



Conventional Leasing vs Islamic Leasing

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ABSTRACT

Leasing developed in time, from the simple form of renting to the modern modality of financial from nowadays, as an alternative for loan. It is present in the entire world, being used both by the financial specialized companies and banks, and the clients are companies and population. The object of leasing contract can be assets and also services, which are rented by the financier (lessor), on definite period, to the client (lessee), in exchange for a leasing rate (rent). The registering in accounting and the fiscal implications in the companies financial administration are different, according to the leasing form which they are using. The capitalist system has in view to obtain profit from renting, but the Islamic System, based on Şaria, forbids renting "haram" assets and services, obtaining interest from renting and using the leasing contract for the transfer of the property.

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1. Introduction

The word "leasing" defines "renting" or "hiring", but, the development of this phenomenon over the years, shows us better a special modality of financing, which takes place between a financier and the user of an asset, on defined period.

Leasing offers to companies and population which don't have financial resources, the opportunity to buy assets for long term use (equipments, cars etc.), without setting up insurance measures, like mortgages in the case of loans.

Due to this advantage, leasing is spread in the economies over the world. Its popularity from the last years is given by the fact that the trend of using property became stronger than that of owning it. But, the leasing operations are analyzed from the juridical and also economic point of view, in a different way, in the capitalist conventional system, and in the Islamic system, based on Şaria.

We will present the main features of leasing, according to both conceptions.

2. Leasing history

Similar forms to leasing operations appeared since antiquity in Mesopotamia, Egypt and Fenicia. They had as object renting agricultural tools and land, and the "contracting parts" were – the rich class (clergy and nobility) and farmers. Still at that time it was obvious that, using an asset in order to obtain profit, was more important than the form of property over that asset (this idea was sustained also by Aristotel).

Renting the private property is mentioned also in the IInd millennium B.C., through the Law Codex of Hammurabi (in Babylon) and in the ancient Greece and Rome, where was used the renting of African slaves for work.

Renting agricultural tools to farmers was registered on clay plates – proofs in this respect were found in the Middle East, dating from IIIth century B.C. and from VIth century B.C. there exist proofs from ancient Rome, when, in the Justinian Codex, it was making the difference between operating and financial leasing.

Leasing operations were registered also in Eastern Europe, like in Russian villages.

At the end of the XIXth century, the first operations similar to modern leasing appeared in U.S.A. (by renting phone boxes to population in 1877).

Also in USA, at the beginning of XXth century, there appeared operations through which investors gave super-markets to their owners, for exploitation (the Safeway stores case, in 1936), or they sold buildings to banks, as mortgages, in order to exploit them on long term, having finally the option to buy them.

In 1952, was founded "United States Leasing Corporation", the first company specialized in leasing operations with movable assets – which put the bases of financial leasing, starting with a capital of 20.000 \$. After only two years, it was financing operations for equipments for the sum of 3 millions \$.

The owner of U.S. Leasing Corporation – D.P. Bootle – had the idea of setting up this company, starting from renting the equipments for his own food products factory.

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Further, the American leasing companies increased their number in an annual average rhythm of 10-15%.

The leasing spreading in USA after the Second World War, had as a cause the need of capital for reorganization of armament industry. This need couldn't be covered by loans, because the companies couldn't present mortgages.

In these conditions, banks preferred to buy assets and to yield their usufruct to their clients, in exchange of a rent paid at fixed periods. If the clients didn't pay, the bank would withdraw the asset, searching another client.

The advantage for the bank was eliminating the risk of clients insolvency, and the advantage for the client was using the asset.

The financial leasing for industrial equipments spread in the 7th-9th decades of XXth century, being sustained by banks, but also by leasing specialized companies, which took advantage from important fiscal facilities, given by Government.

Until 1975, banks from 41 American states have received license to develop leasing activities.

If USA is the unchallenged leader in this area, in Europe, leasing penetrated later, first in England, then in countries like Germany, France, Holland and Belgium, and, after years '70, it spread in Asia and South America.

In the ex-communist countries, leasing appeared in the years '80 first in Czechoslovakia, then in Poland, Bulgaria and Hungary. At the beginning of XXI century, there were functioning seven leasing companies with multinational character in the entire world, and nowadays, leasing is present in all the countries, no matter their economic development level or their political regime. In Romania function in the present 35 leasing companies.

3. Conventional Leasing

Leasing can be defined from juridical and also economic point of view. The juridical aspect takes into consideration the leasing contract, which allows to a person to use an asset without paying the price immediately, and which contains: the defined period of renting and the sums which must be paid by the user as a rent (these sums contain the acquisition cost of the asset and the connected costs of the financier). The legislation is different from a country to another.

The economic aspect takes into consideration the financing operation, based on the contract, through which the owner allows to the client to use the asset for a defined period, in exchange of paying a leasing rate. Thus, from the leasing company point of view, named "lessor", leasing represents buying an asset in the purpose of renting it, followed by a renting in the purpose of selling it - so, a financing operation through which the user can use the asset with the possibility to buy it at the end of the period, after paying the rates and the residual value (if by selling, the asset is yield in exchange of money, by leasing, the usufruct will be yield in exchange of money).

From the user point of view, named "lessee", leasing represents a modality of borrowing the asset acquisition, with payment in rates - by leasing rates and residual value - so, an acquisition with rates payment, and using in the same time the bought asset.

In the capitalist conception, the partners in the leasing operations are: the supplier (who can be the producer or a commercial company which has bought the asset from this one); the lessor (who can be a bank, a leasing company, or even the supplier); the lessee (who uses the asset and who can associate himself with another person, in the case of sub-renting); the insurance company (who draws up the insurance contract and the insurance policy with the lessor, and pays the policy in case of necessity).

During the years, there appeared many types of leasing operations.[7]

In accordance to the period of renting:

- ◆ Leasing on short term (hours, days, months) - having as object renting equipments, cars etc. - including the service for these assets.
- ◆ Leasing on medium term (2-3 years) - having as object renting equipments in succession to many lessees.
- ◆ Leasing on long term - having as object renting the equipments for all its life period (buildings etc.)

In accordance to the modality of transferring the property right:

- ◆ Operating leasing - on a period shorter than the asset period of life; the lessor covers the amortization and the maintenance expenses through the rent paid by the lessee, he is the asset owner during the leasing contract, and, finally, he receives the asset from the lessee (computers, cars, trucks etc.) This modality is in the lessee's advantage.
- ◆ Financial leasing (capital leasing), on a period equal with the asset period of life; the lessor has the purpose to recover the entire value of the asset and to obtain profit; during the leasing contract, the amortization and all the risks on using the asset are transferred to the lessee, who pays the rates and interest and, finally, he becomes owner, by paying the residual value.

- ◆ Lease-back, case when the lessee sells the assets from his property to the lessor, and this one rents them to him, based on a leasing contract; finally, the lessee pays the residual value and the assets come back in his property.
 - In accordance to the contract partners:
 - ◆ Direct leasing, when the lessor is producer of the asset;
 - ◆ Indirect leasing, when the lessor is a specialized leasing company, or a bank.
 - In accordance to the calculation method of leasing rate:
 - ◆ Gross leasing, where the rates include also expenses for maintenance and repairs.
 - ◆ Net leasing, where the rates include only the asset selling price.
 - In accordance to market features and relations with the clients:
 - ◆ Experimental leasing, meaning renting assets to the client on short terms, and further, selling them to the same client.
 - ◆ Time-sharing, meaning renting assets to many clients in the same time (cars for trips, for example).
 - ◆ Work-leasing (on long term), between the hired person, the leasing company specialized in human resources (the lessor) with whom the person signs the contract, and the client (the company which will use the human resources); the leasing company manages the persons' hiring, the salaries payment, and also the payment of social taxes, according to the law.
 - ◆ Vendor leasing, where the supplier signs a general contract with the leasing company, and this one signs contracts with their clients; the leasing company pays to the supplier the price of the assets in the moment of signing the contract and further, it cashes this value in rates, from its clients.
 - ◆ Master-Lease Line, where the leasing company signs a general contract with the client, which will be applied when the opportunities of renting appear.
 - ◆ Leveraged leasing (for expensive assets), between the producer, the leasing company, the bank and the client; the bank pays to the producer the asset price, and cashes the price rates from the leasing company, who is the intermediary between the bank and the client.
 - ◆ Leasing Cross-border (Off-shore Leasing), when the leasing rates payment is made in foreign currency.
 - In accordance to the residence county of partners:
 - ◆ Internal Leasing, where the lessor and the lessee are from the same country.
 - ◆ International Leasing, where the lessor and the lessee are from different countries [8].

4. Accounting and Taxation aspects

Leasing operations need special registrations, both in the leasing company accounting and in the client accounting, and the Fiscal Code stipulates rules regarding the leasing operations, in order to encourage their use.

- ◆ In the contract of Operating Leasing, which has a period smaller than the life period of the asset, the lessor transfers only the usufruct, and, at the end of the period, the lessee returns the asset to its owner.

In the lessee accounting, who doesn't assume the risk of property, the rent expense is recognized as an exploitation expense in the Account of Profit and Loss and it won't affect the patrimonial balance sheet.

This expense covers the amortization during the contract and the maintenance costs. The asset is "simple-entry" registered, both in the moment of receiving it from the owner, and in the moment of returning it to him.

In the leasing company accounting, who keeps the owner quality during the contract, the asset remains registered in the patrimony, its amortization is also registered, and the income from renting covers the amortization expenses and assures him also a share of profit [9].

The Operating Leasing is considered as a set of services for financing and assets administration (materials, maintenance etc.), and the leasing expenses are considered function expenses which don't affect the capital of the company.

- ◆ In the contract of Financial Leasing, which has a period bigger than 75% from the asset life period, at the end of the contract, the right of property is transferred to the lessee, at the residual value. The lessee assumes a part of the risks, but has also some advantages.

This one receives the asset in his patrimony, being recognized in the balance sheet as an increase of active, and also as an increase of passive – because of the long term credit which he has to pay in rates, with its interests.

During the contract, the lessee registers the amortization on exploitation expenses, but also the interest expenses for the leasing rates, modifying the Account of Profit and Loss.

The lessee expenses are bigger in the case of financial leasing, than in the case of operating leasing.

The leasing company removes the asset from his patrimony, being recognized in the balance sheet as a decrease of active and, in the same time, as an increase of active, by registering the debt on long term which he has to cash in rates, with its interests.

During the contract, the leasing company registers the cashed interests as incomes from renting, modifying the Account of Profit and Loss. [9]

- ◆ In the both situations – operating and financial leasing – the invoice of leasing rates, contains also VAT – deductible, for the lessee, and collected for the leasing company. [6]

In the case when, for the rented asset it must pay local taxes, these taxes are beared by the leasing company, if the contract is signed before the deadline of taxes payment, and by the lessee, in the contrary case. For calculating the taxes is taken into consideration the asset value from the contract.

- ◆ The incomes cashed by the non-resident persons as interests or leasing rates, are taxed according to the Romanian fiscal law, by taxation to the source.

In the case of international leasing, the Romanian law stipulates that: [6]

- ◆ For the assets imported by the Romanian lessees from foreign leasing companies, it's applied the regime of temporary admission during the leasing contract, so the lessees are entirely exempted for paying the import rights and custom mortgages.
- ◆ For the assets imported by Romanian leasing companies, based on leasing contracts signed with Romanian lessees, it's applied the custom regime of import, the leasing companies being exempted for paying the import rights.
- ◆ If the lessee didn't return the asset in term, he is obliged to pay the custom tax for the residual value (this value representing at least 20% from the acquisition price of the asset).
- ◆ During the leasing contract, the lessee pays the tax on interest, if the interest is separately registered, or on the entire value of leasing rate, if the interest is included in the leasing rate.

Taking into consideration all the features of leasing operations in the accounting and taxation, the companies must choose the leasing type according to their needs. Each type has its own advantages and deficiencies.

Thus, if the asset will be used on short term, the operating leasing is better to choose, due to its advantages:

- ◆ it's a financing method on short term, for assets with fast depreciation;
- ◆ the company avoids important expenses, because the rates are reduced;
- ◆ the company obtains fiscal advantages, due to the deductibility of expenses;
- ◆ the terms of payment are flexible;
- ◆ the contract can be lasted;
- ◆ operating leasing isn't included in calculating the leverage rate.

As a deficiency, it is returning the asset to its owner at the end of the contract.

If the asset will be used on long term, and the company wants to buy it without having resources, it must choose the financial leasing, due to its advantages:

- ◆ 100% financing without requiring any capital from the company;
- ◆ the deductibility of leasing rates and interests expenses;
- ◆ the contract is signed fast, without mortgages;
- ◆ the period of the contract and the rates value are established according to the economic potential of the company;
- ◆ the transfer of the property right at residual value, at the end of the contract;
- ◆ the insurance of leasing company against the risk of lessee bankruptcy.

There are also deficiencies, like:

- ◆ the advance payment is compulsory;
- ◆ the lessee takes all the risks during the leasing contract;
- ◆ the lessee is controlled by the company for a good using of the asset;
- ◆ banks loan with difficulty the companies which have assets in leasing.

5. Islamic Leasing (Ijarah)

This term designs a "renting", but with a larger meaning, including, beside assets with long term use, also land and work. It represents using the usufruct of an asset, for a certain period, in exchange of a payment. [1] The religious element is still present. Islamic Leasing follows the rules of Conventional leasing, but it takes into consideration the fact that the leasing contract mustn't contain ambiguity (Gharar) and interest (Riba).

Leasing is allowed by Qur'an, where is mentioned that Prophet Moses rented its work on many years, in exchange of a reward, and also, Prophet Muhammad rented land to the Jews, with the condition they work it and keep a half of the harvest.

The Islamic leasing contract contains rules regarding: usufruct, partners, period, payment and sub-renting. [5]

- ◆ Usufruct – must be allowed by Şaria (halal); the assets and work or services "haram" are forbidden (tools for drinks production, work in conventional banks etc.). In order to avoid ambiguity, the contract must specify clearly the asset or work for renting, and mustn't contain interest.
- ◆ Partners – both lessor and lessee have rights and duties established according to Şaria.

The lessor must be the asset owner; he is compensate for risk situations and he bears the expenses with insurance, taxes, losses – for the asset that he will rent.

The lessee has only the usufruct, pays for using the asset/service, bears the maintenance expenses and is responsible for the asset situation during the renting.

In conclusion, the lessor, as owner, takes all the risks and responsibilities of this quality, without moving them to the lessee (this fact would be considered haram, and similar to the interest, as an income obtained without assuming any risk or responsibility).

- ◆ Period – the leasing contract can't last more than the life period of the asset, and the renting period starts in the moment when asset enters to the lessee possession and finishes according to the understanding between the two partners. When the object of renting is work, it must be specified the work schedule.

Starting the renting period in the same time with signing the contract is forbidden because, between this moment and the moment of receiving the asset, the lessee pays a rent without using the asset.

- ◆ Payment – the payment modality must be established in order to avoid ambiguity (Gharar), and the price is negotiable and established with the agreement of the two partners.

Payment can be made: entirely in the moment of signing the contract; entirely after this moment, or in rates. It can be made: in cash, gold, silver but also in goods – different by the rented asset (payment in the same type of goods, is considered a forbidden transaction, a case of Riba-al-Fadl, or a commercial interest. [3])

The rent represents in general a fixed sum, excepting the case of land renting. Then, the rent is calculated as a percent from harvest, in this way, both partners taking their own share of harvest, or bearing the loss, if the harvest was compromised (if the sum was fixed, the lessee would bear alone the loss, and the situation would be similar to usury or gambling). [4]

- ◆ Sub-renting (Sub-lease) – the lessee, as owner of the usufruct during the contract, can rent his usufruct to another person. So, sub-renting is allowed but, only if the lessee has the owner agreement. The object of sub-renting can be assets and also work.

There are Muslim economists who sustain the fact that the owner agreement is necessary only if the sub-rented asset will be used by the new lessee in another purpose than it was rented initially.

Regarding the sub-renting price, the opinions are different.

There are opinions according which the sub-renting profit is allowed. In this way, the lessee can sub-rented for a rent – smaller, equal or bigger than the rent that he pays, with the condition that the sub-renting period doesn't exceed the renting period, and sub-renting isn't made for certain activities.

There are also opinions according which the sub-renting profit is forbidden, and it must be given to the poor.

The types of leasing have in view renting assets and renting work or services.

- ◆ **Renting assets** is used in two modalities:
 - **Operating Leasing** – is the same in Islam like in the conventional system. The owner (lessor) rents the asset to the lessee on defined period, during this time he registers the amortization and cashes the rent from the lessee. At the end of the period, the lessee returns the asset which, all the time, was in the owner property. Operating leasing is allowed in Islam, by respecting the basic rules already mentioned.
 - **Islamic Financial Leasing** or “leasing which finishes with property” – is the method through which, at the end of the contract, the asset goes out from the lessor property and enters in the lessee property. [1]. This type on leasing is not entirely accepted in Islam. Those who consider it forbidden (haram) talk about the following reasons:
 - it represents a mixture between two contradictory transactions;
 - the lessor includes the acquisition cost of the asset in the monthly rent, and the lessee, in the case when he can't pay the rent, can't sell the asset until the end of leasing period, because the asset isn't his property;
 - it represents the risk of not overcharging for the lessee, and for the lessor, the risk of not cashing the rent. Despite these aspects, the Islamic financial leasing is allowed, but with some restrictions – the asset becomes the lessee's property (after paying all the rates), through a separated contract, or a promise to give the asset as a gift.

The Islamic banks use this type of leasing, having as reason – the fact that it makes the client more responsible in using the asset careful, knowing that, when the contract expires, he becomes the owner.

Accounting and Auditing Organization for Islamic Financial Institutions drew up standards and procedures for using Islamic financial leasing, which avoid using connected contracts in the same time, fact forbidden in the Islamic economy. According to these settlements, the stages are following: [2]

- ◆ The client goes to the bank and tells what kind of asset he desires to buy in leasing, and pays to the bank an advance, as a proof of his solvency. Further, the amount can be considered as a rent in advance or, with the client agreement, can be invested by the bank.
- ◆ The bank buy the asset, directly, or by an agent, and, from the moment it becomes owner, it has the right to rent the asset to the client.
- ◆ From the moment when the client receives the asset, he starts to pay the rent to the bank, and, in the case of insolvency, the bank can take the asset back.
- ◆ When the leasing contract expires, the client becomes owner, by three ways:

- the promise of the bank to sell the asset to the client at the end of leasing period, when they sign a separated selling contract, through which the asset enters in the client property; this contract has a formal character, because the client has paid the rent entirely, and the bank has recovered its expenses;
 - the promise that the asset will be given as a gift at the end of leasing period, without any condition;
 - the promise that the asset will be given as a gift at the end of the leasing period, with the condition, of paying all the remaining rates.
- ◆ **Renting work and services** – means every type of persons hiring, in exchange of a reward – as salary or occasional payment. In the case of salary, the type of work and the amount must be known without ambiguity (Gharar). The occasional payment is used especially in the case of selling agents, who receive a share from the selling's value, and, if they don't succeed to sell, they won't receive anything, remaining only with their spent work.

6. Conclusions

Leasing exists from ancient times, appearing from the need of renting land, agricultural tools and slaves work.

The leasing forms became various according to the economic evolution, but there are two modalities which remain the most used: operating leasing and financial leasing, both of them with advantages and lacks, with features in accounting and the taxation area. The conventional system and the Islamic system use leasing both of them, but they analyzed it from different points of view.

The capitalist system has the purpose to obtain profit by calculating interests at the leasing rates and considers enough only the leasing contract for renting and also for the transfer of property.

The Islamic System, based on Şaria, forbids interest and ambiguity in the leasing contract and the transfer of property right is made only by signing another separated selling contract.

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