

## Accounting Treatment of Zakah: Additional Evidence from AAOIFI\*

Dr. Adel Mohammed Sarea<sup>1</sup>

### Abstract

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*This paper focuses on the accounting treatment of Zakah according to the requirements of AAOIFI FAS 9 (Financial Accounting Standard No. 9). The purpose of the release of AAOIFI FAS (No. 9) is to standardize the recognitions, measurements and disclosures of Zakah in the financial reporting. The objective of this paper is to highlight the usefulness of applying FAS (No.9). However, reviewing the requirements of AAOIFI (FAS 9) may serve as a guideline that may reflect the recognitions, measurements and disclosures of financial reporting and become a useful tool to meet the various needs of IFIs. Thus, the paper concludes that, applying the AAOIFI accounting standards for Islamic Financial Institutions are the best choice for increasing the investments and investor's confidence among Muslim societies as well as increase the amount of Zakah collections.*

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**Key Words:** AAOIFI, Islamic accounting, Islamic Financial Institutions, Zakah

\* AAOIFI-Accounting and Auditing Organization for Islamic Financial Institutions

### 1. Research Overview and Literature Review

The most important results of the previous studies are confirmed that, *Zakah* can eliminate poverty in Muslim countries and achieve the desired justice in the distribution of income and wealth (Abdelbaki, 2013). *Zakah* is essential as a social welfare levy imposed to Islamic society's wealthier members and more prosperous businesses and thus helps to close the gap between the poor and the rich (Awang&Abdul Rahman, 2003). However, *Zakah* has been identified as an important source to the economy of the Muslim community and give an impact on socio-economy development of nation (Ibrahim et al., 2013).

According to *Shari'ah* principles, *Zakah* is an obligation in respect of funds paid for a specified type of purpose and for specified categories. It is a specified amount prescribed by Allah the Almighty for those who are entitled to *Zakah* as specified in the Qur'an. The word *Zakah* is also used to indicate the amount paid from the funds that are subjected to *Zakah* (AAOIFI, 2010). Furthermore, *Zakah* also is fundamental to every Muslim as well as *Zakah* is the Islamic contribution to social justice (Dahr and Akhan, 2010). However, *Zakah* is an obligation, prescribed by Allah S.W.T with the ultimate goal as a form of social security, to develop balanced economic growth through redistribution of wealth in society (Abdul Aziz and Abdullah, 2013).

Historically, although in early Islamic states, *Zakah* funds were collected and managed by the state (Hassan, 2010). *Zakah* management has gone through historical challenges after the extinction of early Islamic states.

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<sup>1</sup>Director of MBA, College of Graduate Studies and Research, Ahlia University, Kingdom of Bahrain.

After the colonial era, a few Muslim countries such as Yemen, Saudi Arabia, Libya, Sudan, Pakistan, and Malaysia have opted for mandatory *Zakah* management through government (Hassan, 2010). Other countries such as Egypt, Jordan, Kuwait, Iran, Bangladesh, Bahrain and Iraq, have formed specialized state institutions but participation of public is made voluntary (Hassan, 2010).

## 2. Research Problem

Due to the absence of authorities to implement accounting standards for Islamic financial institutions, IFIs are currently applying different accounting standards in their financial reporting (Sarea & Hanefah, 2013). In addition, Due to the current different regulatory requirements and legislations, the relevance and comparability of financial statements are the foundations upon which accounting standards are predicated. Thus, diversities exist in terms of their class structure, political systems, legal systems, financial systems, educational systems, and the very nature of conducting business and business ownership (Choi and Meek, 2005). In related study, Lovett (2002) documented that, with financial statements prepared under different accounting standards a problem may exist in:

- Comparability of financial statements prepared globally,
- Reliability and creditability.

Islamic financial institutions prepare their financial statements using a number of accounting standards either international accounting standards or local accounting standards, the problem may exist in the practices and the level of understanding among accountants and the level of compliance (Report, KPMG and ACCA, 2010). Accordingly, the need for accounting standards for Islamic financial institutions may possibly be the right way to resolve these issues. In this regard, according to Sarea & Hanefah (2013) as quoted from Maali and Napier (2010) due to unique transactions of Islamic financial institutions, conventional accounting rules such as the International Financial Reporting Standards are not compatible to Islamic banks. Thus, the need to develop and apply the accounting standards related to *Zakah* may reduce any differences in the methods of treatment applied by IFIs.

Therefore, the researcher reviewing many of the previous studies in order to discuss these issues, many initiatives have been taken to facilitate *Zakah* collection and distributions. For instance, the AAOIFI organizations has been recognized and mandated to develop accounting, auditing, governance and ethics standards in order to promote comparable and reliable accounting information.

The formulation and adoption of AAOIFI standards in any country is intended to increase foreign investment as well as investor's confidence. These standards are set up to produce financial statements that are transparent in their preparation and easily interpretable by users (Sarea & Hanefah (2013) as quoted from (Karim, 2001).

## 3. Research Methodology

The objective of this study is to determine the accounting treatment of *Zakah* according to the requirements of AAOIFI FAS 9. The importance of *Zakah* as a source of financing to payout the eight categorizes as mentioned in the Quran. Allah S.W.T says, "Take sadaqah (obligatory alms) out of their wealth through which you may cleanse and purify them" [al-Tawbah: 103].

However, the researcher reviews the requirements of AAOIFI FAS 9 in terms of three elements:

1. Recognitions: to discuss the basic principles that determines the timing of revenue, expense, gain and loss.
2. Measurements: to discuss the principles that determine the amount at which assets, liabilities, owners equity are recognized
3. Disclosures: all information should be available for all users

Accordingly, data were collected from AAOIFI FAS 9 (recognitions, measurements and disclosures) and literature review in order to answer the research question.

#### **4.Accounting Treatment of Zakah: Additional Review of AAOIFI FAS (No.9)**

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), a private standard setting body, was established by the Islamic banks and other interested parties to prepare and promulgate accounting, auditing and governance standards based on the *Shari'ah* precepts for Islamic financial institutions (Sarea & Hanefah, 2013) as quoted from(Karim, 2001).

Background of the standard: The standard for *Zakah* was adopted by the Accounting and Auditing Standards Board in its meeting No. 15 held on 27-28 Safar, 1419H corresponding to 21-22 June, 1998 and shall be effective for financial statements for fiscal periods beginning 1 Muharram 1420 H or 1 January 1999.

This standard aims to set out accounting rules for the treatments related to the determination of the *Zakah* base. Thus, it is expected that the standardization in the methods applied would help to provide useful information to the users of the financial reports, The AAOIFI FAS 9 covers the accounting treatments related to *zakah* base and disclosure of *zakah* (AAOIFI, 2010).

AAOIFI FAS No.9 consist of 21 paragraphs that describe measurements, recognition, and disclosure requirements, as well as setting out accounting rules for the treatments related to the determination of the *Zakah* base and measurement of items included in the *Zakah* base and disclosure of *Zakah* in the financial statements of the Islamic banks and financial Institutions (AAOIFI, 2008).

#### **4.1: Recognition of Zakah**

In reference to the AAOIFI FAS 9 (Para 9, 10 & 11), there are two scenarios to explain the payment of *Zakah*. The first scenario in case the Islamic bank is obliged to pay *zakah* and the second scenario in case the Islamic bank is not obliged to pay *zakah*:

##### **4.1.1: The First Scenario**

In any of the following cases, *zakah* shall be treated as a (non-operating) expense of the Islamic bank and shall be included in the determination of net income in the income statement:

- (a) When the law requires the Islamic bank to satisfy the *zakah* obligation.
- (b) When the Islamic bank is required by its charter or by-laws to satisfy the *zakah* obligation.
- (c) When the general assembly of shareholders has passed a resolution requiring the Islamic bank to satisfy the *zakah* obligation.

In para (9), unpaid *zakah* shall be treated as a liability and presented in the liabilities section in the statement of financial position of the Islamic bank (AAOIFI, 2008).

##### **4.1.2: The Second Scenario**

- (a) In case some or all of the shareholders ask the Islamic bank to act as agent in meeting the *zakah* obligation relating to their investment in the Islamic bank from their share of distributable profits, the *zakah* shall be deducted from the shareholders' share of distributable profits (para 10).
- (b) In case some or all the shareholders ask the Islamic bank to act as agent in meeting their *zakah* obligation and the Islamic bank agrees to do so even if there are insufficient distributable profits to meet the shareholders' obligations, the amount paid by the Islamic banks shall be recorded as a receivable due from these shareholders (para 11).

In para (12), The *zakah* due from the Islamic bank as well as amounts of *Zakah* received from other sources of funds shall be presented in the statement of sources and uses of funds in the *zakah* and charity fund (AAOIFI, 2008).

#### 4.2: Measurements of *Zakah*

According to AAOIFI FAS 9, The *zakah* base shall be determined by using 2.5% for a lunar calendar year and 2.5775% for a solar calendar year based on either of the following two methods: Net Assets, Net Invested Funds (para 2). The AAOIFI (FAS, No.9) offers two methods in order to measure *Zakah*.

##### 4.2.1: The First Method is the Net Assets Method which is based on the Following Formula:

**The first method:** *zakah* base = Assets subject to *zakah*– (liabilities that are due to be paid during the year ended on the date of the statement of financial position + equity of unrestricted investment accounts + minority interest + equity owned by government + equity owned by endowment funds + equity owned by charities + equity belonging to not-for-profit organizations excluding those that are owned by individuals) (para 3, AAOIFI, 2008).

##### 4.2.2: The Second Method is the Net Invested Funds Method which is based on the Following Formula:

**The second method:** *zakah* base = Paid-up capital + reserves + provisions not deducted from assets + retained earnings + net income + liabilities that are not due to be paid during the year ended on the date of the statement of financial position – (net fixed assets + investments not acquired for trading, e.g. real estate for rent + accumulated losses) (para 7, AAOIFI, 2008).

#### 4.3: Disclosure Requirements of *Zakah*

In reference to AAOIFI FAS 9 requirements, there are (8 para) to explore the disclosure requirements in the financial statements of the IFIs. There is also a requirement to disclose the method used for determining the *zakah* base and the rulings of the *Shari'ah* Supervisory Board (SSB). Moreover, disclosure of whether or not the Islamic bank as a holding company pays its share of *zakah* obligations in its subsidiaries as well as of whether or not the Islamic bank collects and pays *zakah* on behalf of holders of investment accounts and other accounts (See para 15, 16, 17 and 18).

Furthermore, in para (19) disclosure shall be made in the notes accompanying the financial statements of the restrictions imposed by the *Shari'ah* supervisory board of the Islamic bank in determining the *Zakah* base. An example of such a restriction is: in the net invested funds method, the total of net fixed assets and investments not acquired for trading should not exceed the total of paid up capital and reserves. In addition, the disclosure requirements in Financial Accounting Standard No.1: General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions shall be observed (para 20).

Finally, The IFIs need to disclose the notes accompanying the financial statements of the restrictions imposed by the *Shari'ah* Supervisory Board of the Islamic bank in determining the *zakah* base. Therefore, the disclosure requirements indicate the needs for IFIs to be more transparent in disclosing the financial information related to *zakah* base.

## 5. Conclusion

This research attempts to discuss the accounting treatment of *zakah* by focusing on the recognitions, measurements and disclosures of *zakah* according to the AAOIFI (FAS No.9).

This research may be considered as additional evidence to determine the accounting treatment of *zakah*. Therefore, this research contributes to a better understanding of *zakah* concept and willing to deal with the requirements of recognitions, measurements and disclosures of financial reporting and become a useful tool to meet the various needs of IFIs. The findings seem to demonstrate that, the accounting treatment of *zakah* according to AAOIFI (FAS No. 9) could contribute to have more transparency of financial reporting. In other words, the financial statements will be more transparent and easily comparable. This paper concludes with some recommendations in order to improve the quality of transparency of financial reporting as well as to example of main differences between domestic accounting standards and the AAOIFI accounting standards.

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### **Further Reading**

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### **Short Bio of the Author:**

**Dr. Adel Mohammed Sarea** received his PhD from Islamic Science University of Malaysia in 2011. Dr Adel joined Ahlia University in January, 2012 as Assistant Professor, Accounting and Economics Department, College of Business and Finance. He Conducted research in the area of Accounting for Islamic Financial Institutions and published in the journals of repute. He is appointed as a recognized supervisor by Brunel University (UK) & Member of Master of Engineering Management Program Committee, George Washington University. He also serves as a member of the editorial boards in a number of international journals. Currently he is the Director of MBA program. He can be reached at [asarea@ahlia.edu.bh](mailto:asarea@ahlia.edu.bh) / [Adelsarea@hotmail.com](mailto:Adelsarea@hotmail.com), Accounting and Economics Department, College of Business and Finance, Ahlia University, Manama, Kingdom of Bahrain.