

**Financial Accounting Standard No. (9)**

**Zakah**



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## Preface

This standard aims at setting out accounting rules for the treatments related to the determination of the Zakah base (i.e., the base on Zakah is to be computed), measurement of items included in the Zakah base and disclosure of Zakah in the financial statements of the Islamic banks and financial Institutions.<sup>(1)</sup> Attached with the standard are details of the juristic rules on which the development of the accounting treatment is based.

It should be noted that this standard deals with the basic issues of Zakah and the assets subject to Zakah that are often acquired by Islamic banks. The Islamic bank shall refer to its Shari'a supervisory board on issues not included in this standard.

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(1) Referred to hereafter as Islamic bank or Islamic banks.

## Statement of the Standard

### 1. Scope of the Standard

This standard shall apply to the accounting treatments related to the determination of the Zakah base, measurement of items included in the Zakah base and disclosure of Zakah in the financial statements of the Islamic bank. Appendix (A) shall form an integral part of this standard.

Should the requirements of this standard contradict with the Islamic bank's charter or the laws and regulations of the country in which it operates, a disclosure should be made of the point of conflict. (para. 1)

### 2. Accounting Treatment of Zakah Base

#### 2/1 Determination of Zakah base

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, and Net Invested Funds. It should be noted that provided items are classified and valued consistently with due considerations given to the different valuation bases used in the two methods, both methods are strictly equivalent by virtue of the statement of financial position identity (see Appendix B). (para. 2)

##### 2/1/1 Net assets method

- a) Using the net assets method, the Zakah base shall be determined as follows:

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)

Assets subject to Zakah include cash and cash equivalent, receivables net of provisions for doubtful debts, assets acquired for trading (e.g., inventory, marketable securities, real estate ... etc.), and financing assets (e.g., Mudaraba, Musharaka, Salam and Istisna'a, etc ...). Financing assets shall be net of provisions for fall in value or non-collectability. Funds used to acquire fixed assets relating to financing assets shall be deducted. (para. 4)

- b) Assets acquired for trading shall be measured at their cash equivalent value on the date on which the Zakah is due. (para. 5)
- c) In determining assets subject to Zakah that are available for trading either in the form of agricultural products or livestock (camels, cows, sheep and goats), consideration shall be given to the rates and Nisab (the minimum amount liable to the payment of Zakah) that are specified for such assets according to Shari'a. (para. 6)

#### 2/1/2 Net invested funds method

- a) Using the net invested funds method, the Zakah base shall be determined as follows:  
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)
- b) As stated in item 2/1, the two methods are strictly equivalent provided their items are classified and valued consistently with due considerations given to the different valuation bases in them. (para. 8)

#### 2/2 Treatment of Zakah in the financial statements

##### 2/2/1 Cases in which the Islamic bank is obliged to pay Zakah:

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.

Unpaid Zakah shall be treated as a liability and presented in the liabilities section in the statement of financial position of the Islamic bank. (para. 9)

**2/2/2 Cases in which the Islamic bank is not obliged to pay Zakah:**

- 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)

**2/2/3 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. (para. 12)**

**3. Disclosure Requirements**

- 3/1 Disclosure shall be made in the notes accompanying the financial statements of the method used for determining the Zakah base and the items included in this base. (para. 13)**
- 3/2 Disclosure shall be made in the notes accompanying the financial statements of the ruling of the Shari'a supervisory board of the Islamic bank on the issues related to Zakah that are not included in this standard. (para. 14)**



- 3/3 Disclosure shall be made in the notes accompanying the financial statements of whether or not the Islamic bank as a holding company pays its share of Zakah obligations in its subsidiaries. (para. 15)
- 3/4 In case the Islamic bank does not pay Zakah, disclosure shall be made in the notes accompanying the financial statements of the Islamic bank of the amount of Zakah that is due from each share. (para. 16)
- 3/5 Disclosure shall be made in the notes accompanying the financial statements of the amount of Zakah that is due from the equity of investment accountholders. (para. 17)
- 3/6 Disclosure shall be made in the notes accompanying the financial statements of whether or not the Islamic bank collects and pays Zakah on behalf of holders of investment accounts and other accounts. (para. 18)
- 3/7 Disclosure shall be made in the notes accompanying the financial statements of the restrictions imposed by the Shari'a 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. (para. 19)
- 3/8 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)

#### **4. Effective Date**

This Standard shall be effective for financial statements for fiscal periods beginning 1 Muharram 1420 A.H. or 1 January 1999 A.D. (para. 21)

## Adoption of the Standard

The standard of Zakah was adopted by the Accounting and Auditing Standards Board in its meeting No. (15) held on 27-28 Safar 1419 A.H., corresponding to 21-22 June 1998 A.D.

### Members of the Board

- |                                 |                 |
|---------------------------------|-----------------|
| 1. Abdul-Malik Yousef Al-Hamar  | Chairman        |
| 2. Noorur-Rahman Abid           | Deputy Chairman |
| 3. Dr. Ahmed Ali Abdallah       |                 |
| 4. Anwar Khalifa Sadah          |                 |
| 5. Dr. Hussein Hussein Shehata  |                 |
| 6. Farahat Saeed                |                 |
| 7. Salahel-Din Ali Abu Naga     |                 |
| 8. Salahel-Din El-Iskandarani   |                 |
| 9. Dr. Abdul-Sattar Abu Ghoddah |                 |
| 10. Mohammed Alawi Thiban       |                 |
| 11. Mustapha Bin Hamat          |                 |
| 12. Musa Abdel-Aziz Shehadeh    |                 |
| 13. Nabil Abdul-Elah Nassief    |                 |

## Appendix (A)

### Example of Items Included in Determining the Zakah Base

| Net Assets Method   | Basis of Valuation (*) |
|---|------------------------|
| <b>Assets:</b>  |                        |
| Cash and cash equivalent  | cash equivalent value  |
| Receivables   | cash equivalent value  |
| Mudaraba financing  | cash equivalent value  |
| Musharaka financing   | cash equivalent value  |
| Salam   | cash equivalent value  |
| Istisna'a   | cash equivalent value  |
| Assets for trading  |                        |
| Inventory   | cash equivalent value  |
| Marketable securities   | cash equivalent value  |
| Real estate   | cash equivalent value  |
| Other   | cash equivalent value  |
| <b>Liabilities:</b>   |                        |
| Current accounts  | book value             |
| Payables due to be paid during the next financial period          | book value             |
| Other liabilities due to be paid during the next financial period | book value             |

(\*) These bases of valuation should be used whether the net asset method or the net invested funds method is adopted.

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|  |                               |
|--|-------------------------------|
| Equity of unrestricted investment accountholders   | book value                    |
| Equity owned by government, equity owned by endowment, equity owned by charity, and equity belonging to not-for-profit organizations excluding those that are owned by individuals | book value                    |
| Minority interest  | book value                    |
| <b>Net Invested Funds Method</b>   | <b>Basis of Valuation (*)</b> |
| <b>Assets not for trading:</b>   |                               |
| Real estate for rent   | book value                    |
| Others   | book value                    |
| Fixed assets (net)   | book value                    |
| Provisions not deducted from assets  | book value                    |
| Liabilities and payables not due to be paid during the next financial period   | book value                    |
| <b>Owner's equity:</b>   |                               |
| Paid-up capital  | book value                    |
| Reserves   | book value                    |
| Retained earnings  | book value                    |
| Net income for the year  | book value                    |

(\*) These bases of valuation should be used whether the net asset method or the net invested funds method is adopted.

## Appendix (B)

### Example Illustrating How to Determine the Zakah Base

#### Islamic Bank Statement of Financial Position (As at xxx Year)

| Assets:                             | \$           | \$                   |
|-------------------------------------|--------------|----------------------|
| Cash and cash equivalent            |              | 204,554,392          |
| Receivables (Murabaha, Salam)       | 442,458,006  |                      |
| Less: Provisions                    | (14,223,790) | 428,234,216          |
| Mudaraba financing                  |              | 20,000,000           |
| Musharaka financing                 |              | 30,000,000           |
| Istisna'a                           |              | 20,000,000           |
| Real estate (for trading)           |              | 11,330,659           |
| Marketable securities (for trading) |              | 164,542,229          |
| Inventory (for trading)             |              | 10,814,130           |
| Other investments (for trading)     |              | 40,500,000           |
| Investments (not for trading)       |              | 34,432,992           |
| Assets for rent                     |              | 82,992,031           |
| Fixed assets (net)                  |              | 10,759,580           |
| <b>Total assets</b>                 |              | <b>1,058,160,229</b> |

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|   |             |                      |
|---|-------------|----------------------|
| <b>Liabilities, equity of unrestricted investment accountholders, minority interest, owners' equity</b>       |             |                      |
| <b>Liabilities:</b>   |             |                      |
| Current accounts  | 21,130,727  |                      |
| Payables (due to be paid during the next financial period)  | 49,561,094  |                      |
| Other liabilities (due to be paid during the next financial period)   | 53,185,054  |                      |
| Provisions for investment risk  | 9,444,298   |                      |
| Long-term liabilities (not due to be paid during the next financial period)                                   | 100,000,000 |                      |
| <b>Total Liabilities</b>  |             | 233,321,173          |
| <b>Equity of unrestricted investment accountholders</b>   |             | 684,504,716          |
| Minority interest   |             | 20,000,000           |
| <b>Owners' equity:</b>  |             |                      |
| Paid-up capital   | 104,000,000 |                      |
| Reserves  | 3,334,340   |                      |
| Retained earnings   | 10,000,000  |                      |
| Net income for the year   | 3,000,000   |                      |
| <b>Total owners' equity</b>   |             | 120,334,340          |
| <b>Total liabilities, equity of unrestricted investment accountholders, minority interest, owners' equity</b> |             | <b>1,058,160,229</b> |

**Additional Information**

1. Owners' equity include equity owned by governmental and endowment bodies totaling \$ 4,000,000
2. Cash equivalent value of assets for trading

| <b>Assets:</b>        | <b>Measurement basis<br/>in the statement of<br/>financial position</b> | <b>Cash<br/>equivalent value</b> | <b>Difference</b> |
|-----------------------|---|----------------------------------|-------------------|
| Marketable securities | 164,542,229   | 180,542,229                      | 16,000,000        |
| Inventory             | 10,814,130  | 15,814,130                       | 5,000,000         |
| Real estate           | (14,223,790)  | 16,330,659                       | 5,000,000         |
| Other investments     | 40,500,000  | 45,000,000                       | 4,500,000         |
| <b>Total</b>          | <b>227,187,018</b>  | <b>257,687,018</b>               | <b>30,500,000</b> |

**Determination of Zakah Base****Net Assets Method**

| <b>Assets Subject to Zakah:</b>                          | <b>\$</b>          | <b>\$</b>            |
|--|--------------------|----------------------|
| Cash and cash equivalent                                 | 204,554,392        |                      |
| Receivables (net)  | 428,234,216        |                      |
| Mudaraba financing                                       | 20,000,000         |                      |
| Musharaka financing                                      | 30,000,000         |                      |
| Istisna'a  | 20,000,000         |                      |
| Inventory  | 15,814,130         |                      |
| Marketable securities                                    | 180,542,229        |                      |
| Real estate for trading                                  | 16,330,659         |                      |
| Other investments for trading                            | <u>45,000,000</u>  |                      |
| <b>Total</b>   |                    | 960,475,626          |
| <b>Less:</b>   |                    |                      |
| <b>Liabilities:</b>                                      |                    |                      |
| Current Accounts   | 21,130,727         |                      |
| Payables   | 49,561,094         |                      |
| Other liabilities  | 53,185,054         |                      |
| <b>Equity owned by governmental and endowment bodies</b> | 4,000,000          |                      |
| Minority interest  | 20,000,000         |                      |
| <b>Equity of unrestricted investment accountholders</b>  | <u>684,504,716</u> |                      |
| <b>Total</b>   |                    | <u>(832,381,591)</u> |
| Zakah base   |                    | 128,094,035          |
| Zakah for the period = 128,094,035 X 2.5775% =           |                    | 3,301,624            |



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**Net Invested Funds Method**

|   | \$                | \$                   |
|---|-------------------|----------------------|
| Total owners' equity (less equity owned by governmental and endowment bodies)   | 116,334,340       |                      |
| <b>Plus:</b>  |                   |                      |
| Difference between cash equivalent value of the assets for trading and their value in the statement of financial position | 30,500,000        |                      |
| Long-term liabilities   | 100,000,000       |                      |
| Provisions for investment risk  | <u>9,444,298</u>  |                      |
|   |                   | 256,278,638          |
| <b>Less:</b>  |                   |                      |
| Assets for rent   | 82,992,031        |                      |
| Investments not for trading   | 34,432,992        |                      |
| Fixed assets (net)  | <u>10,759,580</u> |                      |
|   |                   | <u>(128,184,603)</u> |
| Zakah base  |                   | 128,094,035          |
| Zakah for the period = $128,094,035 \times 2.5775\%$  |                   | 3,301,624            |

## **Appendix (C)**

### **Brief History of the Preparation of the Standard**

On 30 Jumada I, 1416 A.H., corresponding to 24 October 1995 A.D., a letter was sent to Islamic banks to seek their opinion on the standards to be given priority. After taking into consideration the replies from Islamic banks, the Accounting and Auditing Standards Board decided in its meeting No. (10), held on 14-16 Ramadan 1416 A.H., corresponding to 3-5 February 1996 A.D., in Jeddah, Kingdom of Saudi Arabia, to give priority to the preparation of a standard on Zakah.

On 1 Dhul-Qāḍah 1417 A.H., corresponding to 10 March 1997 A.D., two consultants were commissioned to prepare the preliminary studies on the juristic and accounting aspects of the standard.

The juristic study was discussed in the Accounting Standards Committee meeting No. (11), held on 7 Safar 1418 A.H., corresponding to 12 June 1997 A.D., in Bahrain. The revised juristic study and the accounting study as well as an exposure draft of the standard were discussed by the Committee in its meeting No. (12) held during the period of 13-14 Jumada I, 1418 A.H., corresponding to 14-15 September 1997 A.D., in Bahrain. In its meeting No. (13), held during the period of 12-13 Jumada II, 1418 A.H., corresponding to 13-14 October 1997 A.D., in Doha, the Committee reviewed and discussed the revised exposure draft of the standard and the necessary amendments were made in light of the discussions that took place and the comments made by the members.

The exposure draft was submitted to the Shari'a Committee in its meeting No. (8), held on 13-15 Rajab 1418 A.H., corresponding to 13-15 November 1997 A.D., in Bahrain, and the amendments which it deemed necessary were made.

The amended exposure draft was discussed in the Standards Board meeting No. (14) held on 11-12 Ramadan 1418 A.H., corresponding to 10-11 January 1998 A.D., in Jeddah, Saudi Arabia. The Standards Board made further amendments to the exposure draft and decided that it should be distributed to the specialists and interested parties to obtain their comments on the exposure draft in order to discuss them in a listening session.

Two listening sessions were held, one in Pakistan on 18 Dhul-Hajjah 1418 A.H., corresponding to 15 April 1998 A.D., and the other in Bahrain on 22 Dhul-Hajjah 1418 A.H., corresponding to 19 April 1998 A.D. The listening sessions were attended by more than 230 participants representing central banks, Islamic banks, accounting firms, Shari'a scholars, academics and others who are interested in this field. Members of the Accounting Standards Committee responded in the listening sessions as well as to the oral comments that were expressed in the listening sessions.

The Accounting Standards Committee held a meeting on 22 Dhul-Hajjah 1418 A.H., corresponding to 19 April 1998 A.D., to discuss the comments made about the exposure draft. The Committee made the necessary amendments which it deemed necessary in light of the discussions that took place in the two listening sessions.

The revised exposure draft was reviewed and approved by the Shari'a Committee in its meeting No. (8) which was held on 18-19 Muharram 1419 A.H., corresponding to 14-15 May 1998 A.D., after making some changes to the draft.

The Accounting and Auditing Standards Board adopted the proposed standard in its meeting No. (15) held on 27-28 Safar, 1419 A.H., corresponding to 21-22 June, 1998 A.D.

## Appendix (D)

### Juristic Rules for Zakah

#### Preface

The basic principle regarding the Zakah base is that it consists of net trading assets in addition to cash and receivables, otherwise referred to as net working capital or circulating capital, and excludes fixed capital not available for trading. In the case of Islamic banks net trading assets may be either (I) financial assets including cash and receivables in respect of Murabaha and Salam transactions; or (II) non-financial assets owned by the Islamic bank in its capacity as a provider of finance, such as income-earning capital goods (Ijarah), inventories and work-in-progress (Istisna'a), agricultural or horticultural produce held pending resale (Salam), and livestock (camels, cows, sheep and goats) acquired for trading (deferred sale).

However, so far as shareholders are concerned, the obligation to pay Zakah, as prescribed in Shari'a, falls under two cases. The obligation should be discharged either directly by shareholders or by authorising the Islamic bank to do so on their behalf. Alternatively, the Islamic bank may calculate the Zakah base on a combined basis with regard to Nisab (the minimum amount liable to the payment of Zakah), as a generalisation of the principle established in Shari'a texts dealing with Nisab for livestock on a herd or flock basis. In this context, the ruling adopted by the Islamic Fiqh Academy (and prior to that, the First Conference on Zakah)<sup>(2)</sup> attached Zakah to the enterprise as a corporate entity. This applies when the law requires the Islamic bank to satisfy the Zakah obligation; when the Islamic bank is required by its charter or by-laws to satisfy the Zakah obligation; and when the general assembly of the shareholders has passed a resolution requiring

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(2) The First Conference on Zakah, Kuwait, 1404 A.H. – 1984 A.D., Islamic Fiqh Academy, Resolutions of the Fourth Session, Jeddah 1408 A.H. – 1988 A.D.; Al-Qaradawi, Yusuf, "Fiqh Al-Zakah", Al-Risalah Printing Press, 1985, [1: 37-41].

the Islamic bank to satisfy the Zakah obligation. If the Islamic bank satisfies the Zakah obligation, then the shareholders have no obligation to pay it.

### **Definition of Zakah, Its Juristic Rules and the Wisdom Behind It**

Zakah means “blessing, purification, increase and cultivation of good deeds”. In Shari’a, it is an obligation in respect of funds paid for a specified type of purpose and for specified categories. It is an individual duty if the criteria for making it obligatory are satisfied. It is also one of the pillars of Islam, and the government has the authority to collect and spend it for the benefit of the prescribed categories of people. The government may also authorise 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.

### **Conditions for Liability to Zakah<sup>(3)</sup>**

For Zakah to be payable, certain conditions must be fulfilled, which imply financial surplus, because Zakah is levied on assets of those that are capable of paying it. These conditions are as follows:

#### **a) Unencumbered possession**

This is the owner’s ability to dispose of his property. There is no Zakah on the property the owner of which does not know where it is, or is unable to dispose of it. Similarly, there is no Zakah on public funds, or funds held for Waqf (endowment) for charitable purposes and the funds of charitable organizations, because they do not have a specific owner, and are designated for spending it on causes which benefit society in general. This also applies to not-for-profit organizations. However, if the property is held in an endowment fund for the benefit of family members and their future generations, then it is subject to Zakah.

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(3) Al-Kasani, “*Bada’i’ Al-Sana’i’ Fi Tartib Al-Shara’i*”, [9: 2]; Al-Nawawi, “*Al-Majmu’ Sharh Al-Muhadhdhab*”, [5: 339]; Al-Ruhaybani, “*Matalib Uli Al-Nuha*”, [2: 16]; Al-Dussouqi, “*Hashiyat ‘Ala Sharh Al-Dardir Li-Muktasar Khalil*”, [1: 459]; “*Dalil Al-Irshadat Li-Muhasabt Zakat Al-Sharikat*” (Guidelines on Accounting for Zakah of Companies), published by a joint Shari’a accounting committee formed by Bayt Al-Zakah, 1991 A.D., (pp. 1-10).

**b) Growth in real terms or by estimation**

Growth in real terms may take place either by reproduction (livestock) or intention to trade. Growth by estimation may take place if the asset has the potential to yield a surplus and this includes cash and cash equivalent including gold and silver, even if they are not invested. However, assets held as part of fixed or non-circulating capital (notably fixed assets) are not subject to Zakah.

**c) Attainment of the Nisab**

Nisab is the minimum amount not liable to the payment of Zakah. This is in order to exempt a certain minimum of property from Zakah. The Nisab for gold is 85 grams of gold. The Nisab for cash and trading goods is estimated using their cash equivalent compared to the value of gold,<sup>(4)</sup> while the Nisab for silver is 595 grams of silver. For livestock, agricultural and horticultural produce, each category has its own Nisab, which is prescribed in Shari'a.

**d) The passing of Hawl (year)**

This is the passing of a lunar calendar year, starting on the day on which the Nisab is attained. What matters in calculating the liability to Zakah are the balances of funds at the beginning and end of the year. Any decrease during the year is ignored for the purpose of Nisab. This is the position of the Hanafi school that was also adopted in the First Conference on Zakah. However, in the case of agricultural or horticultural produce, the above does not apply, since Zakah on them is payable at the time of harvesting or picking. Almighty Allah says, {*...but pay the due thereof (its Zakah, according to Allah's Orders) on the day of its harvest...*}.<sup>(5)</sup> In the case of cash and trading assets, the passing of the year provides an opportunity for the generation of a surplus through business operations. If the individual or the Islamic bank is observing the solar calendar, an adjustment should be made to compensate for the difference between the solar calendar and the lunar calendar. In the case of the solar calendar the rate of Zakah is increased to 2.5775% instead of 2.5%, as ruled by the Conference on Zakah.

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(4) Islamic Fiqh Academy, Resolutions of the Second Session, Cairo, 1962.

(5) [Al-An'am (The Cattle): 141].



### **Duplication of Zakah<sup>(6)</sup>**

Zakah is payable every lunar year. It cannot be payable twice during the same lunar year. However, if an asset forming part of working capital (e.g., agricultural produce or livestock) is sold during the year and replaced by another asset of a similar or different kind (e.g., cash), then a further Zakah is payable.

### **Tax**

Tax does not rule out the obligation to Zakah because of the differences in their nature, in their bases and in the causes for the benefit of which they are spent. Moreover, tax is not deducted from the amount of Zakah due. However, the tax that was due before the end of the lunar year is deducted prior to arriving at the Zakah base because it represents a liability (account payable).

### **Zakah on Unlawful or Suspect Funds<sup>(7)</sup>**

Insofar as it is not possible to make restitution of funds earned in a manner that fails to comply with Shari'a, Zakah should be paid on such funds, and furthermore, the amount of such funds should be donated to charity. Such a donation is not considered to constitute payment of Zakah.

### **Conditions of Zakah on Trading Assets**

Most of the funds held by Islamic banks, including cash, are subject to the Zakah due on trading assets. The latter include items bought for resale and raw material purchased for manufacturing and subsequent resale. For Zakah to be due on trading assets, the following conditions must be fulfilled in addition to the general conditions mentioned earlier:

#### **a) Business activity**

In general, trading assets are acquired by way of purchase or exchange, or by way of discharge of a debt. Assets acquired by way of inheritance or donation would not be considered as trading assets. Such assets when sold for cash will give rise to a liability to Zakah on the cash proceeds.

#### **b) Intention to trade**

This means an intention to trade in the assets once they are acquired. The intention that matters is that the trading assets should become part of

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(6) Fatwas of the Fourth Seminar on Contemporary Issues of Zakah, Bahrain, 1414 A.H.-1994 A.D.

(7) Fatwas of the Fifth Seminar on Contemporary Issues of Zakah, Beirut, 1415 A.H.-1995 A.D.

the assets held by the business. Items acquired for use as fixed assets are not subject to the Zakah due on trading assets. However, if a fixed asset is subsequently sold in trading, Zakah becomes due on the cash proceeds only if the Nisab is attained and the cash proceeds are still on hand at the end of Hawl (the relevant financial year). On the other hand, an asset acquired for trading but subsequently converted to use as a fixed asset is no longer counted as a trading asset.

The Maliki jurists make a distinction between trading assets held for sale at the current market price and those held in expectation of selling them at a specific price in the future. In the case of the latter, Zakah is due on the cash proceeds when they are sold. However, the majority of jurists do not make this distinction.

#### **Valuation of Trading Assets**

Trading assets should be valued for Zakah purposes at their market selling price (cash equivalent value), and not at historical cost. This is in order for the Zakah base to include the historical cost and any holding gains (losses).<sup>(8)</sup>

#### **Payment of Zakah from the Same Goods or from Their Value**

The principle in paying Zakah on trading assets is to pay them on the basis of their cash equivalent value. It has been narrated that Omar, May Allah be pleased with him, said to a trader: "Evaluate it (your merchandise) and then pay its due Zakah." It is also narrated that Jabir Ibn Zayd said about the trading goods: "Evaluate them on the day when Zakah is due on them and then pay their due Zakah." Maymun Ibn Mahran also said: "If Zakah is due from you, take a count of the cash or trading goods you have and then evaluate them in cash equivalents".<sup>(9)</sup> This is also better for those who are entitled to Zakah. However, it is permissible to pay Zakah from the same goods, if this makes things easier for the Zakah payer at times of recession and lack of liquidity and at the same time serves the interests of those who are entitled to Zakah by taking goods from which they can benefit.<sup>(10)</sup>

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(8) Fatwas of the Seventh Seminar on Contemporary Issues of Zakah, Kuwait, 1417 A.H.-1997 A.D.; Al-Hattab, *"Mawahib Al-Jalil"*, [2: 323].

(9) Abu Ubayd, *"Al-Amwal"*, (P. 416).

(10) Fatwas of the First Seminar on Contemporary Issues of Zakah, Cairo, 1409 A.H.-1988 A.D.



### **Zakah on Debts Owed by Third Parties (Accounts Receivable)<sup>(11)</sup>**

Zakah is obligatory on accounts receivable which are acknowledged by debtors who are able to pay them. It is also obligatory if the debtors refuse to acknowledge the account receivable but there is evidence that they are due and they are collectible. In these cases, Zakah is due on such account receivable together with other items of working capital and cash. In the case of debts the collectability of which is doubtful, either because the debtor refuses to acknowledge them and there is insufficient evidence to prove their existence, or because the debtor is insolvent or a procrastinator, Zakah is payable only on the amount of the debt recovered when it is recovered. Moreover, Zakah is only payable once at the time of recovery and not during the years during which the amount may have remained outstanding.

### **Debt (Liabilities)<sup>(12)</sup>**

According to the majority of Fuqaha, debt that is payable during the current or future financial periods should be deducted from assets subject to Zakah. However, the Shafi are of the view that any debt payable whether now or in future should not be deducted from assets subject to Zakah. In this standard, we have adopted the view of the Shafi school with respect to medium and long term debt; i.e., they should not be deducted from assets subject to Zakah. This means that only debt due to be payable during the year following the date of the statement of financial position should be deducted.

### **Zakah on Other Types of Assets**

The First Conference on Zakah and the Islamic Fiqh Academy concluded that banks should calculate their funds using the manner of calculation used by a natural person. In other words, funds subject to Zakah are recognized and measured by calculation of Nisab, according to the nature and type of these funds, whether cash, livestock, agricultural and horticultural produce, trading goods, or otherwise.

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(11) Ibn Qudamah, *"Al-Mughni"*, [4: 47]; and Qalyubi, *"Hashiyah Ala Sharh Al-Mahalli Lil-Minhaj"*, [2: 3].

(12) See: *"Dalil Al-Irshadat Li-Muhasabat Zakat Al-Sharikat"*, for more details on debt financing of business activities and the purchase of fixed assets, op. cit.; Fatwas of the First Seminar on Contemporary Issues of Zakah, and the Second Seminar Contemporary Issues of Zakah, op. cit.; Fatwas of the First Conference on Zakah, Item (10), 1984 A.D.

### **Zakah on Livestock**

Zakah on camels, cows, sheep and goats is obligatory, provided that the prescribed Nisab for each of them is attained, that a Hawl has elapsed, and that they should not be used as work-animals (e.g., for ploughing or as draught animals). However, the majority of jurists have stipulated the condition that animals liable to Zakah should be freely grazing for most of the year, without being fed fodder. The Malikis, however, did not stipulate this condition. There are tables of numbers which are provided in Shari'a texts concerning the Zakah due on every category of livestock.

### **Zakah on Agricultural and Horticultural Produce**

According to the Hanafis, Zakah is payable on all crops that grow on land, and items grown for purposes other than the production of a crop are excluded. Allah says: {*"...Spend of the good things which you have (legally) earned, and of that which We have produced from the earth for you..."*}<sup>(13)</sup> The Prophet (peace be upon him) also says: *"On what has grown by water, rainfall and natural springs, or water that is drunk freely one tenth (tithe) is due, and that which has been irrigated by machinery one half of a tenth (half-tithe) is due."*<sup>(14)</sup> Other Schools of Fiqh have their own details and conditions on what is subject to Zakah from agricultural and horticultural produce.<sup>(15)</sup>

The Nisab for agricultural and horticultural produce is five Awsuq (unit of measure equal to 653 kg of wheat and the like). The obligatory Zakah due in cases of irrigation by natural rainwater is one tenth (10%), and in cases where irrigation is by way of machinery is half of one tenth (5%). In cases where irrigation combines both methods, Zakah is three quarters of one tenth (7.5%).<sup>(16)</sup>

### **Gains**

Zakah is payable on the balance of each type of working capital at the end of Hawl, including any gains from employing that type of working capital, such as business profits or increase of livestock. This is the opinion

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(13) [Al-Baqarah (The Cow): 267].

(14) Related by Imam Al-Bukhari, [2: 22], Bolaq Printing Press.

(15) Ibn Abidin, *"Hashiyat 'Ala Al-Durr Al-Mukhtar"*, [2: 49]; Al-Dussouqi, op. cit., [1: 447]; Qalyubi, op. cit., [2: 16]; and Ibn Qudamah, *"Al-Mughni"*, op. cit., [2: 690].

(16) Ibid.

of the Hanafis, and this is a safe way as a compromise between the divergent views as to the different times when Zakah is due on gains.<sup>(17)</sup>

### **Methods of Determining the Zakah Base**

#### **a) The method prescribed by Fuqaha (the net assets method)**

It is substantiated by the narration of Maymun Ibn Mahran: “If Zakah is due from you, take a count of the cash or trading goods you have and then evaluate them in cash equivalents. Calculate whatever debts are owed to you, deduct your own debts payable, and then pay Zakah on the balance.” Al-Hasan Al-Basri also said: “When the month in which a man pays his Zakah comes, he must pay Zakah on all his funds, and on all the stock-in-trade he has bought, and all debts, except for the debts which are doubtful.”<sup>(18)</sup> The application of this method requires the valuation of the commodity assets at their market selling price and examination of the items included in the statement of financial position in order to calculate the Zakah due, taking into consideration what has been added or deducted from the Zakah base in accordance with the Shari’a valuation.

#### **b) The net invested funds method<sup>(19)</sup>**

This method is used by some governmental organizations in the calculation of Zakah, and it is explained in the standard.

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(17) Ibn Al-Humam, “*Fath Al-Qadir*”, [1: 510]; and Ibn Abidin, op. cit., [2: 8].

(18) Abu Ubayd, op. cit., (P. 426).

(19) Exposure Draft of Zakah and Tax, Saudi Authority for Chartered Accountants, Riyadh, 1996 A.D.; Abdul-Aziz Jamjum, “*Al-Zakah Wa Al-Daribah Fi Al-Mamlakah Al-‘Arabiyyah Al-Sa’udiyyah*” (Zakah and Tax in the Kingdom of Saudi Arabia), 1996 A.D., (pp. 35-42); Shawqi Shihatah, “*Al-Tatbiq Al-Mua’sir Lil-Zakah*” (Contemporary Application of Zakah), (P. 163); Chamber of Commerce and Industry, “*Dalil Rijal Al-‘Amal*” (Directory of Businessmen), Jeddah, (pp. 21-31).

## **Appendix (E)**

### **Reasons for the Standard**

In their response to AAOIFI's letter of 30 Jumada I, 1416 A.H., corresponding to 24 October 1995 A.D., Islamic banks gave priority to the preparation of a standard, among others, on Zakah. This was endorsed by the Standards Board in its meeting No. (9) held on 24-25 Rabi' II, 1416 A.H., corresponding to 19-20 September 1995 A.D., in Bahrain.

The reasons for the standard can be attributed to the following:

- a) Zakah is one of the pillars of Islam and an ordinance performed by Muslim in servitude and approach to Allah, the Almighty. This rite is connected with the wealth of Muslim, for in his performance thereof, there lies a purification of his soul and growth and purity of his wealth.

This era witnesses a revival of the Zakah ordinance in most of the Muslim countries. This lays a major responsibility on Islamic banks to participate in the entrenching of this rite through different means, among which are the calculation and collection of Zakah on behalf of the shareholders' funds and the funds of holders of investment accounts and their equivalent who permit the Islamic bank to pay it to the bodies concerned with spending Zakah according to the rules specified by the Shari'a.

Accordingly, the preparation of a standard on Zakah would help Islamic banks that perform this ordinance to apply the accounting rules stated in this standard.

- b) Differences exist in the methods used by Islamic banks in determining the Zakah base, the items included in determining this base, the measurement of these items and the different degrees of disclosure of such bases from one Islamic bank to another. For example, the

treatment of Zakah as an expense or distribution to the shareholders, the disclosure of the method used by an Islamic bank in the determination of the Zakah base, and the attributes used in measuring the assets subject to Zakah. These differences would not enable users of financial statements to compare the various results of Islamic banks in a manner that helps them in taking decisions.

- c) The standardisation of the methods used by Islamic banks to calculate Zakah and the disclosure of these methods in the financial statements of the Islamic bank would help in providing useful information to users of financial reports of Islamic banks. The importance of such information stems from the fact that in the cases where the Islamic bank is obliged to pay Zakah, the accounting treatment of Zakah affects the determination of the Islamic bank's net income, which is an important indicator used by users of the financial statements in making their decision.

## Appendix (F)

### Basis for Conclusions

In its meetings, the Accounting Standard Committee has reviewed a number of alternatives and in particular the alternatives proposed in the preliminary study<sup>(20)</sup> to be adopted in the accounting treatments of Zakah. The Accounting Standards Committee recommended the adoption of the alternatives which were found to be in compliance with the provisions of the previous Statement of Financial Accounting No. (1): Objectives of Financial Accounting for Islamic Banks and Financial Institutions, and the Statement of Financial Accounting No. (2): Concepts of Financial Accounting for Islamic Banks and Financial Institutions (Statement of Concepts).

#### **Determination of the Zakah Base**

The standard specifies two methods by which the Zakah base can be determined:

- Net assets method.
- Net invested funds method.

Given that either one of the two methods would give the same numerical result, provided each item in the statement of financial position is classified using the appropriate method and valued accordingly (for example, the use of the cash equivalent value in measuring assets acquired for trading and forming a revaluation reserve for the difference between the book value and the cash equivalent value), the Accounting and Auditing Standards Board has decided to give the Islamic bank the option to choose the method that it considers appropriate for the bank, and that disclosure should be made of the method that has been adopted.

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(20) Ibrahim, Mubarak Ali, "A Study on Accounting for Zakah for Islamic Banks", Accounting and Auditing Organization for Islamic Financial Institutions, 1418 A.H.-1997 A.D.



### **Measurement of Assets Subject to Zakah**

The standard requires that assets acquired for trading should be measured at the cash equivalent value (the market selling price) on the Zakah date. This measurement basis was adopted by the Zakah Seminar No. (7), as reported in Appendix (D) which sets out the juristic rules for Zakah.

### **Treatment of Zakah in the Financial Statements of the Islamic Bank**

The Accounting and Auditing Standards Board has adopted the resolution of the First Conference on Zakah (1984 A.D.), which is stated in the previous Statement of Concepts concerning the payment of Zakah by the Islamic bank on behalf of its shareholders.

The standard differentiates between the cases in which the Islamic bank is obliged to pay Zakah, namely:

- a) When the law requires the company to satisfy the Zakah obligation;
- b) When the company 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 company to satisfy the Zakah obligation; and
- d) The case in which some or all shareholders may ask the Islamic bank to pay Zakah on their behalf.

In the first case in which the payment of Zakah is considered obligatory on the Islamic bank, Zakah is treated as an expense recognized in the income statement of the Islamic bank. This treatment complies with what is stated in the previous Statement of Concepts concerning the definition of an expense as the gross decrease in assets or increase in liabilities or a combination of both, provided such a decrease in assets and an increase in liabilities should not be the result of distribution to or investment by the shareholders. However, since the intention to trade is a prerequisite condition for the validity of Zakah [see: Appendix (D) on Juristic Rules for Zakah], then one alternative to fulfil this condition is for the authority passing the law of Zakah to exercise its jurisdiction by making the payment of Zakah mandatory. Secondly, the intention to trade can be expressed implicitly by stipulating in the charter or by-laws of the Islamic bank that it should pay its Zakah dues. The third alternative is through the passing of a resolution by the Islamic bank's general assembly to pay the Zakah dues.

In the second case, where the Islamic bank is not obliged to pay Zakah, but is asked by some or all of its shareholders to act as agent in meeting their Zakah obligation, the standard distinguishes between two situations. In the first situation in which the Islamic bank acts as an agent and there are distributable profits, the standard treats Zakah as an appropriation of the distributable profit. In the second situation where there are no distributable profits, the standard made the payment of Zakah conditional on the consent of the Islamic bank to perform this obligation on behalf of the shareholders. This is because in Shari'a an agent is not obliged to pay from his own funds an obligation relating to a proxy. Accordingly, the amount of Zakah to be paid on behalf of the shareholders is treated as a receivable due from them.



## Appendix (G)

### Definitions

#### **Zakah**

Literary, Zakah means blessing, purification, increase and cultivation of good deeds. It is called Zakah because it blesses the wealth from which it is paid and protects it. In Shari'a, 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 subject to Zakah.

#### **Cash and Cash Equivalents**

Cash and cash equivalents include local and foreign currency and deposits with the central bank and other institutions which the Islamic bank can withdraw in full on demand.

For Zakah purposes cash and cash equivalent includes, in addition to the above, gold, silver in the form of currencies, bullion and others.



