

A proposed model for Zakah on financial instruments: accounting approach

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Abstract

Purpose – This paper aims to propose a model of Zakah treatment for financial instruments. The model depends on the link between the financial assets and liabilities that emerge from a financial instrument contract.

Design/methodology/approach – The determination of Zakah on contemporary financial instruments is controversial, with various conflicting Fatwas being presented. This paper introduces a theoretical model that integrates Fiqh rules, accounting, finance and economic principles to propose a method for calculating Zakah on financial instruments. This theoretical model can be the foundation for future empirical and statistical testing.

Findings – The proposed model advocates omitting the financial assets/liabilities when determining the Zakah base for companies, as the Zakah burden relies on the owner of the real asset. The paper elaborates on the implementation of the model on debts, investments and cash accounts.

Research limitations/implications – The paper does not investigate whether or not the accounting approach in dealing with financial contracts is deemed acceptable by Fiqh scholars, nor does it discuss whether or not this may affect the Zakah fatwas regarding these types of accounts.

Practical implications – The paper establishes a conceptual framework for the Zakah on financial assets. This will pave the way for future empirical research and testing to validate the framework in different contexts. In addition, if regulators adopt this model and apply it to all companies, it would promote fairness and justice at the national level.

Social implications – The proposed model advocates omitting the financial assets/liabilities when determining the Zakah base for companies, as the Zakah burden relies on the owner of the real asset. The paper elaborates on the implementation of the model on debts, investments and cash accounts.

Originality/value – To the best of the authors' knowledge, this is the first attempt to utilize the accounting approach in order to determine the amount of Zakah.

Keywords Zakah, Financial instruments, Financial assets, Debts, Investments, AAOIFI

Paper type Research paper

1. Introduction

Zakah is considered one of the most essential pillars of Islam. However, there are different, and sometimes contradicting, *Fatwas* among *Fiqh* scholars regarding the *Zakah* and its base for companies and businesses. The evolution of complex business contracts imposes great challenges on scholars in this regard. This paper focuses on the *Zakah* on financial assets and liabilities resulting from financial instruments (e.g. cash, stocks, bonds, loans, debtors and creditors). The current practice of *Fiqh* scholars is to perceive the financial assets and liabilities resulting from these instruments as individual unrelated accounts without considering the macro-level interrelations between them. In accounting, the relationship between financial assets and financial liabilities is reflected, and the accounting treatment for the accounts resulting from a financial instrument is handled in the same accounting standard (Ismail and Taufiq, 2015).



The traditional approach for determining *Zakah* on financial assets/liabilities depends on the *Fqih* schools' interpretations, and this issue is still controversial between *Fqih* schools. The Organization of Islamic Cooperation (OIC) recognized this in its Resolution No. 1 (1 / 2) “*Zakah* on Debts.” The Council of the International Islamic Fiqh Academy of the OIC stated in the resolution that there is no explicit reference in the Quran or the Sunnah detailing the rulings concerning *Zakah* on debts. Additionally, various opinions from the Companions and their Followers have been reported regarding the method of paying *Zakah* on debts. Furthermore, the Islamic schools of jurisprudence have clear differences on the subject. The varying legal opinions on this matter are caused by differing views on the fundamental principle of whether receivable assets can be classified as received (OIC, 2021, p. 2).

Therefore, new ideas and approaches should be explored in this arena. This paper offers new insight into the field of *Zakah* on financial instruments utilizing accounting concepts. In other words, the accounts resulting from financial contracts are linked together, and the relationship between them is considered when determining the *Zakah* base.

It is worth mentioning that, traditionally, *Shariah* scholars dominate the research area of *Zakah* as a major *Shariah* field, with minor contributions from other specialties, such as accounting and finance experts. Due to the changeable business environment and the rapid evolution of business contracts, accountants and finance experts with sufficient knowledge of *Shariah* principles are required to contribute to this field. *Shariah* scholars may lack a comprehensive understanding and interpretation of such contracts.

The uniqueness of the paper lies in the integration of accounting, finance and economic principles with *Fiqh* rules to develop a comprehensive theoretical model. This approach addresses a gap in the existing literature, which often treats financial instruments in isolation without considering the macro-level interrelations between them.

1.1 *Zakah* and financial instruments

Zakah is not only a mandatory financial obligation but also a crucial pillar in Islam that plays an essential role in ensuring proper wealth distribution and social stability. This perspective of *Zakah* as a societal system, rather than just an individual obligation, is in line with the Islamic concept that it should benefit the entire community (Dhar, 2013). Therefore, the amount of *Zakah* and the mathematical calculation of *Zakah* on individuals and companies have an impact on the national level.

Johari *et al.* (2014) argue that the obligation of *Zakah* extends to various forms of wealth, including business revenues and financial assets. This aligns with the principles of *Shariah* that aim to ensure equitable distribution of wealth and prevent hoarding. Therefore, integrating modern financial instruments with traditional *Zakah* principles is essential and helps maximize *Zakah*'s impact on poverty alleviation and economic development (Arif, 2017).

The study by Wan Ahmad *et al.* (2014) contributed to the discussion about whether debts would impact the *Zakah* base for both parties involved, the debtor and the creditor. It argues that the treatment of debts can change the amount of *Zakah* for each party and may even affect their eligibility to pay *Zakah*. However, it's important to note that the study examined the *Fiqh* opinions regarding *Zakah* on debts without considering the connections between the two parties as implemented in the accounting approach.

Different calculation methods can lead to discrepancies and affect the effectiveness of *Zakah* in poverty alleviation (Dhar, 2013). For example, financial firms in Malaysia exhibit a range of *Zakah* calculation methodologies, reflecting a lack of standardization. This diversity includes methods based on net profit, working capital and adjusted growth approaches, which can lead to inconsistencies and challenges in *Zakah* compliance (Abojeib *et al.*, 2019).

Calculating *Zakah* on modern financial instruments, such as shares and sukuk, requires detailed guidelines and clear standards to ensure compliance, prevent manipulation and ensure fair assessment (Abojeib *et al.*, 2019). Consequently, there is an urgent and significant need to standardize *Zakah* calculation methods to ensure uniformity and fairness.

This paper presents a theoretical model for calculating *Zakah* on financial assets and liabilities. The model extends accounting concepts to a national (macro) level viewpoint and aims to offer a clear and standardized approach to *Zakah* calculation

1.2 The international financial reporting standards perspective

International Accounting Standard (IAS) 32: “Financial Instruments: Presentation” [1] specifies that the financial instrument is “a contract that gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity”. This means that one party of the contract has a financial asset in his accounting books, whereas the other has a financial liability or an equity instrument. IAS 32 provides explanations and examples for the categories of financial assets/liabilities.

Financial assets include:

- any cash (see section four);
- equity instrument (see section three); and
- a contractual right, where a party can receive cash or another financial asset from another entity (see section two) [2].

As for a financial liability, it is defined as a contractual obligation to deliver cash in the future.

Common examples of financial assets representing a contractual right to receive cash in the future and corresponding financial liabilities representing a contractual obligation to deliver cash in the future are:

- trade accounts-receivable and payable;
- notes-receivable and payable;
- loans-receivable and payable; and
- bonds-receivable and payable.

In each case, one party has the contractual right to receive cash while the corresponding party is obligated to pay cash.

IAS 32 distinguishes between financial assets and real assets. Real assets include physical assets (e.g. land, building, PPE, inventories), right-of-use and intangible assets. The control of real assets creates an opportunity to generate profit. This is because real assets participate in producing goods and services. In contrast, financial assets transfer funds from the parties with surplus funds to those who need funds to finance real assets (Ankargren *et al.*, 2017; Fabozzi *et al.*, 2010; Choudhury, 2010; Peter and Jürgen, 2010). Economists also support this view by differentiating between the real and financial economy, where the real economy is that part of the economy that involves the production, transportation and selling of goods and services – as opposed to the financial economy, whose function is to transfer funds through financial assets/liabilities (Pirounakis, 1997; Cartas and Harutyunyan, 2017). For example, the cash proceeds from borrowing or issuing capital securities can be used to purchase real assets. Real assets generate income through production, after which the income is allocated among parties (investors, creditors) according to the financial instrument contract specifications.

1.3 Expanding international financial reporting standards perspective into macro-level perspective

As mentioned above, a financial asset in one entity has corresponding financial liability or equity instruments in another entity. What if all respective entities belong to one accounting group? How are these financial assets, liabilities and equity instruments presented in the group's consolidated financial statements? The conceptual framework for financial reporting (IASB, 2018, chapter 4, 4.10) argues that:

If a reporting entity comprises more than one legal entity, debt instruments or equity instruments issued by one of those legal entities and held by another of those legal entities are not economic resources of the reporting entity.

Therefore, the consolidated financial statements eliminate these financial assets and the corresponding financial liabilities and equity instruments. If Entity One in the group has an obligation to transfer an economic resource to Entity Two in the group, then Entity Two has a right to receive that economic resource. Therefore, and from the group's point of view, no assets or liabilities should be recognized. Furthermore, if one entity in the group has equity ownership (investment) in another group entity, then neither investments nor equity should be reported in the consolidated financial statements [3].

Let's assume that this concept (the elimination process) is extended to the macroeconomy level when preparing the aggregate accounts for all companies in the economy. In that case, all financial assets, financial liabilities and, partially, equity instruments will disappear from the aggregated accounts, ending up with cash, inventory, PPE and other real assets. Building on this argument, the paper proposes eliminating debts (receivable and payable) and investments from entities' accounts and considering other remaining real *Zakatable* assets in order to determine the *Zakah* base. This is the core concept of the paper, and further elaboration is conducted in the following sections.

The paper proceeds as follows: Section two demonstrates *Zakah* treatment for debts (for creditors and debtors) according to the proposed model. It introduces the *Fiqh* opinions in this area and how the proposed model fits within these opinions. Section three tackles the *Zakah* for another financial asset: investment in other companies. The section explores who is obligated to pay *Zakah* – the investor or the investee – depending on who controls the resources. It further delves into how this concept meets the proposed model. The next section investigates the *Zakah* on cash as a financial asset. It presents the evolution of currency money from gold and silver, and the eligibility of *Zakah* on cash. The last section concludes the merits of the proposed model and its ability to handle different financial assets and liabilities in a way consistent with *Fiqh* opinions.

2. *Zakah* on debts (for both creditors and debtors)

The creditor/debtor relationships emerge from a financial instrument representing contractual relationships, where the creditor has a right to receive cash and the debtor is obliged to deliver cash in the future.

Traditional Islamic scholars debated whether the creditor should add the debt to his *Zakah* base, and whether the debtor should deduct the debt from his *Zakah* base. The Islamic *Fiqh* schools recognize multiple contradictory opinions depending on each school's jurisprudence. These different opinions arise due to varying interpretations of the conditions of *Zakah* eligibility, mainly the full ownership of wealth and the potential growth of wealth.

2.1 Full ownership as a condition for *Zakah* eligibility

Full ownership materializes when nobody else has a right in the asset in question, the owner can dispose of the asset the way he likes, and the owner of the asset is the sole owner of the income generated from the asset (AAOIFI, 2017, p.873).

In businesses, debts (receivable and payable) usually emerge when one party transfers a real asset, mainly cash or inventory, to another party. Thus, the transferer of the real asset recognizes debt receivable (financial asset), and the receiver recognizes debt payable (financial liability). The “full ownership” feature is investigated in the hypothetical example below, for both parties of a transaction with a debt component.

2.1.1 Hypothetical example. Let’s assume that company A (retailer) purchased 100 Currency Unit (CU) goods from company B (wholesaler) on account. This transaction will result in initiating/increasing two accounts in A’s books: inventory (real asset), which will increase by 100 CU, and trade payable (financial liability) which will increase by 100 CU. In B’s books, inventory (real asset) decreases by 100 CU [4], and trade receivable (financial asset) increases by 100 CU. The effect of this transaction on the *Zakah* base for company A and company B is debatable, and four different treatments for the financial asset/liability (debt receivable/det payable) are recognized by the *Fiqh* schools. The four combinations are as follows:

- (1) Case 1: The debtor deducts the debt, and the creditor doesn’t add it;
- (2) Case 2: The debtor deducts the debt, and the creditor adds it;
- (3) Case 3: The debtor doesn’t deduct the debt, and the creditor doesn’t add it; and
- (4) Case 4: The debtor doesn’t deduct the debt, and the creditor adds it.

To analyze the effect on *Zakah* base for both parties, the transfer of the real asset “inventory” between the two companies will be considered first (this effect is similar across the four cases), after which the impact of financial asset/liability is demonstrated, considering the four *Fiqh* opinions.

It is worth mentioning that the proposed model employs the macro-level perspective when dealing with financial instruments. Hence, the inventory asset (real asset) should be included in the *Zakah* base, while the financial assets/liabilities (receivable/payable) should be canceled out. [Table 1](#) summarizes the *Zakah* base under the four cases for each company individually and collectively at the macro level.

2.1.1.1 The effect of the transfer of inventory. Company A will increase its *Zakah* base by CU 100, as it has full ownership and control over the inventory purchased (the real asset) even though it was acquired by debt. Thus, company A is responsible for paying *Zakah* on inventory (this treatment is consistent in the four cases). Alternatively, Company B will decrease its *Zakah* base by CU 100 due to the inventory transfer as it loses control (ownership) over the real asset.

2.1.1.2 The effect of the financial asset/liability

2.1.1.2.1 To deduct/not to deduct the debt payable from the *Zakah* base for the debtor. Deducting trade payables from the *Zakah* base is debatable. Many scholars have approved the deduction. For example, the Accounting and Auditing Organization For Islamic Financial Institutions (AAOIFI) states that “if the debts owed by the institution (company) have arisen from obtaining current *Zakatable* assets for the purpose of trade, they should be deducted from *Zakah* base”. (AAOIFI, 2017, p. 889). For cases 1 and 2, shown in [Table 1](#), the trade payable is deducted from the *Zakah* base according to the previous perspective. However, the other opinion states that trade payable shouldn’t be deducted from *Zakah* base relying on verse 103, Surat Al Tawbah “(Prophet!) take a portion of their possessions as *Zakah* so that you may purify them and enhance them in their virtuous deeds”. The verse requires the *Zakah* on the owned resources without excluding the debt amounts. This opinion is adopted in cases 3 and 4 in [Table 1](#).

Table 1. The effect on Zakah base for a transaction with a debt component

Case no.	Company A (debtor)			Company B (creditor)			Macro effect
	Inventory	Payable	Total	Inventory	Receivable	Total	Total (a + b)
Case 1 ^a	+100CU	-100CU	Zero	-100CU	Not added	-100CU	-100CU
Case 2 ^b	+100CU	-100CU	Zero	-100CU	+100CU	Zero	Zero
Case 3 ^c	+100CU	Not deducted	+100CU	-100CU	Not added	-100CU	Zero
Case 4 ^d	+100CU	Not deducted	+100CU	-100CU	+100CU	Zero	+100CU

Notes: a = the debtor deducts the debt' and the creditor doesn't add it; b = the debtor deducts the debt' and the creditor adds it; c = the debtor doesn't deduct the debt' and the creditor doesn't add it; d = the debtor doesn't deduct the debt' and the creditor adds it

Source: Table by authors

2.1.1.2.2 To add/not to add debt receivable to the Zakah base for the creditor. According to one of the *Fiqh* opinions, *Zakatable* assets include receivables. AAOIF adopts this opinion, as it states that:

If the debt owed to the Institution is a cash amount, the Institution should pay *Zakah* on it annually – whether such debt is due or not - since the Institution will certainly receive it (AAOIFI, 2017, *Shariah* Standard No. 35).

Furthermore, the standard states that “*Zakah* shall be paid on the amounts payable to the Institution against goods or services sold on debt”. This opinion is adopted in cases 2 and 4 in Table 1. However, the other opinion states that the receivables that emerged from this transaction should not increase the *Zakah* base, due to the absence of the full ownership principle. The company lacks control of the receivable amount, no income can be generated from this financial asset, and no potential growth is expected. This opinion is adopted in cases 1 and 3 in Table 1.

2.2 Discussion

The previous example presumes transferring a real *Zakatable* asset (inventory) between two companies. This transfer initiates a financial asset (debt receivable) in one company and a financial liability (debt payable) in the other. On the national level, this transaction should not affect the amount of *Zakah*, as the *Zakatable* asset (inventory) is the same before or after the transfer.

It is worth mentioning that the traditional *Fiqh* scholars handled the *Zakah* of debts (receivable/payable) and real assets separately, where they did not link the debts between companies (receivables and payables) together, unlike the proposed approach. Thus, the four cases mentioned above reflect the different scholars' opinions. These cases differ in determining the responsible party for paying *Zakah* and the amount of the *Zakah* base for each party. Accordingly, the *Zakah* based on the national level may differ across these treatments.

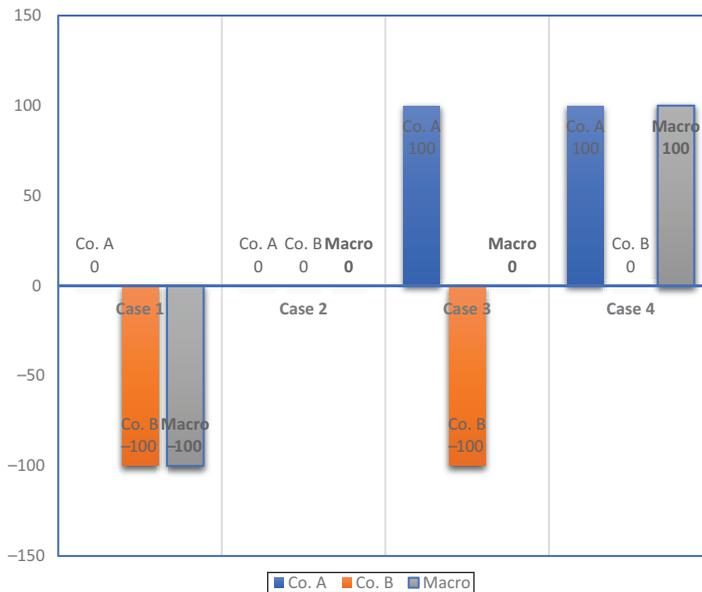
In case one, the *Zakah* base for company A will not change, while the *Zakah* base for company B will decrease by CU 100. On the national level, the *Zakah* decreases. This circumstance may negatively affect the rights of the eligible people of *Zakah* and, hence, should not be allowed. On the other hand, case four raises the *Zakah* base on the national level, as the *Zakah* base for company A increases, while the *Zakah* base is not affected for company B. This causes duplication in paying *Zakah* (*Zakah* is paid twice for the same asset). Case four should not be allowed as Althunia (duplication) is not accepted by *Fiqh* scholars.

Case two and case three don't change the *Zakah* base on the national level, but the responsible party for paying *Zakah* differs. For case two (the debtor chooses to deduct payable and the creditor to add receivable), the debtor's *Zakah* base (company A) doesn't increase because it adds the inventory and deducts the payable. In addition, the creditor's *Zakah* base (company B) does not decrease because it deducts the inventory and adds receivables. This case aligns with AAOIFI standards, but it may contradict the principle of full ownership. The debtor owns the inventory but doesn't pay its *Zakah*, and the creditor disposes of the inventory and still pays its *Zakah*. In case three (the debtor chooses not to deduct payable and the creditor not to add receivable), the responsible party for paying *Zakah* is the debtor/purchaser. The debtor now owns the inventory which meets the full ownership condition set by scholars.

The proposed model of the paper is to ignore the financial asset/liability when determining *Zakah* as they cancel each other out on the national level. The payer of *Zakah* would be the owner of the real asset as this meets the full ownership *Shariah* principle. Case three in the previous example is similar to the model proposed by the paper, as the financial asset/liability is ignored by the debtor's and creditor's sides (not added or deducted). It is evident that the proposed model does not oppose mainstream Islamic views but instead adopts one of them. Figure 1 demonstrates the relationships between companies A and B with regards to the *Zakah* base and at the macro level across the four cases.

3. *Zakah* on investments in equity instruments

An equity instrument is any contract that evidences a residual interest in an entity's assets after deducting all of its liabilities (IAS 32). This paper will focus on the equity instrument, of the share type, that the investor acquires.



Source: Figure by authors

Figure 1. *Zakah* at the company and macro levels in the four cases

The first section discusses who is obliged to pay *Zakah* on the company's assets; the company itself or its owners/stockholders. Afterward, the concept of control and *Zakah* treatment are presented.

3.1 Who is obliged to pay *Zakah* on investment in shares?

Islamic scholars debate whether the corporation is obliged to pay *Zakah* on its assets as a separate legal entity, or whether the obligation extends to the corporation owners/stockholders. Many Muslim jurists have recognized the legal person concept since the early days according to the *Khulta* notion (joint ownership of cattle). To determine the *Nisab* of *Khulta*, multiple persons' joint property is considered one amount. Hence, *Khulta* is regarded as a separate entity from its owners (Ramli and Abdul Ghadas, 2019). Moreover, the Messenger said "The property of different (owners) should not be joined; nor should the joint property be split for fear of *Zakah*" (Sahih Al-Bukhari, 2:526 hadith no. 1382). The legal person concept is employed to form several Islamic establishments like *Waqf*, *Bayt al-mal* and Mosques.

From a legal perspective, the concept of a separate legal entity dictates that the company is recognized as a legal entity apart from its owners. Hence, the company enjoys multiple legal features like entering into legal proceedings, controlling the assets under its name, and continuous life even when the stockholders are changed. Therefore, the view of obliging the company to pay its *Zakah* has merits from *Shariah* and legal perspectives.

AAOIFI approved this view, but with additional conditions: the company is committed to paying *Zakah* if an enforceable *Zakah* law is in place, or if it is stipulated in the company's articles, or if the general assembly decides so. In the absence of any of the conditions above, payment of *Zakah* becomes the responsibility of Shareholders/owners (AAOIFI, 2017, *Shariah* Standard No. 35). This paper argues that the company, not the stockholders, should pay *Zakah* on its assets. This is because, in addition to what was mentioned above regarding the *Shariah* and legal perspectives, the company's assets are not under each stockholder's disposal (lack of full ownership/control principle).

3.2 What is control according to international financial reporting standards?

The asset is defined as a present economic resource controlled by the entity. Therefore, assessing whether control exists and on what item helps to identify the asset for which the entity accounts. The accounting framework states that control includes the present ability to prevent other parties from directing the use of the economic resource and from obtaining the economic benefits that may flow from it. For investment in shares, two levels of control could be identified. When an entity acquires shares in another entity (investee), these shares may qualify the investor to exercise power over the investee and enable him to direct the investee's activities (the activities that significantly affect the investee's returns). This usually happens when the investor acquires a significant portion of the investee's share. Therefore, according to international financial reporting standards (IFRS) (10), the investor who controls the investee should consolidate the financial statements with the investee, and the investment in shares is not considered a financial asset. On the other hand, if an entity acquires a small number of shares in the investee without controlling the rights arising from ownership of the entire investee, then the investor's shares are treated as a financial asset. In other words, the ownership of a small number of shares gives the shareholder rights to receive dividends, proceeds from liquidation or to sell the share to another party, but not to control the investee's assets (lack of full ownership requirement as discussed in the previous section).

Zakah on investment in equity instruments will be presented under two classifications used by IFRS: the investor not having control over the investee (IFRS 9), and the investor having control over the investee, i.e. interest in subsidiaries, associates, and joint ventures (IFRS 10, IAS 27).

3.2.1 Investments in equity instruments with no control or significant influence. Under this category, the investor acquires equity instruments (shares for this study) in the investee without control or significant influence over the investee (passive investor). The treatment for *Zakah* for the investor, according to AAOIFI, is to determine the *Zakah* according to the purpose of acquisition (AAOIFI, 2017, Shariah Standard No. 35). If the shares are acquired for trading (marketable securities), the *Zakah* amount is 2.5% of the investment fair value (similar to commodity current assets). However, if the purpose of investing in shares is to retain them for a long time (Namà), then the investor should determine the exact amount of *Zakatable* assets (cash, articles of trade and repayable debts) per share. If the investor fails to determine the *Zakatable* assets in the investee, *Zakah* could be reached by estimating the *Zakatable* assets per share.

Thus, AAOIFI treatment may result in two different calculations for *Zakah* for the same assets (or fractions of assets) depending on the intention of the stockholders, i.e. *Namà* or trading. Let us assume that the stocks of company A are 30% owned by long-period stockholders (*Namà*) and 70% are owned by traders, and the company doesn't pay *Zakah* by itself. According to AAOIFI treatment, the long-term investors will pay *Zakah* on 30% of the *Zakatable* assets (or the estimate of *Zakatable* assets) of the company. The *Zakah* for the other 70% of stocks will be paid according to the fair value of the stocks regardless of the amount of *Zakatable* assets owned by the company. Hence, this treatment results in multiple bases for calculating *Zakah*. The fair value of stocks usually doesn't represent the value of the *Zakatable* assets in the company, but rather the expectations of the participants in the stock market. This value could be understated if the traders perceive a negative future performance for the company and vice versa.

The authors believe that the *Fiqh* scholars, in classifying the investment into *Nama* and trading, are affected by the accounting standard setters' perspective in this contemporary issue. In financial reporting, the standard setters' focus is to help financial statement users make economic decisions. The purpose of classifying investment into current and long-term is to provide information to the users about the company's liquidity, which is considered crucial to investors. This classification should not change the *Zakah* amount for the investee assets.

The proposed model of this paper is free from this flaw. The burden of paying *Zakah* rests on the shoulder of the investee, which controls its assets and can determine the amount of the *Zakatable* assets. The investor lacks full ownership and control over the investee's assets, and should not be obliged to pay *Zakah* for its investment.

It is worth mentioning, from an accounting perspective, that if the company (investee) doesn't pay *Zakah*, its net income would be overstated by the unpaid amount of *Zakah* (assuming *Zakah* is treated as expenses). Accordingly, the investor share would be overstated, but still, the investor has no control over the investee's assets. If the investor sells his share, with a presumably high price due to overstated net income, then he pays *Zakah* on the cash proceeds from the disposal of his investment.

3.2.2 Investments in equity instruments with control or significant influence. According to AAOIFI, a subsidiary is an entity in which the mother company owns 50% of the shares. Assuming that the subsidiary does not pay its *Zakah* directly, the mother company pays its share of *Zakah* in proportion to its shareholding in the subsidiary, while the remaining part of the *Zakah* of the subsidiary is to be paid by the other parties. The proposed model is in line with the treatment mentioned above. As consolidated financial statements should be prepared if the investor controls the investee, the investment account will be replaced with the assets and liabilities stated in the investee balance sheet. Hence, in this case, the investor will pay *Zakah* on the aggregate assets (parent and subsidiary) and not on the investment account.

4. *Zakah* on cash

Cash is a financial asset because it represents the medium of exchange and is, therefore, the basis through which all transactions are measured and recognized in financial statements.

Historically, gold and silver were used as a medium of exchange and a measure of value, and they dominated international and local trades for centuries. Gold and silver are mentioned in multiple Islamic scripts (Qur'an and Sunnah), and these scripts indicate that *Zakah* is due on gold and silver (Al Qaradawi, 2000). Hence, Muslim scholars agree unanimously and throughout all generations on this. Currently, gold and silver have been replaced by paper currency (cash) in financial transactions and as a medium of exchange. Paper currency used to be issued by central banks (or other regulated institutions) with full coverage of gold. Recently, most countries eliminated the gold coverage (totally or partially) for the paper currency, and the value of the paper currency became linked to the economic system of the country instead of the gold value. Classical jurists did not discuss the *Zakah* of paper currency, as this issue has emerged in the last few centuries. However, *Jumhur Ulama* consider that paper currency replaces gold and silver in all activities and functions of gold and silver, especially as a medium of exchange, where paper currency can be exchanged for gold and silver at any time without difficulty. Therefore, the paper currency should be subject to *Zakah*, similar to gold and silver (Yasir et al., 2019). Jurists have all reached this conclusion, albeit through different perceptions. Shafi'ites consider paper money as debts on the issuing banks (central banks), and the rules of *Zakah* on debts apply. Hence, the person who possesses the paper currency must pay *Zakah* on debt. Hanafites consider paper money to be claims on the bank and are *Zakatable*. Malikites consider the function of paper money (medium of exchange) as gold and silver, so they are *Zakatable*. Muhammad Hasanain al 'Adawi, in his booklet titled *al Tibyan fi Zakah al Athman*, refuses to consider paper currency as debts because paper currency – unlike debts – is a growing asset used to exchange goods and services, and a stock of value. He argues that paper currency is *Zakatable* on the basis that it is used as a measure of value that is acceptable in transactions and replaces the function of gold and silver in this field. This argument is very similar to the interpretation introduced by IFRS. According to IAS 32, currency (cash) is a financial asset because it represents the medium of exchange and is, therefore, the basis on which all transactions are measured and recognized in financial statements. IAS 32 considers a deposit of cash with a bank or similar financial institution as a financial asset because it represents the contractual right of the depositor to obtain cash from the institution. But should a deposit of cash at a bank be subject to *Zakah* just like cash at hand? The answer depends on the type of the deposit. IFRS classifies deposits under different account titles according to the features of these deposits. For example, demand deposits (a deposit of money that can be withdrawn on demand and without prior notice) like current account deposits, saving account deposits, and call deposits are classified under a “cash and cash equivalent” account title. IAS 7 “Statement of Cash Flows” states that cash comprises cash on hand and demand deposits. On the other hand, deposits with a fixed maturity (term deposits) may not be classified as “cash and cash equivalent” depending on the terms of the deposit (short maturity, convertible to known amounts of cash, insignificant risk of changes in value) and the purpose for which it is held (to meet short-term cash commitments or for investment). From *Zakah* point of view, and based on the previous argument, cash and cash equivalent accounts are considered *Zakatable*, as is the case with gold and silver. For *Zakah* on other cash deposits, the treatment demonstrated in section two applies (financial assets raised from contractual rights).

5. Conclusion

The last era witnessed significant advancements in complex financial contracts due to the continuous evolution of the business environment. This imposes challenges on Shariah scholars regarding the *Zakah* on contemporary financial contracts. One of these challenges is that Fiqh

scholars perceive the assets and liabilities resulting from these contracts separately without linking both sides of the financial transactions together or considering the macro-level interrelations between them. The paper employed accounting and economic concepts to propose a model for Zakah on financial instruments. In accounting, the financial instrument gives rise to a financial asset of one entity and a financial liability or equity instrument of another entity. In addition:

If a reporting entity comprises more than one legal entity, debt instruments or equity instruments issued by one of those legal entities and held by another of those legal entities are not economic resources of the reporting entity (IASB, 2018, chapter 4, 4.10).

The proposed model applies these two concepts on the macro level. The result would be eliminating these financial assets and the corresponding financial liabilities and equity instruments. Hence, the general rule of the model is that the holder of the financial asset is not responsible for paying Zakah on it, and the bearer of a financial liability is not allowed to deduct it from its Zakah base. This approach aligns with the full ownership condition of Zakah eligibility and results in considering real assets for Zakah rather than the financial assets/liabilities.

It is worth mentioning that the proposed model reflects the distinction between the real economy and the financial economy and their respective roles and functions within the broader economic system. Real assets play a central role in producing goods and services in the real economy, making them a vital part of economic growth. While the financial economy primarily deals with financial instruments that transfer funds through financial assets/liabilities. These instruments represent claims on future cash flows and do not have intrinsic value like real assets.

Notes

1. The financial instruments are tackled in three international accounting standards: IAS 32 “Financial instruments: Presentation,” IFRS 7 “Financial instruments: Disclosure,” and IFRS 9 “Financial instruments.” The objective of IAS32 is to establish principles for presenting financial instruments. Thus, it is concerned with the classification of financial instruments from the issuer side into financial assets, financial liabilities and equity instruments. The principles in IAS 32 complement the principles for recognizing and measuring financial assets and financial liabilities in IFRS 9 and disclosing information about them in IFRS 7.
2. This paper will not cover all types of financial assets included in this category such as derivatives and financial guarantee contracts. These instruments are still immature in the Islamic countries’ financial markets, and there is a *Fiqh* debate about their permissibility.
3. The focus in this context is the elimination process and not the measurement issue, as the financial asset in one party could be measured differently from the corresponding liability/equity in the other party.
4. For simplicity, consider the inventory is recognized at its fair value in A’s books and not at cost. The fair value is in line with *Zakah* principles.

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