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# Accounting Treatment for Corporate Zakat: A Critical Review

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## Abstract

This paper reviews the accounting treatment for zakat. Few articles or books have been written on this topic (with the notable exception of Al-Moghaiwli 2001; Mursyidi, 2003, Al-Habshi, 2005). However several zakat accounting standards and guidelines have been promulgated and developed. This includes the Financial Accounting Standard (FAS) No. 9 by the Accounting and Auditing Organization for Financial Islamic Institutions (AAOIFI), the Technical Release *i*-1 (TR *i*-1) on 'Accounting for Zakat on Business' and the Financial Reporting Standard (FRS *i*-1) by the Malaysian Accounting Standard Board.

This paper first reviews these articles and accounting standards. In turn a theoretical examination from both religious as well as from theoretical accounting perspectives is suggested. Some analysis on the practices of Islamic banks and financial institutions will be also carried out to ensure their compliance with both standards promulgated and ontological aspects of zakat.

It is expected that this paper may contribute an alternative view to enrich and improve the accounting treatment for zakat. In turn it is hoped that this will contribute towards a better collection and disbursement of the zakat system, for Islamic commercial institutions in particular, as well as for other business organizations in general.

Keywords: Zakat, Accounting Treatment, Accounting Standard, Islamic Institutions.

## Introduction

The discourse on zakat generally and zakat accounting in the academic environment in particular has been steadily expanding. It is no longer perceived by many that zakat is merely limited to the domain of religious or sharia studies and discourses, but has been widened to include the issue of social economics.

It is commonly understood that zakat is the third pillar of Islam. It is also mentioned repeatedly in the Holy Furan and some ahadith (a plural of hadith[1]). Al-Qardawi [2004, 39] notes that some Muslim scholars claim that the Qur'an mentions zakat in eighty-two places, while according to Al-Qardawi himself, the word is stated some 30 times, while 27 occurrences are affirmed together with the order of salat or regular prayers. This is evidence of how important zakat is in Islamic teachings.

Second, zakat is commonly considered as an important alternative to solving one of the most prevalent social and economic problems in the world, namely poverty. In some Muslim countries, like Malaysia and Indonesia for example, the effort to collect zakat has showed a remarkable and promising upturn (see: Table 1). The collection of zakat is no longer constrained by individual muzakkies (zakat payers). It has rather broadened to institutional payers like companies or corporations.

The fact that zakat is a 'financial' form of ibadah makes the computation of zakat indispensable in fulfilling this obligation. Accounting as a medium of computing zakat, thus has a role in determining a proper and fair assessment of payable zakat. The importance of accounting is in fact not only limited to zakat obligation, but also to other aspects of human life. This has been duly recognized in Islam as stated in Al-Quran 2:282.

[1] hadith (hädēth') , a tradition or the collection of the traditions of Muhammad, the Prophet of Islam, including his sayings and deeds, and his tacit approval of what was said or done in his presence. [http://www.answers.com/topic/hadith ]

Table 1: Amount of zakat collected from 1991 to 2006 based on Income, Wealth, Saving and Trade in Malaysia.

| Year | Zakat on Income | | Zakat on Wealth | | Zakat on Saving | | Zakat on Trade | |
|---|---|---|---|---|---|---|---|---|
| | Amount zakat collected in million RM | Number of Zakat Payers / Muzakkies | Amount zakat collected in million RM | Number of Zakat Payers / Muzakkies | Amount zakat collected in million RM | Number of Zakat Payers / Muzakkies | Amount zakat collected in million RM | Number of Zakat Payers / Muzakkies |
| 1991 | 3.7 | 5,381 | 3.3 | 1,983 | 3.9 | 5,264 | 1.6 | 301 |
| 1992 | 5.1 | 7,399 | 6 | 3,441 | 5.5 | 11,307 | 2.4 | 395 |
| 1993 | 7.3 | 9,752 | 9.6 | 4,378 | 6 | 12,574 | 1.8 | 480 |
| 1994 | 9.4 | 10,730 | 10.9 | 4,402 | 7.4 | 13,655 | 4.3 | 744 |
| 1995 | 9 | 10,783 | 12.1 | 4,536 | 6.9 | 15,962 | 3.3 | 588 |
| 1996 | 11.8 | 12,126 | 16 | 5,008 | 7.8 | 15,007 | 4.3 | 698 |
| 1997 | 12.2 | 12,466 | 16.2 | 4,896 | 7.9 | 14,750 | 13.2 | 738 |
| 1998 | 10.7 | 12,002 | 15.9 | 4,930 | 6.2 | 8,816 | 10 | 681 |
| 1999 | 7.4 | 10,015 | 9.2 | 3,244 | 6.3 | 7,110 | 9.6 | 560 |
| 2000 | 18.5 | 16,289 | 16.6 | 4,479 | 7.7 | 8,644 | 12.5 | 629 |
| 2001 | 33.2 | 20,730 | 14.9 | 4,028 | 7.9 | 12,532 | 13.6 | 623 |
| 2002 | 42.9 | 24,201 | 16.5 | 4,061 | 7.8 | 8,976 | 13.1 | 644 |
| 2003 | 54.1 | 30,473 | 16.3 | 4,030 | 8.7 | 7,833 | 12.9 | 718 |
| 2004 | 63.7 | 33,856 | 17.1 | 4,106 | 9.9 | 8,335 | 15.4 | 712 |
| 2005 | 76.7 | 35,807 | 18.6 | 4,112 | 10.6 | 8,788 | 20.1 | 747 |
| 2006 | 89.1 | 40,809 | 18.8 | 4.101 | 12 | 9,020 | 22.8 | 885 |
| **Total** | 454.8 | 292,819 | 218 | 65,735 | 122.5 | 168,573 | 150.9 | 10,143 |

Source: PPZ Selangor Annual Report, 2006.

This link between accounting and zakat has stimulated wide ranging discussion among academics. As mentioned there are however only limited papers and books published in this area. These include Al-Moghaiwli, [2001], Al-Habshi [2005], Maliah [2003, 2005], Mursyidi [2003], Khan [2003], Islahi and Obaidullah [2004], Bahari and Hamat [2004], Abdul Rahman [2002, 2007] and Abu Bakar [2007].

Among those publications (albeit pertaining to zakat and accounting) very few are focused on the accounting treatments of zakat for business organizations. In other words, the majority of these discussions revolved around general ideas on this issue and thus do not offer steps towards the development of accounting standards. This is especially required by institutional zakat payers. Despite the limited literature it is fortunate that there are a number of regulatory bodies in some countries who have actually taken plausible moves by developing accounting standards (or at least accounting guidelines), which may be useful for business zakat assessment. These bodies include the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Malaysian Accounting Standard Board (MASB) and the Indonesian Institute of Accountant (Ikatan Akuntan Indonesia – IAI). Their commendable initiatives towards the promulgation of zakat-related standards are arguably stimulated by the increasing number of business organizations performing this obligation.

Through the issuance of zakat accounting standards, which will govern the accounting treatment for zakat, it is expected that the following two-fold positive consequences will occur. First, that it may enhance the uniformity and comparability of business financial statements with that of others within related industries (see also Abu Bakar, 2007; Abdul Rahman, 2002). This uniformity and comparability will in turn assist the auditing process of zakat accounts [See also Abdul Rahman, 2007, 92].

The other possible positive implication of the issuance of zakat accounting standards are that it may contribute towards an increase in the amount of a business' zakat collection (see also Abu Bakar, 2007). However currently there is no empirical evidence to support this assertion.

This paper does not intend to examine the above-mentioned issue, but rather to study the accounting treatments that have been proposed by the standards issued by the said accounting bodies (i.e. AAOIFI, MASB and IIA). The rationale behind this study is based on the premise that the current accounting standard does not offer a fair and proper assessment of zakat wealth for corporations. A case in point is that zakat assets and zakat paid is treated as one of a number of 'expenses' in a company's income statement. This misclassification is simply a manifestation of the respective bodies' misconceptions about the overall spirit and nature of zakat in Islam.

As a result of this mistreatment of zakat wealth, it is feared that some negative attitudes and behaviors in performing this obligation might arise among some corporations. The idea of how incorrect accounting treatment may result in unfavorable practice is actually in line with one well-supported accounting theory proposition. This argues that accounting will influence people's behavior (and their environment) as well as *vice versa*. [See for example Choi and Levich, 1990 in, and Godfrey et al, 2006]. This is supported in Al-Moghaiwli's [2001] study conducted in Saudi Arabia, whereby his research found that managers of Saudi companies managed earnings via accounting for zakat so as to maximize their own wealth and/or the market value of their companies.

In light of the above, it is vital that there should be a proper and fair accounting treatment and assessment of a corporation's zakat, not only to ensure positive and favorable zakat behavior among corporations, but most importantly to ensure that these corporations can rightly fulfill their zakat obligations. It is the aim of this study to explore this issue utilizing a conceptual framework point of view, and by scrutinizing the existing accounting treatments for zakat.

The paper is organized as follows: A review on accounting treatments is first presented, whereby all accounting treatments promulgated by AAOIFI, MASB and IIA will be briefly described. Afterwards, an examination based on the conceptual framework is conducted. An alternative view of the above discussion is then offered in the final section of this paper.

**Accounting Standards Related to Corporate Zakat Assessment**

'Accounting standard' refers to accounting guidelines developed to deal with specific financial accounting and reporting issues. To date there are several accounting regulatory bodies that have demonstrated their concerns regarding the accounting treatment of corporate zakat by issuing accounting standards or guidelines. This includes the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), the Malaysia Accounting Standard Board (MASB) and the Indonesian Institute of Accountant (IIA or Ikatan Akuntan Indonesia - IAI).

The AAOIFI has issued the Financial Accounting Standard (FAS) No. 9 which specifically governs zakat accounting treatments for Islamic banking and financial institutions. The standard was adopted by the AAOIFI Board at its meeting of 21 – 22 June 1998, and were effectively applied into practice from 1 Muharram 1420 H or 1 January 1999 [para 21].

In the case of Malaysia, it has released the MASB Technical Release *i* –1: "Accounting for Zakat on Business", that became effective on 1 July 2006. TR *i*-1, however, it emphasizes that since most business-related zakat issues fall under the SIRC's jurisdiction (and thus are considered outside the MASB's purview), TR *i*-1 only deals with financial reporting issues related to a corporation's zakat (Abu Bakar, 2007). Other decisions on a corporation's zakat made by an entity (including issues such as zakat chargeability, calculation, determination of the zakat base, and eligibility of assets and liabilities) should be subject to the conclusions reached in cooperation with the respective zakat center.

In Indonesia, according to Sriyanto, Technical Director of The Indonesian Institute of Accountants [See: http://www.kafeis.or.id/?pilih=lihat&id=439], the standards are expected to be issued in March 2008. However, unlike the AAOIFI's FAS No. 9 and MASB's TR *i*-1, the Indonesian accounting standard is mainly designed to accommodate the scores of zakat institutions that exist in that country, either in the form of public (established by the government) or private entities. The main reason for designing the accounting standard for zakat for the purpose of zakat institutions is the assertion put forward by the Ulama Indonesian Council that muzakkies are individuals and not companies, as quoted by Sriyanto [Aru, 2007]. The companies or business entities accordingly are not obliged to pay zakat. In the case of Islamic banks, however, they are allowed to collect zakat (from their customers and employees), as well as to distribute zakat appropriately.

Due to the above conditions, the review to be conducted on the existing accounting treatments for corporate zakat will be focused on the AAOIFI's FAS 9 and the MASB Technical Release *i* –1.

**Accounting Treatments for Corporate Zakat**

The accounting standards generally used to deal with basic issues include definition, classification, recognition, measurement, presentation and disclosures. This review will be focused on these issues.

This discussion will first commence with definition, account classification and recognition. According to the AAOIFI:

> Zakat means 'blessing, purification, increase and cultivation of good deeds'. In Shari'a, it is an obligation in respect of funds paid for a specific type of purpose and for specified categories … The government may also authorize shareholders to pay it personally if it is satisfied that they will do so, or it may instruct Islamic banks to organize its payment on behalf of Islamic banks' shareholders, using the combined basis for nisab as described [above].
> [AAOIFI, 2001, p. 322].

With regards to the treatment of zakat, the FAS 9 describes two possible scenarios. One is the case in which an Islamic bank is obliged to pay zakat. The other is the opposite of this. There are three situations in which an Islamic bank may fall into the first category, that are: (a) when the law requires the Islamic bank to satisfy their zakat obligation; (b) when the Islamic bank is required by its charter or by-laws to satisfy their zakat obligation, and/or (c) when the general assembly of shareholders has passed a resolution requiring the Islamic bank to satisfy their zakat obligation [AAOIFI-FAS 9, 2001, para 9].

Unlike the AAOIFI FAS 9, which is basically meant for Islamic financial institutions and thus may not be immediately applicable to other (business) entities (Abdul Rahman, 2002; Abu Bakar, 2007), the MASB Technical Release *i* –1, has focused the accounting standard only for business. This means that it can be used by any company of any existing industry. The MASB defines zakat as: 'obligatory contribution assessed based on certain assets owned by a Muslim that satisfy certain conditions and is to be distributed to specified categories of beneficiaries'. While zakat on business is defined as an 'obligatory contribution assessed based on business assets owned by an entity that satisfy certain conditions and is to be distributed to specified categories of beneficiaries'.

Examining the definitions offered by both FAS 9 and TR *i* –1 the former definition can be considered as both more comprehensive as well as closer to the true concept of zakat. The latter, as stated earlier, defines zakat very technically.

However, the account classification and recognition of zakat is defined quite similarly by both FAS 9 and the TR *i*1. FAS 9 recognizes it as a non-operating expense that has to be included in the determination of net income in the income statement. The same goes for the TR*i* –1 which recognizes it as an expense to be included in the income statement for the period in which it is incurred. It is argued here that though the transaction, and thus the consequent treatment may be agreeable to the expense concept in accounting, it does not augur well with the intended spirit of paying zakat. This point will be further elaborated in a later section of this paper.

The second issue regards the measurement and zakat determination. FAS 9 offers two different methods. These two approaches however yield the same result, provided that the items included are consistently classified and valued, with due considerations given to the different valuation basis in them [para 8]. The first method is known as the Net Assets Method which is based on the following formula:

> … zakat base = assets subject to zakah – (liabilities that are due to be paid during the year ending 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]

The second method is called the Net Invested Funds Method. In this instance the formula or zakat base shall be calculated as follows:

> Paid up capital + reserve + provisions not deducted from assets + retained earning + net income + liabilities that are not due to be paid during the year ended on the date of statement of financial position – (net fixed assets + investment not acquired for trading, e.g. real estate for rent + accumulated losses). [para7].

The MASB Technical Release *i* –1, on the other hand also recommended two methods: (a) Adjusted Working Capital Method; and (b) Adjusted Growth Method. The first method calculates zakat base as net current assets, adjusted for items that do not meet the conditions for zakat assets and liabilities. The adjusted growth method calculates zakat base as owners' equity and long-term liabilities, deducted for property, plant and equipment and non-current assets, and adjusted for items that do not meet the conditions for zakat assets and liabilities as determined by the relevant zakat authorities. It is emphasized that a business entity has to apply any chosen method consistently from one period to another, although both methods would result in the same amount of zakat base. Unlike the FAS 9, the TR*i* –1, does not present any example for each method suggested.

The third issue regards the presentation. The FAS 9 of AAOIFI characterized the presentation of zakat as depending on two circumstances (i.e. the Islamic bank which is obliged to pay zakat and the opposite situation).

In the first scenario, where an Islamic bank is obliged to pay zakat, as alluded to earlier, the zakat shall be treated as a non-operating expense and shall be included in the determination of net income in the income statement. Whereas the unpaid zakat shall be treated as a liability and presented in the liabilities section of the statement of financial position of the Islamic bank. In addition to the above, section 2/2/3 of FAS 9 states: 'the zakat due from the Islamic bank as well as amounts of zakat received from other sources of funds shall be presented in the statement of sources and uses of funds in the zakat and charity fund' [para 12].

In the MASB Technical Release *i* –1, presentation of zakat is highlighted in point 15, where it states: 'The amount of zakat assessed for the current period shall be presented as a line item on the face of the income statement'.

The fourth is related to disclosure. In this regard FAS 9 set up eight rules about disclosure, which include: the obligation to make available in notes accompanying the financial statements of: (i) method used for determining the zakat base and the items included in the base [para 13]; (ii) the ruling of the Sharia's supervisory board of the Islamic bank on issues related to zakat that are not included in the standard [para 14]; (iii) whether or not the Islamic bank as a holding company pays its share of zakat obligations in its subsidiaries [para 15]; (iv) the amount of zakat that is due from each share (if the bank does not pay zakat) [para 16]; (v) the amount of zakat that is due from the equity of investment account holders [para 17]; (vi) whether or not the Islamic bank collects and pays zakat on behalf of holders of investment accounts and other accounts [para 18]; (vii) the restrictions imposed by the Shari'a supervisory board of the Islamic bank in determining the zakat base [para 19]. In addition, in the last paragraph [i.e. para 20] of the disclosure requirement, it also states (viii) the need to observe the FAS No 1:

General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions.

The disclosure requirements are set up in points sixteen and 17 of MASB Technical Release *i* –1. The requirements are much simpler than the rules that govern FAS 9. It states, for example, the entity shall disclose in the notes accompanying the financial statements: (i) method used in the determination of zakat base; (ii) its responsibility towards payment of zakat on business; and (iii) major components of zakat. It is further stated that components of zakat may include: (a) current zakat expense; (b) zakat payment; (c) zakat liability; and (d) any adjustments recognized in the period for zakat of prior periods.

**An examination of some concepts**

After reviewing issues related to definition and classification of account, recognition, measurement, presentation and disclosure, this paper will now examine these issues in the context of their conceptual dimensions.

*Definition and account classification*

In FAS 9 of AAOIFI, it is noted that although zakat is defined only in the appendix (D: Juristic rules for zakah, p 322, 2001), this generally accepted definition serves as an important reference in commencing the standard. The definition of zakat as provided by AAOIFI can be considered as an appropriate definition and reflects the substance of zakat. In fact, equivalent definitions are also being used by numerous authors [e.g. Al-Qardawi, 2004; Muhammad, 1980 and Sabiq, 1985 in Abdul Rahman, 2007]. Nevertheless, despite the fitting definition of zakat offered, it is unfortunate that zakat paid has been inappropriately regarded as 'an expense' in the very same standard.

This plain treatment of zakat paid as 'an expense' is indeed against the very substance and spirit of zakat itself. This is based on the following justifications. First is pertaining to the concept of ownership in Islam. It is very clear in the view of Islam that the real owner of everything in this world is Allah alone [see for example: Al-Quran 2:115,116, 191, 284; 42: 4, 12, 49, 53; 43:83; 45:27; 48: 7, 14 and that wealth given by Allah is in trust (Al-Ghazali, 1983, p.80). The proprietors, who are mere trustees, are constantly reminded of the fact that they are in reality simply agents appointed by God to administer their holdings. Accordingly, Abdalati (1980, p.128) emphasized that the proprietor must always be ready to spend in the way of God and to contribute to worthy causes. Further, zakat also is meant to purify the wealth of the payers, since in part of their wealth lies some portions which is the right (or due) of others, and thus needs to be delivered to the latter [Al-Quran 17:26, At-taubah:104]. It is thus argued here that zakat payment is purely a manifestation of submission to Allah's clear instructions to return the temporarily deposited wealth to the rightful owner; hence zakat does not constitute an expense in any way.

Next justification is concerning the definition of zakat itself. As discussed earlier, one of the literal meanings of zakat is 'growth' and 'increase'. Growth can be seen from various perspectives. This includes both psychological growth and material growth. Similarly, increase can also be interpreted in many ways including increasing the payer's good deeds resulting in an increase in their religious merits and blessings (Abu Bakar & Abdul Rahman, 2007). Not only that, on the recipients' side there will be growth or increase in their wealth too. Further, in the Qur'an Chapter 2:261, Allah has described the multiplier effect of wealth paid according to His way (which includes zakat) to be seven hundred times[2]. This has actually been confirmed by many Muslim economists whereby they argue that zakat has a multiplier effect to the economy. Zakat is said to be able to gradually eliminate poverty and consequently, unemployment. Income will be increased thereby increasing standards of living and thus eventually enhancing the aggregate volume of zakah collection.

According to another perspective, some scholars argue that increase will also be implicated in the payers' wealth. In other words, whoever rightly performs zakat obligation would be given an increase in his or her wealth. Simply put, any asset or amount paid as zakat is promised to grow significantly, in many different aspects, including spiritual, psychological and financial, benefiting payers as well as the entire economy. The distinctive nature of zakat does not therefore permit it to be treated as a mere 'expense' since it represents two diverse concepts.

[2] "The likeliness of those who spend their wealth in the Way of Allah is as the likeness of a grain (of corn); it grows seven ears, and each ear has a hundred grains. Allah gives manifold increase to whom He wills. And Allah is All-Sufficient for His creatures' needs, All-Knower. [Al-Quran 2:261].

The third justification is in connection with a well acknowledged hadith narrated by Bukhari and Muslim, whereby Rasulullah (pbuh) recalled that all rewards will be cut-off after death, except for three things, namely: shadaqah jariah (which includes zakat), the knowledge shared and utilized by others, and the saleh off-springs who make the do'a (call) for his/her parents. This hadith indirectly signifies the dissimilarity between zakat with other payments.

Zakat payment is basically the payers' real (if not eternal) 'asset'. Taking into consideration all of the above issues, it is thus not acceptable to regard zakat payment as merely like any other obligation payment. Zakat is unique and distinct in both its concept and implications. The inappropriateness of treating zakat as one type of expense can be further demonstrated by thoroughly analyzing the concept of expense from a general accounting understanding.

From an accounting perspective there are many definitions of expense. Perhaps the simplest definition can be seen at http://www.investorwords.com/1842/expense.html, where expense is defined as 'any cost of doing business resulting from revenue-generating activities'. It is obvious that zakat cannot be classified as an expense since it is not resulting [merely] from revenue-generating activities.

The second definition of expense is referenced in the Free Financial Dictionary. [See: http://financial-dictionary.thefreedictionary.com/Expenses]. It defines expense as:

> (1). Money spent by a firm to continue its ongoing operations. (2). Money spent or costs incurred that are deductible and reduce taxable income. Notes: Expenses are the opposite of income. Costs that are not deductible are called 'capital expenditures' and must be depreciated or amortized instead.

Again, it is difficult to see how zakat can fit into the above definition of expense since zakat is neither intended to continue the ongoing operations of a business nor is it meant for the purpose of capital expenditure. It is also not a payment that can be deducted only from income, because zakat determination may also be based on assets. It means that in certain conditions, although the company has not earned the income, as long as the total net assets value achieves the nisab, the obligation to pay zakat has arisen.

More definitions of expense (as they are evolving from time to time) can be referred as follows:

> Expense: The decrease in net assets as a result of the use of economics service in the creation of revenues or the imposition of taxes by government units (AICPA, ARS No.3).
>
> Expense in the broadest sense includes all expired costs which are deductible from revenues (Committee on Terminology, Accounting Terminology Bulletin No. 4: Proceed, Revenue, Income, Profit and Earnings, AICPA, para 31).
>
> Expenses – gross decrease in asset or gross increase in liabilities recognized and measured in conformity with generally accepted accounting principles that result from those types of profit directed activities of an enterprise (Accounting Principles Board, Statement No. 4, para 134).
>
> Expenses are outflows of others using up of assets or incurrences of liabilities (or a combination of both) during a period of delivering or producing goods, rendering services, or carrying out other activities that constitute the entity's major or central operations (FASB, SFAC No. 6; para 80).
>
> Expenses are decreases in economic benefit during the accounting period in the form of outflows or depletion of assets or incurrences of liabilities that result in decrease in equity other than those relating to distributions to equity participants (Framework, para 70 in Godfrey et al., 2006)

The only basis that one may argue that zakat paid is actually an expense is that zakat paid shall decrease the assets or, increase the liabilities, or a combination of both. Even for this type of argument it is inappropriate to regard zakat as an expense due to the underlying purpose behind zakat payment (the purpose of cash outflow), which is distinct in nature and in-equivalent to any other type of expense as defined above.

Thus far definitions of expense provided are those taken from conventional or Western accounting thought. The examination of classifying zakat account can also be scrutinized from the conceptual framework promulgated by an Islamic accounting authority like AAOIFI. The below is a definition of expense as provided by the AAOIFI.

> Expenses are gross decrease in assets or increase in liabilities or a combination of both during the period covered by the income statements which result from legitimate investment, management of investment,

trading and other activities of the Islamic bank, including the rendering services (SFA No. 2; para 33).

Unlike the definitions cited from the conventional Western sources above, the AAOIFI adds to the expense definition, the following characteristics:

a) The gross decrease in assets or the gross increase in liabilities should not be the result of distribution to or investment by owner(s), withdrawals or deposit by unrestricted investment account holders or their equivalent, or withdrawals or deposits by current or other non-investment account holders.

b) The gross decreases in assets or the gross increases in liabilities should have the same characteristics of assets and liabilities

c) The gross decreases in assets or the gross increases in liabilities should relate to the period covered by the income statement

As pointed out earlier, the payment of zakat is basically an act of transferring back the temporarily trusted wealth to the Real Owner. The first criterion stated above is not, and can never be, fully matched. In other words, the classification of zakat an ‘expense’ (operating or not) is not acceptable to Islam. The existing classification found both in FAS 9 and MASB Technical Release *i*-1 should be consequently refused. The question then is: how to treat zakat more appropriately?

Since it is payment with a special purpose (i.e. to fulfill one’s obligation towards the Real Owner of wealth by delivering the trusted wealth to the designated categories of people), it is then sensible to classify it under the item which represents payment to ‘temporary owners’ (i.e. the beneficiaries of zakat). The closest category of item available in the present financial statement that matches the criteria of such payment is essentially the dividend. It is therefore proposed that zakat payment shall be treated in the same way as that of dividend, instead of a non-operating expense, nor any other type of expense. It is believed that the former treatment is much more relevant than the latter. This notion is in line with other views proposed by Khan [1994], Al-Habsyi [2005] and Nasir and Hasan [2005].

*Recognition*.

The recognition in accounting refers to the determination of time to record a transaction [See: SFA No. 2, para 81]. The FAS No. 9 does not specifically address the recognition issue with regards to zakat. However, as the principle of nisab[3] and hawl[4] are fully acknowledged in one of its appendix (i.e. Appendix D), it presumed that the recognition concept shall be based on these two principles. In other words, the recognition of zakat is subject to the fulfillment of nisab and hawl requirements. There appears to be no arising issues on this matter both in the FAS 9 and TR*i* – 1.

With regards to measurement, The SFA No. 2 states that:

> 'Accounting measurement refers to the determination of the amount at which assets, liabilities and, in turn, equity of the holders of unrestricted investment accounts and their equivalent and owners' equity are recognized in the bank's statement of financial position' [para 82].

It is generally understood that measurement pertaining to zakat is about the determination of amount of zakat liable to the zakat payer. It has been reviewed above that both FAS No. 9 and TR*i*-1 offers two different methods. Both accounting bodies have also stated that each method would yield a similar zakat base (as long as the accounts involved are consistently treated periodically). The only dissimilarity between methods proposed by these two bodies is that the FAS 9 is for Islamic financial institutions, while the I TR*i*-1 can be used for any business organization.

The essence of calculation methods offered by each accounting body also seems to be comparable, although the labels given are different. However, there are some problematic issues when measurement is integrated with the expense concept. Let us take the Net Invested Fund method as proposed by FAS 9 or the Adjusted Growth method as set up by the TR*i*-1. The zakat base in each method is determined, based on (among others), the value of equity account, which includes yearly Net Income, that is that the income statement needs to be ready first otherwise a zakat base could not be determined. This is paradoxical since zakat has been treated as an expense by the very same standard or pronouncement and this 'expense' as we know constitutes a major

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[3] "Nisab is the minimum amount not liable to the payment of zakat" [See: AAOIFI, 2001, p. 323]

[4] "… is the passing of a lunar calendar year, starting on the day on which the nisab is attained" [See: AAOIFI, 2001, p. 323].

part of the income statement. It is unclear whether in the calculation of net income the ‘zakat expense’ has been accommodated. While trying to rationalize this method, there are at least two possibilities, the first being that zakat has been expended and has subsequently reduced the value of net income. However, the question is: what was the basis used to determine the ‘zakat-able’ amount?

The other possibility is that zakat expense has not yet been included in the net income calculation. This means that the net income figure is the net income before zakat, which is presumably used as the base for zakat calculation. If this is the case it means that some part of the standards (in both FAS 9 and TR *i*-1) have been neglected. This implies that those two standards are in error due to conflicting components.

*Presentation*

In terms of presentation, as zakat is thus far treated as either a non-operating expense or a normal expense, both FAS 9 and TR*i*–1 stated zakat to be presented as any other expense account. This means that zakat is supposed to be presented in the Income Statement. The unpaid zakat – according to FAS 9 – shall be treated as liability and presented in the liabilities section in the statement of financial position of the Islamic bank. In addition to this, FAS 9 has required Islamic banks to present the statement of sources and uses of funds in the zakat and charity fund [para 21].

The above presentation requirement is a consequence of assuming zakat as similar to an expense. However, since the treatments proposed by both FAS 9 and TR*i*-1 are not acceptable, then the presentation shall also be adjusted.

As stressed earlier, based on both Islamic accounting points of view, zakat can be recognized as a type of distribution, instead of an expense. Again, the item in the financial statement that is closest to this notion of distribution is dividend. It is appropriate then to follow the manner on how dividend is presented. Dividend, as generally accepted, is presented in the equity group of accounts. The distribution of dividend is normally treated as a deduction of equity, or more specifically, a deduction of retained earnings. This approach of presentation is actually in line with the concept of measurement where zakat shall be calculated based on either net invested fund (a second method offered by FAS 9), or adjusted growing method as proposed the MASB TR i-1

*Disclosure*

Disclosure is about providing all material information needed by the users of financial statements [See SFA No. 2, para 130]. As reviewed above, the FAS 9 has stated eight requirements that need to be disclosed accompanying zakat payments reported by Islamic banks and financial institutions. The TR*i*-1 on the other hand, requires less complex disclosure.

Examining requirements set by the two accounting bodies confirms that those requirements are considered logical and acceptable. They are conceptually satisfactory and practicable. The only arising problem with disclosure requirement is that the commitments and/or compliance of institutional zakat payers with those requirements. Based on a cursory examination, many companies in Malaysia only present zakat as an expense and provide no disclosure at all. Obviously this is one of the many challenges that needs to be resolved by related authority bodies in the near future, particularly in their efforts towards promoting an enhanced disclosure in companies' financial statements.

## Concluding Remarks

This paper has critically reviewed the accounting treatments for *zakat* of business organizations, particularly the two standards or technical releases issued by the AAOIFI (i.e. FAS No. 9) and the MASB (Technical Release *i*-1). They were examined both from the substance of *zakat* understanding and the accounting conceptual framework. This included definition and classification, recognition, measurement, presentation and disclosures. Two conceptual discourses were referred respectively: Western or conventional accounting and the Islamic one as issued by the AAOIFI.

Two fundamental objections were raised accordingly. One is the definition and recognition of *zakat*. In turn, this relates to the presentation. The other is the issue of measurement or determination of *zakat.*

Due to the above concerns there is a need to rectify existing standards. This cannot be avoided. All related parties have to take into account these important issues as they affect not only the technical aspects of *zakat* accounting, but also the behavioral impact on *zakat* payers.

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