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**Article**

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# Contemporary issues of form and substance: an Islamic law perspective

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## Abstract

**Purpose** – This paper aims to analyse the concept of form over substance and introduces the term substance gap to the literature. The substance gap is defined as the difference between the way a concept is expressed and its intended result. Besides, the study investigates the issue from both classical and contemporary viewpoints.

**Design/methodology/approach** – The methodology adopted in this paper is descriptive research.

**Findings** – This paper has depicted the substance gap in contemporary contracts and found that form is equally important as substance in Islamic finance contracts. This paper offers a fresh outlook on form and substance to highlight the importance of the issue and its significance. The findings of the study will help researchers address the issue at its roots and help them to bridge the gap between the form and substance of Islamic finance contracts.

**Originality/value** – This paper investigates the substance gap in contemporary contracts that exists between the *fiqh* rules and conditions of an Islamic contract, and their development and construction. Further, the gap could also be attributed to the pressure to cope with a complicated modern finance environment.

**Keywords** Form, Form over substance, Substance gap

**Paper type** Research paper

## Introduction

Over the past decades, the Islamic financial system has achieved tremendous progress. However, it has also faced criticisms regarding its operations, products and services. A few

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scholars have argued that it is a replication of the conventional financial system (Chong and Liu, 2009; Khan, 2010; Beck *et al.*, 2013). Critics have referred to it as putting old wine in a new bottle by changing the name and adding a Sharī'ah-compliant tag (Zaher and Hassan, 2001; Hasan, 2015). Ahmed (2011a) further reasoned that Islamic financial transactions are compatible with Sharī'ah (Islamic law) in form, but fail to meet its substance and spirit. Besides, many debates have given attention to the application of “form”, hence circumventing the “economic substance” of Islamic financial transactions. This raises concerns regarding how authentic some Islamic financial transactions are.

The debate of form over substance is triggered by the offer and acceptance of the underlying intention of the contracting parties. The term substance over form refers to the principle of recording a transaction based on its economic substance or financial reality, not necessarily its legal form (Hanif, 2016). Even though no reference is made to the intention (substance) with regard to legitimate contracts in the Malaysian Contracts Act 1950, there is a long-standing debate about it among Muslim jurists. The Shāfi'ī School, for instance, is more inclined towards form over substance in conflicts between internal will and external consent, approving only *bi al-kitābah* (what is written) as a rule in the courts. However, the Ḥanafī School strictly adheres to substance over form in exchange of offer and acceptance; for instance, regarding *bay' al-wafā'* (redemption sale) contract, it considers it a guarantee instead of a sale. The Mālikī School places emphasis on the importance of the substance of contracts when ruling on the permissibility of business activities, as in the case of *bay' al-mu'āṭah* (sale by conduct). This form of sale is concluded when a buyer and a seller agree on the object of the sale and its price, and exchange the object for the price without explicit verbal offer and acceptance (Al-Zuhaili, 2001). In this respect, Sharī'ah stresses that both form and substance are important, but they shall not contradict each other. Abozaid (2010) stated that Sharī'ah prioritises substance over form in cases where inconsistencies arise between the two.

Previous studies on the issue of economic substance and legal form in Islamic finance have raised various criticisms on the application of certain techniques to validate the contract as Sharī'ah-compliant (Usmani, 2002; Khan, 2010; Rosly, 2010; Maali and Atmeh, 2015). Researchers such as Hanif (2016) investigated the economic substance and legal form in Islamic finance and found that the legal form of selected Islamic finance contracts is in line with the theory, but the economic substance is quite similar to their conventional counterparts. In a recent study, Atmeh and Maali (2017) examined the use of combined contracts and donation (*hibah*) from an accounting perspective and found mixed results in the application of economic substance and legal form in conventional and Islamic financial contracts. Overall, to quote Rosly (2010, p. 132) on this issue, “Form over substance is a technique that closes the front door of *ribā* (usury) while opening the back door for *ribā* at the same time”. Hence, the issue calls for much diligence in the application of form and/or substance when developing Sharī'ah-compliant products and services to ensure compliance of the contracts in line with their objectives.

The issue of mismatch between the form of a text and its intended meaning and outcome is not unique to Islamic finance contracts. It is also encountered in the field of accounting and law, for example. Today's Islamic contracts, laws and accounting entries are all expressed in texts, and they can all exhibit substance gaps. According to Dusuki and Bouheraoua (2011), substance over form is an accounting concept which means that the economic substance of transactions and events must be recorded in financial statements rather than just their legal form to present an accurate and fair view of the entity's affairs. The substance over form concept requires evaluation on the part of the preparers of financial statements for them to present transactions in a manner that best reflects the

actual business sense of the transactions. However, the legal forms of events are necessary to provide more relevant information to the readers of financial statements.

Law is another area where substance gaps appear. The letter of the law is its literal meaning, while the spirit of the law is its perceived intention. In some cases, one could adhere to the letter of the law but not its intended objectives, resulting in unfairness (McBarnet and Whelan, 1991). As explained, the term substance gap is used to denote the difference between the form of a text and its intended substance measured by its performance.

In this paper, the aim is to assess the issue of form and substance in Islamic financial transactions from an Islamic law perspective. It thus introduces the concept of substance gap. Identifying the substance gap is meant to pinpoint the area of disjoint between the form and its intended substance.

The remainder of the paper is structured as follows. The second section describes the concepts of form and substance from the Sharī'ah perspective, while the third section elaborates the accounting perspective. The fourth section discusses the contemporary issues of form and substance arising in Islamic financial transactions, and the last section concludes the paper.

### **Form and substance: a Sharī'ah perspective**

In principle, Sharī'ah emphasises that every contract must comply with its legal form, i.e. its essential requirements and its nature and implications. This implies that the form and substance of the transaction are both necessary (Ahmed, 2011b). However, most Islamic financial products are designed by using a series of contracts. Debates arise as to whether the effect of each contract in isolation is to be recorded – hence recognising the “form” of each contract – or whether the economic effect of the series of transactions is to be recorded – thus recognising the “economic substance” of the overall operation.

One area where there has been much controversy over the application of substance over form is the issue of *ijārah* (leases). The discussion can be illustrated with the product known as *ijārah muntahiyah bi al-tamlīk* (lease ending with ownership). It is a form of finance lease whereby the lessor leases an asset to the lessee for an agreed lease period, and at the end of the lease period, the lessee becomes the legal owner of the asset. During the *ijārah* tenure, the lessee rents the asset. At the beginning of the lease tenure, there is usually a *wa'd* (promise) by the lessor to transfer the ownership of the property to the lessee with a promise by the lessee to acquire the property from the lessor at the end of the lease term. The lessor can transfer the ownership of the property by any of the following means: a gift; a sale contract at a token price, a predetermined price or market price; or through the gradual transfer of shareholding (Abdul Rahman, 2010). In the case of transfer of ownership through a sale contract at the end of the lease term, a separate sale and purchase agreement will take place between the lessor (seller) and the lessee (buyer).

If the principle of form over substance is used for the recording of this transaction, the financial statements will recognise two separate transactions:

- (1) rental throughout the *ijārah* (lease) tenure; and
- (2) sale, when the *'aqd* (contract) to transfer the *ijārah* (lease) asset is executed.

However, if the substance over form concept is applied, the financial statements will recognise one transaction, which is to account for the final sale like the case of a conventional hire–purchase agreement, whereby the two contracts of the lease (hire) and sale (purchase) are combined into one.

The substance over form debate also arises under a *bay' al-'inah* (sale and buy-back) contract. *Bay' al-'inah* refers to a sale contract with an immediate repurchase. If the principle of substance over form is applied, the financial reporting will record the overall effects of all contracts involved in the transaction, whereby the profit generated from the contracts will be recorded as the financing cost payable by the customer. In contrast, if the principle of form over substance is adopted, the financial statement will record two separate transactions:

- (1) sale of an asset from the financier to the customer; and
- (2) sale of the same asset from the customer to the financier.

As such, in cases where Islamic financial products are designed by using a series of contracts, clarification on Sharī'ah opinions about the principle of substance over form is essential. The following section examines the views from the classical literature on the issue.

#### *Views from the classical literature on the principle of form and substance*

An investigation into the classical literature reveals differing positions and opinions on the issue of form and substance of classical Islamic contracts, sometimes within the same school. It is better illustrated by exploring the opinions of the four schools of Islamic jurisprudence regarding the issues of *bay' al-'inah* and sham contracts.

In the case of *bay' al-'inah*, the Hanafīs, Mālikīs and Ḥanbalīs considered it to be unlawful. On the other hand, the Shāfi'īs ruled it permissible, but a prominent later scholar from the same school, al-Nawawī, deemed it discouraged (*makrūh*) (Shaharuddin, 2012). Al-Shāfi'ī did not consider *bay' al-'inah* as a legal trick and he gave priority to the form over its substance because we cannot evaluate people's hidden intentions. Al-Shāfi'ī treated *bay' al-'inah* as two separate contracts, in which each of them complies with the features of a sale contract. He did not give any weight to the intention of the contracting parties (Al-Zuhailī, 2001). The Mālikī scholar al-Shātibī, on the other hand, viewed the application of *bay' al-'inah* as a legal trick to legalise *ribā* (usury/interest) (Al-Zuhailī, 2001). There is nonetheless no consensus among jurists about the issue of legal stratagem (*ḥīlah*); it is a matter of debate. Applying a legal trick to an Islamic contract involves separating the substance from the form and creating a substance gap in the contract. Establishing the presence of substance gaps in classical Islamic contracts is dependent on the intentions of the contracting parties. Abozaid (2014) stated that, although the Hanafīs were most willing to employ legal stratagems, they did not accept their use in *bay' al-'inah*, supporting the notion that form must match substance. Because the contracting parties intend to lend and borrow money and not to trade, it cannot be permissible.

A sham contract is one where the contracting parties enter two contracts at the same time – a declared one and a hidden one. The openly declared one fulfils all contracts' conditions but it does not reflect the actual intention of the two parties, while the hidden one does. A contemporary example of sham contracts is sham marriages in Western Europe and North America. It is a frequent practice among hopeful immigrants, where they enter into fake marriage contracts with nationals of these countries to gain nationality and passports in return for financial rewards. Countries like the UK have developed laws, policies and procedures to weed out such contracts and determine what the true intentions of the marrying couples are. It is usually done in court, and if the sham marriage is proven, the participants face judgments ranging from fines to jail sentences.

An example of a sham contract from classical literature could be *bay' al taljī' ah* (pre-emptive sale), where a person is forced into entering a sale contract in fear of the authority confiscating or forcibly buying his asset. The appearance of the contract is a sale while the

true purpose is the desire to safeguard his asset. It is done by the consent and knowledge of the two contracting parties. There are two positions in classical jurisprudence regarding this type of contract. The first is adopted by the Shāfi'īs and some of the Ḥanafīs. In the case of a dispute between the two contracting parties, they consider the declared contract to take precedence over the hidden intention (Al-Mawsū'ah, 2007). The second position is adopted by the Ḥanbalīs and Mālikīs. They consider the hidden contract and its intention to take precedence over the declared one as long as there is evidence to support it (Al-Mawsū'ah, 2007).

### Accounting perspective on form and substance

International Financial Reporting Standards (IFRS) provide higher weight to economic substance rather than legal form for recognition and measurement purposes of accounting transactions. For instance, in paragraph 4.6 of the International Accounting Standards Board's (IASB) Conceptual Framework for Financial Reporting (IASB, 2010, p. 26), the preference for economic substance over legal form is expressly mentioned as follows:

In assessing whether an item meets the definition of an asset, liability or equity, attention needs to be given to its underlying substance and economic reality and not merely its legal form.

It does not, however, mean that the legal form is ignored. The Conceptual Framework acknowledges that to achieve faithful representation, a complete depiction must include all information necessary for a user to understand the phenomenon being depicted (Epstein and Jermakowicz, 2010). In theory, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) provides consideration for substance and form:

If information is to represent faithfully the transactions and other events that it purports to represent, it is necessary that they are accounted for and presented in accordance with their substance and economic reality as well as the legal form. Financial reporting involves consideration of the substance of an economic phenomenon as well as its legal form (AAOIFI, 2010, p. 31).

Meanwhile the Institute of Chartered Accountants of Pakistan (ICAP) denies the distinction between substance and form (Atmeh and Maali, 2017). It states that in an Islamic finance transaction, substance cannot be different from its legal form (AOSSG, 2011). For example, if two people entered into a transaction where the true intention is to finance the other party, not to trade, then the transaction is not permissible in Islam. This study considers the example of a *murābahah* contract (purchase and sale contracts with deferred payments) and *ijārah muntahiyah bi al-tamlīk* (finance lease) to provide a brief explanation of substance and form from the Islamic accounting perspective.

In the case of *murābahah*, the profit is allocated proportionately over the period of credit (AAOIFI, 2010). The economic substance of *murābahah* is lending, although sale and purchase transactions are performed (Atmeh and Maali, 2017; Shakil and Mustapha, 2017). Moreover, the accounting treatment depicts the economic substance of the transactions owing to the allocation of profit over the period of time.

Meanwhile, in the case of *ijārah muntahiyah bi al-tamlīk*, AAOIFI (2010) requires one separate transaction for the operating lease and another for disposal of the asset. It is evident from the accounting treatment that AAOIFI emphasises more on the form of the contract of *ijārah muntahiyah bi al-tamlīk*, while the conventional accounting framework focuses more on the economic substance.

The principle of substance over form in the reporting of a Sharī'ah-compliant transaction means that the result or substance of the transaction is recorded. The point of contention



regarding this approach is that, in applying substance over form, the reporting of the Sharī'ah-compliant transaction may signify it as indistinguishable from a Sharī'ah non-compliant transaction. It is, however, argued that a Sharī'ah-compliant transaction may yield the same returns and cash flows as a Sharī'ah non-compliant transaction. Despite that, the nature of the contract undertaken would make the former *ḥalāl* (permissible), while the latter would be *ḥarām* (impermissible). For Muslims, therefore, it is imperative that the contract or series of contracts used in the financing arrangement be clarified and that Sharī'ah-compliant transactions be depicted as distinct from interest-bearing financing. As such, some have advocated the application of alternative principles of recognition and measurement for Sharī'ah-compliant transactions instead of adopting the IFRS approach (Atmeh and Maali, 2017).

### Contemporary issues

Abozaid (2012, p. 8) identified three reasons for substance gaps in Islamic finance contracts:

- (1) negligence of the contract substance by the deactivation of some contract rules;
- (2) negligence of the contract substance by attaching another contract or condition; and
- (3) negligence of the contract substance by the misapplication of the contract.

In the following sub-sections, the form over substance issue will be addressed by tackling examples of substance gaps in real Islamic finance practice. The three reasons identified by Abozaid (2012) as the causes of substance gaps will be used as measures of their existence in Islamic finance contracts.

#### *Wa'd (promise)*

A *wa'd* could be written or oral, and it is unilateral from one individual to another. In classical *fiqh* (Islamic jurisprudence) thought, *wa'd* is morally binding but not legally binding because it falls under the category of voluntary contracts. There is a different perspective that, if a *wa'd* depends on a condition or is not performing, it causes the promisor to incur cost or damages and it becomes morally and legally binding. The first position is adopted by the majority: Ḥanbalīs, Ḥanafīs, Shāfi'īs and a few from the Mālikī School (Ibn Bayyah, 2010). The second position is adopted by Ibn al-'Arabī of the Mālikī School, who viewed that if the promise results in a specific consequence, its fulfilment is obligatory, but if it is a promise *per se*, without any significant effect, fulfilling it is not made obligatory (Ibn Bayyah, 2010). The ruling is affirmed by the Hanafī School which distinguishes between absolute promise and conditional promise (ISRA, 2012). The latter becomes binding in the contract of exchange in avoidance of *gharar* (uncertainty) in the subject matter of the promise. This rule is very similar to the concept of guarantee established by the *kafālah* contract, which is the difference between a legally enforceable promise and all other promises we have been making or breaking in all our lives.

In the classical sense, the form of the *wa'd* concept is closely matched with its substance, and there is no opportunity for a substance gap to exist. When a person makes a promise and keeps it, there would be no issues, but if they do not keep the promise, they could be held liable for the damages suffered to the promisor, if any. However, a substance gap exists between the classical use of *wa'd* as a unilateral promise between two individuals, whether binding or not, and its modern-day utilisation by Islamic financial institutions. Modern-day *wa'd* is a promise between a client and a financial institution in an exchange contract, e.g. forex *wa'd*, or to facilitate an exchange contract, e.g. *murābahah* to the purchase orderer (MTPO).

The current use of *wa'd* has moved its substance away from its classical form, creating a substance gap; an example would be the forex *wa'd*, which is similar to the conventional option. A bank will promise a customer to exchange one type of currency for a different kind of currency at the pre-agreed rate and price on a future date. On the same date, the bank will receive a fee from the customer for its undertaking. The fee payment changes the *wa'd* from a unilateral agreement to that of an exchange, because without the fee payment, the bank will not agree.

*Wa'd* is also used to facilitate MTPO to circumvent the illegality of selling something the bank does not own, by making the customer enter into a *wa'd* to buy. *Wa'd* should be voluntary and not compulsory, but the MTPO's customer has no option but to make the *wa'd* to buy, otherwise the agreement cannot be concluded. Applying Abozaid's (2012) third rule (misapplication of contract) to test for the existence of substance gap to the current use of *wa'd*, one can conclude that its current form does not represent its classical substance. This is because the misapplication is evident in the *wa'd*. The *wa'd* is between clients and financial institutions and not individuals. It is to execute exchange contracts and facilitate their execution. Having a different substance from what it was initially intended for does not necessarily make the use of *wa'd* in modern Islamic financial transactions erroneous. However, it must be evaluated based on its new effect in society by using a measure like *maqāṣid al-Sharī'ah* (objectives of Islamic law).

### *Ṣukūk*

AAOIFI (2015, p. 468) defines investment *ṣukūk* as "certificates of equal value representing undivided shares in ownership of tangible assets, usufruct and services or (in the ownership of) the assets of particular projects or special investment activity". For the *ṣukūk*'s form to match its substance, the *ṣukūk* issuance should adhere to Islamic contract conditions and should not exhibit any of Abozaid's (2014) three identified symptoms of form over substance. The form of the *ṣukūk* structure should satisfy the underlying Sharī'ah contract conditions and should distinguish it from a conventional bond (Maurer, 2010).

Critical to the debate of form and substance in *ṣukūk* is the concept of asset-backed and asset-based *ṣukūk*, where it is agreed that the former is closer to the true substance of *ṣukūk* than the latter (Tasnīa *et al.*, 2017). In asset-based *ṣukūk*, the asset is present for Sharī'ah fulfilment to serve as a basis for profit and capital payments (ISRA, 2016). In this case, the *ṣukūk* holders have no exclusive right over the assets. They depend on the originator's creditworthiness for repayment either from internal sources or from its ability to refinance. In asset-backed *ṣukūk*, the underlying assets are the only source of profit and capital payments (ISRA, 2016). In the case of default, the *ṣukūk* holders would be able to recover their exposure by taking control of and ultimately realising the value from the asset (ISRA, 2016). In the case of bankruptcy, the originators' creditors do not have recourse to the underlying asset because it is owned by the *ṣukūk* holders (ISRA, 2015).

One can conclude that asset-based *ṣukūk* are structured and supported by an enhancement to affect their risk and return profile to mimic that of bonds. This is done to appeal to the international investor. On the other hand, the asset-backed *ṣukūk* is closer to the actual substance of Sharī'ah because the *ṣukūk* holders experience the risk of ownership of the underlying asset.

### *Organized tawarruq*

The word *tawarruq* is derived from *wariq* (silver coins). The Arabs used it to mean seeking silver, and in modern-day financing, it means monetisation. *Tawarruq* could be defined as



buying a commodity by deferred payment and selling it to a person other than the seller for a lower price with immediate payment (Al-Shalhoob, 2007; Soualhi, 2015).

There are three kinds of *tawarruq*, the basis for the classification being who carries out the *tawarruq*: done on an individual basis, organised by the seller or organised by the bank. AAOIFI (2015, p. 758) defines individual *tawarruq* as:

[. . .] the process of purchasing a commodity for a deferred price determined through *musawamah* (bargaining) or *murābahah* (mark-up sale), and selling it to a third party for a spot price so as to obtain cash.

In organised *tawarruq*, the seller handles the process by which cash is acquired for the *mutawarrīq* (the person/customer who seeks liquidity). The seller does so by selling a commodity to him for delayed payment; he then sells it on his behalf for cash by taking the payment from the buyer and handing it over to the *mutawarrīq* (Abozaid, 2014). Meanwhile, in banking *tawarruq*, the bank organises the sale of the commodity between a dealer in an international commodity market and the customer seeking monetisation, for a delayed future payment.

The majority of *fiqh* scholars opine that individual *tawarruq* is permissible if it satisfies certain conditions to guarantee proper application (Al-Dabū, 2009; ISRA, 2012). As for organised and banking *tawarruq*, there is no consensus on their permissibility among the scholars. Some consider banking *tawarruq* allowable as long as it meets certain conditions, while others consider it a trick to circumvent the prohibition of *ribā* (Iqbal and Mirakhor, 2011; Mohamad and Ab Rahman, 2014).

This paper assesses the question of substance and form for banking *tawarruq* compared to individual *tawarruq*. The essential condition for the individual *tawarruq* to be permissible is that the commodity purchased needs to be sold to a third party other than the seller for a lower price with immediate payment. The process of individual *tawarruq* creates two separate sale contracts and avoids the charge of *‘inah* (buy-back) sale. For example, in the past two decades in Sudan, a form of individual *tawarruq* has become widespread and common. The locals term it as *kasir*, meaning “a break” in Arabic. The process follows this sequence: the person in need of immediate finance will buy a highly demanded product like a wide-screen TV in exchange for some post-dated cheques. Then they will sell it to a consumer or another trader at a price below the market price to speed up the sale and gain cash. The unfortunate consequence of this type of *kasir* financing is that many people may not get paid their debts, and they may end up in prison as a result of their debts for unlimited sentences.

Those who reject banking *tawarruq* believe it clashes with the principle, “matters are to be evaluated in light of their objectives”. They perceive the aim of the two sales to be procurement of cash in exchange for a deferred payment of a more substantial amount of cash. This renders both sales not actual sales, and the practice suffers from a substance gap, satisfying Abozaid’s third criterion of misapplication of a contract (Iqbal and Mirakhor, 2011; Abozaid, 2012). For the form of banking *tawarruq* to match the *fiqh tawarruq*, the customer and the bank would have to experience the risk of ownership of the commodity, but in practice, this risk is minimised to the degree of non-existence. In practice, this is done by adopting the following procedures:

- The transactions occur within a short time period between each other.
- The bank often acts as an agent on behalf of the customer (in the customer’s transaction with the commodities broker).
- First and second commodity brokers know each other, and have a pre-arrangement to trade the said commodity. Broker A sells the commodity to the bank, the bank then sells the commodity to Broker B who sells it back to Broker A.

- Commodity price quotes from both brokers are valid for 24 h.
- There is a purchase undertaking with the first commodity broker (put option).

The above reasons and practices take away the substance of *tawarruq* from its classical form. The Council of the International Islamic Fiqh Academy, in its 19th Session, which was held in Sharjah, United Arab Emirates, from 26 to 30 April 2009, decided that:

It is not permissible to execute banking *tawarruq* because simultaneous transactions occur between the bank and the *mustawriq* [the party who seeks liquidity by entering into the *tawarruq*], whether it is done explicitly or implicitly or based on common practice, in exchange for a financial obligation. It is considered a deception, i.e. to get the additional quick cash from the contract. Hence, the transaction is considered as containing the element of *ribā* (ISRA, 2010).

In issuing this resolution, the Fiqh Academy affirmed that *tawarruq*, as practised by modern financial institutions, suffers from a substance gap between its form and substance. For this reason, they changed their position from permissible to impermissible.

### *Ijārah*

Linguistically, the Arabic term *ijārah* means to rent or hire, and it could be defined as the transfer of the usufruct of a specific property from one party to another in exchange for rent, or transfer of the labour of one person to another in exchange for fee payments. There are two types of *ijārah* of usufruct, depending on the type of contractual agreement. The first is an operating lease, and this is used for leasing different assets, for instance, buildings, ships, aeroplanes and heavy-duty equipment. It is characterised by the absence of a purchasing agreement at the end of the lease. The second is a financial lease, which involves the purchasing or gifting of the asset at the end of the lease; this is named *al-ijārah thummah al-bay'* (AITAB) in Arabic.

The rules of *ijārah* are like those of a sale because in both cases something is transferred to another person in return for a price. The only difference between *ijārah* and sale is that in the latter, the property is transferred to the purchaser, while in the former, the property remains in the ownership of the transferor; only its usufruct is transferred to the lessee. In its original form, *ijārah* is not a mode of financing but a normal business activity like a sale. However, due to certain reasons – in particular, tax concessions in Western countries and the retention of ownership by the lessor to enhance credit security – financial institutions started to use leasing for financing. Instead of giving an interest-bearing loan, some financial institutions offered lease financing of assets. The best example is the use of AITAB for the sale of cars in Malaysia.

To arrive at the same result as offering a loan, these institutions will add the total cost they incurred in the purchase of these assets and also add the interest amount they could have claimed on such amounts during the lease period. The total is divided by the number of months of the lease period to fix the monthly rentals. It is already clear that even in a conventional finance lease, the substance is just an interest-bearing loan and this circumvent is done partly for tax purposes. Also, it is practised to reflect the substance of the transaction.

The question of whether leasing can be used as a mode of financing in Shari'ah depends on the terms and conditions of the contract. The question that follows is: Does *ijārah* also suffer from a substance gap between the original *ijārah* concept and its application as a contract in modern-day Islamic finance?

The common mechanism of *ijārah* as it is applied in Islamic banking contracts follows this sequence. First, the customer identifies and approaches a vendor or supplier of an asset

that he needs and collects all the relevant information. Then the customer approaches the bank for *ijārah* of the asset and promises to obtain the asset on lease from the bank upon the bank's purchase of it. The bank makes the payment of the price to the vendor; the vendor transfers ownership of the asset to the bank. The bank then leases the asset, transferring its possession and specific right of use to the client. The customer pays *ijārah* rental over the agreed period. When the *ijārah* tenure expires, the asset is gifted or sold for a nominal value to the customer (Abozaid, 2014).

Muslim jurists have pointed out contentious areas in this modern application of *ijārah* that might create a substance gap between its classical form and modern use (ISRA, 2012; Abozaid, 2014). The first falls under Abozaid's second criterion of combining two contracts in one; here, the customer makes a promise to the bank to rent the identified asset before the bank buys it. Scholars in support of this step claim that the lessor and lessee relationship has not been established yet, and hence, there are no two contracts in one (Zaher and Hassan, 2001; Abozaid, 2014). The same point resurfaces at the end of the *ijārah* tenure when the bank promises to pass the ownership of the leased asset to the customer by a nominal purchase or gift. Also, the promises are both unilateral and binding only on the promisor; the intention is to enhance the *ijārah* contract, and in so doing, it mimics a conventional loan.

Another issue in the *ijārah* contract is that rentals in long-term contracts are sometimes linked to an interest rate benchmark like LIBOR (Zaher and Hassan, 2001). Linking rental payments to an interest benchmark is an attempt to preserve the rental amount's value of money, but this is a risk that should not be shifted to the lessee from the lessor. If an *ijārah* contract adopts interest rate benchmarking, this will widen the substance gap between the classical form of *ijārah* and its substance where the lessor has a certain risk he/she must endure. Adopting a clear benchmark such as a government tax rate or an agreed-upon percentage between the lessor and lessee introduces an element of risk to both sides because the rental payments can go up and down in real terms depending on the rate of inflation.

Another contentious issue in *ijārah* contracts is who is supposed to endure the risk of ownership during the period of the contract. Usmani (2002, p. 111) summarises the rule thus:

As the corpus of the leased property remains in the ownership of the lessor, all the liabilities emerging from the ownership shall be borne by the lessor, but the liabilities referable to the use of property shall be borne by the lessee.

In contracts where this is observed, the substance gap should narrow down and come closer to the true substance of the classical *ijārah* contract.

In answering the question of form over substance, one should place greater emphasis on the intention in forming a contract. The Shāfi'ī School adopted the opposite view on the basis that it is not the jurist's business to ascertain people's purposes. Thus, evaluation should be limited to the exterior signs to arrive at an opinion. The paper favours the first argument. This is because we do not know the historical context that led the Shāfi'ī School to adopt this position, but in modern times it will be abused and will drive a significant wedge between current Islamic finance contracts and their *maqāṣid* (objectives).

When it comes to the *ijārah* financing contract, the intention is clear from the beginning – that of not transferring the usufruct but transferring the ownership. The evidence is in the name which translates into “a lease that leads to purchase”.

In conclusion, the modern-day *ijārah* contract suffers from the most significant substance gap of all the contracts. That is because it is engineered to such a degree that it no longer resembles its classical form. A better term that would more genuinely reflect its substance would be sale using *ijārah*.

## Conclusion

This study assesses the issue of form and substance from an Islamic law perspective and introduces the new concept of substance gap in the literature. Identifying the substance gap is meant to pinpoint the area of disjoint between the form and its intended substance within the contract process from product development to execution to effects. This study investigated the issue of form and substance from classical and contemporary angles; the issue was also identified in the fields of law and accounting.

The study has shown that the substance gap in contemporary contracts exists between the *fiqh* rules and conditions of an Islamic contract and their development and construction in the modern practice. It could be attributed to the pressure to cope with a complicated modern finance environment. This identification should help researchers who desire to address the issue at its roots and help bridge the gap between the form and substance in Islamic finance contracts.

Abozaid's (2014) criteria were used to assess contemporary Islamic finance contracts of *wa'd*, *shukūk*, *tawarruq* and *ijārah* for the presence of substance gaps. All studied contracts were found to suffer from substance gaps with varying degrees of complexity, which demonstrated that form is just as important as substance. This paper offered a fresh outlook on substance and form to highlight the significance of the issue.

Islam was sent to humanity as an agent of change to make a difference in people's lives; therefore, more research is needed to better understand the social and economic impact of contemporary Islamic finance contracts and not just their substance.

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