2. Ijarah transactions concerning licensing agreements of certain items such as motion pictures, video recordings, manuscripts, patents and copyrights.
3. Labour contracts and hiring of professional services.

Financial Accounting Standard No. 8 (FAS 8) on Ijarah and Ijarah Muntahia Bittamleek defined Ijarah as "Ownership of the right to the benefit of using an asset in return for consideration"<sup>5</sup>. Some Fuqaha

5. Zilai'e, *Kashf Al-Haqa'ek*, Vol.2, 5 p.151, 1322H. edition; Sarakhsi, *Al-Mabsoot*, Vol.15, p.74, first edition; al Shafie, *Al-Omm* Vol.3, p.250, first edition 1321H; Ibn Qudamah, *Al- Mughni With Asharh Al-Kabeer*, Vol.6, p.3 Manar edition, 1347H; Aldardeer, *Sharh Assagheer Ala Aqrab Al-Masalek*, Vol.4 p.5.

(jurist) have included in the definition the duration of the benefit". The definition of Ijarah is also given in the FRSi-1 Presentation of Financial Statement of Islamic Financial Institutions. According to FRSi-1, Ijarah is –

“A contract of exchange whereby the IFI (Islamic Financial Institution) acquires an asset sought by a customer and subsequently leases it to the customer for a fixed period and at a fixed rental according to the terms and conditions stipulated in agreement between the contracting parties. Any damage to the leased asset during period of the leasing agreement is to be the responsibility of the IFI. A form of Ijarah called Ijarah Muntahia Bittamleek entails transfer of ownership of the leased asset to the lessee affected by an undertaking by the lessee to acquire the asset at the conclusion of the Ijarah period made in advance”.

While the definition of Ijarah as given by MASB EDi-2 Ijarah refers to a contract under which the lessor transfers the *usufruct* of an Ijarah asset to a lessee for a specified period in exchange for an agreed rental payment or series of payments. During the term as well as at the conclusion of the contract, the ownership or the legal title of the Ijarah asset remains with the lessor.

According to the majority of fuqaha, Ijarah must consist of three general and six detailed elements as follows:

a) **The wording:** This includes offer and acceptance whereby there is a clear intention of two parties to do leasing by way of an expression of their desire, either verbally or in other equivalent form such as in writing or sign language. An offer may come from the owner of the asset and the lessee will accordingly express his acceptance.

b) **Contracting parties:** This includes a lessor (*mu'jir*), the owner of property and a lessee (*musta'jir*) the party that benefits from the use of the property. In Ijarah contract, the contracting parties (lessor and lessee) must be persons of sound mind and judgment. Besides, the parties involved should have the authority to act in order to formulate



the contract. For the contract to be valid, the contracting parties should mutually agree the terms and conditions for the contract.

c) **Subject matter of the contract:** The subject matter of an Ijarah contract is the usufruct and the consideration or rent. The consideration either in monetary terms or in quantity of goods fixed to be paid against the benefit of good or service is called the rent (*ujrah*). For the contract to be valid, there are few conditions regarding the usufruct and rent that must be fulfilled. Conditions that must be fulfilled regarding the usufruct:

- i. The usufruct must be lawful and permissible in Shariah. The usufruct may not be something that is derived from, used for, or involves the use of impermissible elements. Example of unlawful usufruct is to use a vehicle to transport prohibited merchandise;
- ii. The usufruct must be specified and identified by both parties so that no dispute will arise like specifying the Ijarah asset, the extent of use and period of Ijarah.
- iii. The usufruct must be legally realisable. The lessor is not permitted to lease something that is not in the possession or the ownership of him.
- iv. The usufruct is capable of being valued or measured; and
- v. If the usufruct from the Ijarah asset is impaired as a result of the lessee's negligence, the lessee is obliged to restore the Ijarah asset.

While conditions regarding the rent are given as follows:

- i. The rent must be determined at the time of contract for the whole period of Ijarah;
- ii. The rent must be specified, either as a lump sum covering the period of the Ijarah contract, or by instalments for parts of the period. The rent amount can be fixed or variable provided that both parties mutually agree it.
- iii. The entitlement to the rent does not necessarily commence on

the date of signing the Ijarah contract. The lessor's entitlement to the rent is effective when the lessee starts to benefit from the Ijarah asset or once the Ijarah asset is made available to the lessee;

- iv. The contracting parties may agree to amend the rent of future period by way of renewal of the Ijarah contract; and
- v. The lessor does not have the right to increase the rent unilaterally.

In addition to those requirements, the lessor and lessee are also required to fulfil the following duties or obligations under the Ijarah contract. The lessors are required to:

- a) Make the leased asset available throughout the duration of the lease. This includes equipping and preparing the asset in the manner which enabling the lessee to enjoy the benefit of the leased asset.
- b) Guarantee in respect of defects.
- c) Maintenance of the leased asset. According to the majority of fuqaha, the lessee is entitled to revoke the contract if the lessor refuses to maintain the asset and carry out all repairs that would make it suitable for use unless the lessee leased subject to that condition. Under Shariah, the lessee can be asked to carry out the maintenance costs under few situations like operating maintenance required to ensure the asset continuous utilisation (for example lubrication for machines).

While the lessee's obligations under the Ijarah contracts are:

- a) Utilisation of the leased asset according to the conditions of the contract.
- b) Payment of rental and safeguard the leased asset. Even though the leased asset is a trust in the hands of the lessee, if the leased asset is impaired without violation or negligence on the part of lessee, then he is not be liable for such impairment. The lessee is not to be held as a guarantor

for the leased asset.

Those responsibilities of lessor and lessee as prescribed in detail in the Islamic accounting standard (MASB EDi-2) however are not prescribed under the conventional accounting standard. As for the scope of the standard, it is similar to the scope covered for Islamic accounting standards (like lease agreements to explore for or use natural resources, such as oil, gas, timber, metals and other mineral rights; and licensing agreements for such items as motion picture films, video recordings, plays, manuscripts, patents, and copyrights) except that the lease agreements regarding labour contracts and hiring of professional services are not mentioned clearly in the conventional accounting standard. The standard just mentions that the contracts for services that do not transfer the right to use assets from one contracting party to the other are not covered by the standard (Para 3, FRS 117). Thus, it is questionable here whether the hiring of professional services are covered under the conventional standard or not.

### **Comparison of Conventional Lease and Islamic Lease**

As mentioned in the earlier section, the conventional accounting standards categorised the leases into two types of lease namely operating lease and finance lease, based on the extent to which risk and rewards incident to ownership of leased asset lie with the lessor and lessee. 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. All other leases that do not meet this criterion are to be classified as operating leases.

According to the conventional accounting standard (FRS117), in determining whether a lease is a finance lease or an operating lease depends on the substance of the transaction rather than the form of the contract (substance over form concept). The substance for leased asset refers to the benefits derived from the use of the asset while the form refers to the legal title and the ownership of the asset. FRS 117 prescribes that if a lease satisfies any one of these five situations, then a lease must be classified as finance lease. These five situations are as follows:

- a) The lease transfers ownership of the asset to the lessee by the end of the lease term;
- b) 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;
- c) The lease term is for 75 percent or more of the economic life of the leased asset;
- d) 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 when it equals or exceeds 90 percent of the asset's fair value; and
- e) The leased assets are of a specialised nature such that only the lessee can use them without major modifications being made.

The substance over form concept in the conventional lease case can be explained as follows. In the form, a lessee may not eventually obtain the legal title to the leased asset, but if the financial and economic reality of the transaction is such that the lessee obtains all the benefits and the accompanying risks for the use of asset (if the lease term is for 75% or more of the economic life of the leased asset), then in substance the transaction is a finance lease. Finance leases are normally non-cancellable and such that the lessee assumes most of the risks of the assets like technological obsolescence and damage. The lessor on the other hand would normally expect to recover his capital outlay plus a return on his investment by letting out the leased asset principally (90% or more of the assets fair value) to a single lessee.

Thus for finance lease, since the risks and rewards incident to ownership are transferred to the lessee, the leased asset would be treated as a fixed asset of lessee even though the title may or may not eventually be transferred to the lessee. While for operating leases, the leased asset could not be capitalised in the lessee's balance sheet as the risks and rewards incident to ownership are not transferred to the lessee. As such from the viewpoint of the lessee, an operating lease for asset is more like a rental of asset.

While for Islamic lease, accounting standard on *Ijarah* and *Ijarah Muntahia Bittamleek* i.e. FAS 8 also recognised two types of leases namely operating *Ijarah* and *Ijarah Muntahia Bittamleek*. According to the standard, *Ijarah* contract is classified as Operating *Ijarah* if the legal title of the *Ijarah* asset is not transferred to the lessee, which is similar to the principle applied under the conventional accounting standard. *Ijarah Muntahia Bittamleek* on the other hand is a contract that transfers the legal title of the *Ijarah* asset to the lessee. Even though *Ijarah Muntahia Bittamleek* is also called "Islamic Finance Lease" and it seems similar to the conventional finance lease which transfer the legal title of leased asset to the lessee, but it is still different because *Ijarah Muntahia Bittamleek* is considered a combination of two contracts i.e., an *Ijarah* contract over the lease period, and a sale and purchase contract at the end of the lease period. According to the Shariah standard (FAS 8), in *Ijarah Muntahia Bittamleek* contract, the lessee cannot transfer all the risk and rewards to the lessee. The legal title of *Ijarah* asset can be transferred to the lessee only by way of gift, token consideration, predetermined price, equivalent price and gradual transfer. As such, *Ijarah Muntahia Bittamleek* cannot be treated as similar to conventional finance lease.

Furthermore the substance over form concept which applied in determining the finance lease as prescribe under the conventional accounting standards does not apply in Islamic lease. If the substance over form concept applies in Islamic lease, it will imply the asset is in full control of the lessee, whereas in *Ijarah*, the lessee only has the rights to the benefits (usufruct) of using the asset but not the rights of ownership of leased asset. Thus the substance over form concept is not consistent with the Shariah. Besides the substance over form concept, it is important to note that Shariah law also prohibits any transaction that involves with the interest and contingency. Thus, unlike conventional lease, there is no element of interest and contingent revenue or expenses recognised in *Ijarah* contract.

In addition to these principles, it must be noted that *Ijarah* asset is different from the leased asset under the conventional lease because to be considered as *Ijarah* asset, the asset must be a legitimate asset and

free from elements that can render it Shariah non-compliant. To fulfil this condition, the lessor (*mu'jir*) must ensure that the asset is a lawful asset from Shariah perspective in which the asset is considered lawful as long as it is not derived from, involves the use of or use to produce unlawful elements. Examples of unlawful assets are stolen cars, vats from producing alcoholic beverages or slot machine for gambling. Thus, the leased asset under Islamic lease contract must be deemed "halal" under Shariah and must not involve with "haram" elements. This requirement however does not apply to the leased asset under conventional lease. A summary of differences between *Ijarah Muntahia Bittamleek* and conventional finance lease are presented in the Table 2.

**Table 2: Comparison of Ijarah Muntahia Bittamleek and Finance lease.**

Characteristics	Ijarah Muntahia Bittamleek	Conventional Finance lease
Leased asset	Involves the usufruct of an asset and the asset is permissible under Shariah.	Involves an asset itself and can be any asset.
Substance Over Form Concept	Not applicable	Applicable
Recognition of leased asset	Ijarah asset is reported in the lessor's book.	Leased asset is reported as fixed asset in the lessee's book.
Depreciation of leased asset	Lessor records the depreciation of Ijarah asset.	Lessee records the depreciation of leased asset
Maintenance cost	Borne by lessor.	Borne by lessee.
Lease revenue	Ijarah revenue is not divisible. No interest income involves.	Interest income is accrued and accounted for separately.
Financing rate	Ijarah rate is reflective of the market rental rate.	Cost of financing is not related to rental rates.

Regarding to the conventional Operating lease and Operating *Ijarah*, even though there are fundamental differences between these two like the subject matter and *Ijarah* asset involve in the contract, operationally they are similar. Therefore, most of accounting treatments apply to conventional Operating lease also applies to Operating *Ijarah* like the recognition and measurement of leased asset, depreciation expense and maintenance cost which is shown in the Table 3.

**Table 3: Characteristics of Conventional Operating lease and Operating *Ijarah*.**

Characteristics	Conventional Operating lease	Operating <i>Ijarah</i>
Leased asset	Involves an asset itself and can be any asset.	Involves the usufruct of an asset and the asset is permissible under Shariah.
Ownership of the asset	Remains with the lessor	Remains with the lessor
Recognition of leased asset	As a fixed asset in the lessor's book	As a fixed asset in the lessor's book
Measurement of leased asset	Record at cost	Record at cost
Depreciation	Recorded by lessor	Recorded by lessor
Maintenance cost	Lessor's responsibility	Lessor's responsibility

## **Conclusion**

In summary, the conventional lease is different from the Islamic lease (Ijarah) in terms of the definitions given under the standards, their underlying principles, the leased asset and the subject matter involve and also in the accounting treatments. Even though Operating Ijarah operationally is similar to conventional operating lease and the accounting treatments prescribed for these two are almost similar, it must be noted that there is still different in terms of the underlying principles, Ijarah asset and the subject matter involves in the contract.

Furthermore, for the Ijarah contract to be valid, there are few conditions that must be fulfilled by both parties (lessor and lessee) as prescribed under the Islamic accounting standard. In this case, it seems that Islamic accounting provides clearer guidance and detailed explanation regarding the leasing contract as compared to conventional accounting standard in which certain area is silent or unanswered.

The discussion regarding a comparison between conventional lease and Islamic lease (Ijarah) in this paper cannot be said without any limitation. However, it is hoped the discussion might provide some insights or general idea to the users of financial statements in understanding the differences between conventional lease and Islamic lease and how these two leases are reported in the financial statements.



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