

## Proposed Best Practices of Financial Information Disclosure for Zakat Institutions: A Case Study of Malaysia

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**Abstract:** Zakat is a compulsory levy imposed on the Muslims who are relatively financially well. Zakat plays a crucial role in Islamic economy since it is one of the important economic tools to elevate the poverty. The confidence of the zakat payers on the process of zakat collection and distribution performed by the zakat institutions plays the essential role in order to collect more zakat. Public confidence can be gained by transparent and full disclosure of financial information of the institutions. Many international organizations such as AAOIFI and IFSB and local standard setting bodies like MASB have provided the accounting guidelines and standards for the transparency of the companies. The prevailing standards focus on the profit oriented institutions and to the extent of our knowledge, no guideline has been issued for the financial reporting aspect of zakat institutions. Thus, the objective of this research is to propose best practices of financial information disclosure for zakat institutions. Both primary and secondary data are used in this study. Primary data is collected from the questionnaire and secondary data is obtained from the relevant books, articles and internet resources. In addition, library research and in terms of data analysis, descriptive statistics is employed. The results from the questionnaire reveal that there is a need for the guidelines for financial information disclosure. The respondents highlight that disclosure on accounting policy and changes and board of trustees, risk management, statement of internal control, important highlights, disclosure on zakat collection and distribution and statement of cash flow are the essential components of reporting. The findings will be the interest of zakat authorities, regulators, zakat payers, zakat recipients and researchers.

**Key words:** Financial reporting • Transparency • Zakat • Malaysia

### INTRODUCTION

Zakat as a pillar of Islam has been known since the birth of Islam. *Zakat* is one of the non-profit organizations established on the basis of religion obligation, since Muslims are obliged to extract part of their wealth to be given to the specified beneficiaries, called the-eight *asnaf*. The initiative to institutionalized *zakat* as an institution was originally initiated by the second Caliph after the death of Prophet Muhammad, Umar Al-Khattab, also known as the transformer of Muslim world. The notion is adapted and practiced through-out the world until these present days, including Malaysia, where the function of the institution is mainly to manage all the public finance,

including *zakat*. However, in Malaysian context, the authority to manage religious affairs is delegated to the state government, called State Islamic Religious Councils (SIRCs). For that reason, *zakat* falls under the jurisdiction of SIRCs, not the federal government. This fact basically reveals that there will be different implementations of *zakat* in each and every different state in Malaysia, depending on the state's governing law.

The important role of zakat is aware among the Muslims and much research has been conducted. Kahf [1] examined issues of zakatable items during the time of the Prophet (PBUH) and the potential proceeds of *zakat* in eight countries. His study suggested that zakat can eliminate poverty in the Muslim world within a reasonable

timeframe however only if new forms of wealth and income are made zakatable. Buang [2] study focused on the issue of zakat management. His study outlines basic principles of zakat management derived from the main sources of *shariah* and from relevant *fatawas* on zakat administration. Bakar and Rahman [3] discussed zakat and modern taxation and the implementation of zakat and taxation in Malaysia. Rahman [4] also discussed prerequisites to effectively integrate zakat into the Islamic Financial System in Malaysia. Moreover, [Kaslam [5], Kaslam [6]] proposes zakat institutions to be the social institutions in Malaysia.

This paper is presented in nine sections. The second section mentions problem statement. The third section outlines the research questions. The fourth section provides research objectives. The fifth section discusses the history of zakat institutions in Malaysia. The sixth section elaborates on the theoretical framework. The seventh section explains on research methodology. The eighth section discusses findings and the last section concludes this paper.

**Problem Statement:** With the increasing awareness of zakat role in uplifting the living standard of Muslims, the collection and distribution of zakat is institutionalized in Malaysia. Since then, the disclosure on collecting and distributing of zakat by the institutions becomes essential to discharge the fiduciary duty of the institutions. Importance of recording the financial information has been recognized not only from the conventional perspective but also from the Islamic perspective. It has been evidenced by the development of financial reporting standards by the developed countries such as United States of America and United Kingdom and developing countries such as Malaysia and Indonesia. Malaysia as one of the countries which try to position itself as Islamic finance hub, it comes out with financial accounting and reporting standards for the Islamic financial institutions. In addition, many international Islamic organizations such as AAOIFI and IFSB have come out with the financial reporting standards. However, to the extent of our knowledge, there is no guideline on the best practices of financial information disclosure focused on non-profit making organization, for instance, zakat institutions. We believe that zakat is one of the pillars of Islam and there should be proper recording and transparent information is essential.

**Research Questions:** The research questions of this research are:

- Whether is there necessary to have a guideline on best practices of financial accounting and reporting for zakat institutions?
- What are the proposed contents of financial information disclosure for zakat institutions?

**Research Objectives:** The respective research objectives are:

- To find out whether there is a necessary to have a comprehensive guideline on best practices of financial accounting and reporting for zakat institutions.
- To propose the contents of financial reporting disclosure for zakat institutions.

**History of Zakat Institutions in Malaysian Environment:**

The history of zakat in Malaysia can be categorized into four different periods: Pre-colonial period, during colonial period, *Zakat* administration pre-1990 and *Zakat* administration post-1990. Islam first arrived in the Malaysian peninsula during the 13<sup>th</sup> century and it was around this time that *zakat* administration began in Malaysia. The pre-colonial administration of zakat was undertaken using informal channels. The traditional practice was delivery of goods to religious teachers who would later distribute them accordingly with the needs of the available beneficiaries [7].

During the British colonial rule was the period when the separation of religious, cultural and temporal matters took place. All the matters concerning Islamic and Malay customs were to be administered by a new special body which was known as *Majlis Agama Islam Negeri* (MAIN). All other matters would fall under the jurisdiction of the British civil and criminal law code. With this new special body in place, all matters relating to zakat would fall under their purview. Zakat administration in Malaysia has taken a reformation. Zakat administration comes directly under the state jurisdiction under the patronage of HRH *Yang Di-Pertuan Agong* for the federal territories and the Sultan or Raja for the other respective states. However, the zakat administration falls under the responsibility of MAIN of each state except Kedah which has a special zakat institution which is independent of MAIN.

Before 1990, the zakat collected was relatively low. There were a few factors that contributed to this [8]. One of the factors was the payment of *fitriah* and the zakat payments from paddy yield were given priority while other forms of zakat were neglected. Zakat collection was considered a seasonal task done normally during the

month of Ramadan and the harvesting period. An issue during this period was a heavy workload and poor designation of task which resulted in poor collection of zakat [1].

After 1990, a new era of privatization of zakat administration took place. Designated institutions with the specific tasks of collecting all forms of zakat in a professional and systematic manner were established. These institutions are subsidiaries of MAIN.

**Theoretical Framework**

**Stewardship Theory:** The origin of the stewardship theory started from 1990s and it has been recognized as one of the corporate governance theories. In this theory, it is assumed that board of directors as stewards will perform their bests to enhance the profitability of the companies which is in line with the ultimate objective of the shareholders. This theory expects the relationship between the board and the shareholders is based on the trust. Board is motivated to perform their best due to the intrinsic reward such as achievement and recognition [9-11]. In sum, the boards of the zakat institutions are the trustee of the zakat payers and recipients and hence, the board should be responsible to provide the transparent and full accounting information disclosure.

**Stakeholders Theory:** Stakeholder theory has been popular since 1970’s and this theory extends the responsibility of the board of directors from the shareholders to other stakeholders such as customers, suppliers, communities, government and etc. This theory recognizes the right of all the stakeholders [10, 12]. This theory seems to add the ethical and moral responsibility of the board by extending their responsibility toward the other stakeholders. When the responsibility and tasks of the boards of trustees from the zakat institutions are reviewed, they should be accountable to the society at large. The main reason of the existence of the zakat institutions is to meet the commands of God, i.e. to have the proper and right channels of zakat collection and to distribute to the right zakat recipients. In order to gain the public confidence,

the transparent disclosure on the collection and distribution of zakat is the foundation of the success and sustainability of any zakat institutions. Thus, the stakeholder theory can be applied in describing the responsibility of boards of trustees of zakat institutions.

**Islamic Accountability Theory:** In Islam, it is believed that board of directors will be accountable not only to the shareholders and stakeholders but also to the God. Islamic accountability comprises of two accountabilities where the primary accountability with shareholders is due to the contractual relationship and the secondary accountability towards the God is due to his creation and he is the ultimate owner of everything. Due to the consequence of the primary accountability, the responsibility of the directors is extended to the society at large [10, 13, 14]. In addition, the board of directors is trustees of God and they are entrusted to discharge their responsibility, especially in the case of zakat which is one of the pillars of Islam.

**Research Methodology:** The research uses both primary and secondary data. Primary data is collected from the questionnaire and the secondary data is obtained from the journals, books and internet resources. Quota sampling is used since this research in the exploratory nature. In addition, library research is adopted to get the relevant literature for this research. Questionnaire is developed based on the Generally Accepted Accounting Principle (GAAP) for non-profit organization and relevant articles. Questionnaire is prepared using five likert scale arranging from (1= least important to 5= most important). Questionnaire is structured into seven sections. It covers disclosure on accounting policy and changes and board of trustees, risk management, statement on internal control, important highlights, disclosure on zakat collection and distribution and statement on cash flow.

**Findings:** The findings of this section are based on the respondents from 5 out of 14 states in Malaysia.

Section A: Disclosure on Accounting Policy and Changes and Board of Trustees

No.	Description	Mean
1.	Adopted accounting standards or guidelines (e.g. MASB, IFRS, GAAP)	4.5
2.	Accounting policy adopted in recognizing the receiving of Zakat, for instance, cash basis or accrual basis and valuation of assets.	4.6
3.	The reason for the change in accounting principle (an explanation of why the newly adopted accounting principle is preferable)	4.1
4.	If there is any mistaken in the previous year, the correction should be provided and its impact on the current financial positions should be stated.	4.7
5.	Profile of board of trustees	4.8
6.	Remuneration policy on board of trustees and the management	4.6
7.	Breakdown of remuneration for each board of trustees	4.8

Section A includes the zakat institutions' opinion towards the information disclosure on the accounting policy and board of trustees. Based on the mean score, it is important for the zakat institutions to adopt the suitable accounting standards or guidelines in order to get the clear picture on what the information should be disclosed and to provide more transparent information disclosure. It is also important to disclose the adopted accounting policy and valuation method and the reasons for changes if any. It is also strongly recommended to highlight the mistakes (if any) and to inform the correction. Regarding the board of trustees, zakat institutions are highly recommended to disclose their profile, remuneration policy (if any) and the breakdown of the remuneration amount given to each trustee. Thus, it can be concluded that disclosure on accounting policy and changes and board of trustees is highly recommended.

Section B: Disclosure on Risk Management

No	Questions/recommendations	Mean (s)
1.	Segregation of the duty among the officers who assess the eligibility, approve and distribute the zakat	4.7
2.	Decision making process from the receipt of application until disbursement of zakat	4.8
3.	Report on variance analysis between the budget and the actual and justification if the actual does not meet the targeted amount.	4.9
4.	Disclosure made of the concentration(e.g source of zakat and categories of zakat recipients) of collection and distribution	4.7
5.	Disclosure on the reasons for delay or balance in distributing zakat	4.6
6.	Risk management policy on assessment and timely distribution of zakat	4.5
7.	Communicating channel among the risk management committee, audit committee and zakat officers	4.8

Risk is everywhere although different risks might incur in different places and situations. Hence, risk management is necessary in zakat institutions. The risks exposed to these institutions are distributing the zakat not to the right recipients, late in distribution and not having the proper assessment criteria. Thus, this section examines the level of importance towards risk management information disclosure. The mean values show that the respondents strongly agree the risk management information disclosure. The information related to risk management includes segregation of duties among the zakat officers to ensure there is check and balance in their work. In addition, the decision making process to pay zakat should be clearly stated in the annual report in order to gain the confidence from the public. In addition, to examine the performance of zakat collection center, it is necessary to disclose variance analysis report which shows the budgeted amount and the actual amount. In addition it is highly recommended to provide the justification why actual amount cannot reach the target. In risk management, diversification plays a significant role to mitigate the risks. It is strongly recommended to provide the disclosure on concentration of zakat collection and distribution. Since zakat should not be left undistributed and in the case it happens, the justification should be disclosed. In addition, the necessary steps taken by the zakat institutions in managing the risks and communication among the organizations are strongly recommend disclosing in order to mitigate all the undesirable risks. Therefore, it can be concluded that disclosure on risk management information is strongly recommended in zakat institutions.

Section C: Statement on Internal Control

No.	Description	Mean
1.	Description on the existence of the audit committee	4.6
2.	Audit committee composition and their profile	4.4
3.	Internal audit committee and its role in the zakat institutions.	4.7
4.	Report on internal control system to ensure that the amount collected is distributed to the right recipients within the reasonable time frame.	4.6
5.	Communication of audit committee with board of trustees and management and other stakeholders	4.8

Section C inquiries regarding the disclosure related to internal control functions and audit committee. The existence of audit committee is essential to have the strong internal control system of the zakat institutions in order to minimize the risk exposure. The findings of this section strongly recommend having the information disclosure on audit committee, its composition and profile. In addition, the process of internal controls system and how well communication among them should be transparently disclosed. Hence, the disclosure on the existence of audit committee to monitor the proper internal control system is strongly recommended.

Section D: Disclosure on Important Highlights

No.	Description	Mean
1.	Number of zakat recipients for each category	4.8
2.	Amount of zakat distribution for each category	4.7
3.	Zakat collection and distribution for each district	4.6
4.	Number of collection centers	4.8
5.	Percentage of zakat distribution to each category compared to the total amount of distribution	4.9
6.	Zakat collection from each source of income, for instance, salary, business, share and etc.	4.6
7.	Graph for zakat collection and distribution	4.7
8.	Graph for undistributed zakat by the end of each year	4.8
9.	Graph for operating expenses to collect and distribute the zakat	4.9
10.	Efficiency ratios, for instance, ratio of operating expenses (including the advertising expenses) to total amount of zakat collection	4.7

Section D provides what additional information disclosure should be disclosed in order to provide the comparative information of zakat institutions. Regarding eight categories, the number of recipients This includes the number of zakat recipients for each category, amount of zakat distribution for each category, collection and distribution for each district, number of collection centers, Percentage of zakat distribution to each category compared to the total amount of distribution, zakat collection from each source of income, for instance, salary, business, share and etc, graph for zakat collection and distribution, for undistributed zakat by the end of each year and for operating expenses to collect and distribute the zakat as well as the efficiency ratios, for instance, ratio of operating expenses (including the advertising expenses) to total amount of zakat collection. The respondents highly recommend providing the information in Section D since the mean value ranges from 4.6 to 4.9. Therefore, the zakat institutions are strongly recommended to provide the comparative information in the annual reports.

Section E: Disclosure on Zakat Collection

No.	Description	Mean
1.	Strategy and future plan on zakat collection	4.7
2.	Separation of zakat collection, for instance, zakat al- mal & zakat fitrah	4.9
3.	Sources of zakat collection, from salary, business, investment from shares and etc.	4.5
4.	Disclosure on the list of zakat collection centers.	4.8
5.	Classification of zakat centers, for instance, mosques and banks, etc.	4.5
6.	Disclosure in the notes to account regarding the amount collected based on specific methods for zakat collection, for instance, zakat collection monthly or yearly	4.6
7.	Policy on zakat collection and incentives for instance, rebate or exemption from income tax	4.6

Section E basically covers disclosure on zakat collection. This type of information disclosure is important is because it is part of the religious duty and it is necessary to discharge the accountability of zakat institutions. Every organization is necessary to have the strategy to meet its target and to earn the success. Thus, there is no exception for the zakat organizations to disclose the information related to strategy and future plan on zakat collection, i.e. their main purpose of existence. In addition, zakat collection is necessary to split between *zakat al-mal* and *zakat al-fitrah* and hence, the respondents strongly agree to disclose all collection separately since the mean value is 4.9. In addition, it is highly suggested to disclose list of the zakat collection centers (mean 4.8) and locations (mean = 4.5). Since in Malaysia, zakat payers, especially the salary earners, request their employers to deduct the zakat payable amount every month from the salary. Therefore, it is also essential to know which collection method is most common in Malaysia and the respondents also strongly agree to disclose on this (mean = 4.6). Moreover, Malaysia as a Muslim country, it provides the incentive the individual zakat payers to exempt or rebate from zakat. According to the mean value of 4.6, the impact of income tax on zakat payers should be highly recommended to disclose so that the zakat payers are aware of it. Therefore, it could be summed that the information disclosure on zakat collection is essential in the annual reports.

Section F: Disclosure on Zakat Distribution

No.	Description	Mean
1.	Disclosure on policies of distribution (e.g. one-eighth [1/8] for each <i>asnaf</i> )	4.9
2.	Disclosure on criteria to assess each beneficiary (e.g. gross family income, income per dependent family member, etc.)	4.7
3.	Detailed description on the list of recipients	4.8
4.	Disclosure on the amount of disbursement for each category of beneficiary	4.8
5.	Disclosure on the types/ kind of wealth distributed for each beneficiary if the respective state authority extends the beneficiaries in addition to original eight beneficiary groups	4.9
6.	Disclosure on average time taken from collection to distribute to the beneficiaries	4.8
7.	Disclosure on the average time taken for each application to receive the zakat, i.e. from the application date until the decision is done	4.7
8.	Disclosure on the channel of distribution (e.g. bank transfer, collection from the center, sending to home)	4.7
9.	Disclosure on the approval process in allocating the zakat amount for each categories and assessment criteria to be qualified as zakat recipients	4.9
10.	Disclosure on means of application (e.g. application on line, manually filling up the form, personal interview with officer from zakat authority) to ask for zakat	4.8
11.	Disclosure on new list of recipients introduced within each category, for instance, travelling includes the students who are studying.	4.9

Section F focuses on zakat distribution. Zakat institutions are highly recommend to disclose on policies of distribution (e.g. one-eighth [1/8] for each *asnaf*) to know how zakat has been equitably distributed since the mean value is 4.9. Transparency is necessary to reveal the criteria (mean = 4.7) which assesses each beneficiary (e.g. gross family income, income per dependent family member, etc.) since based on that, zakat recipients will be selected and to show the accountability of the institutions towards the zakat payer and ultimately to God. Furthermore, the list of recipients and the amount of disbursement for each category of beneficiary are also important to disclose since their mean value is 4.8. It is strongly suggested the zakat institutions if they have added the new type of zakat recipients with the mean value of 4.9. Information on the average time taken from collection to distribute to the beneficiaries (mean = 4.8) and also the average duration on the process of the application from the date of application until the decision made on the entitlement of zakat (mean = 4.7) are strongly recommended. In addition, the channel of zakat distribution (e.g. bank transfer, collection from the Centre, sending to home) and the approval process in allocating the zakat amount for each categories and assessment criteria to be qualified as zakat recipients are essential to disclose since their mean values are 4.7 and 4.9. Means of application (e.g. application on line, manually filling up the form, personal interview with officer from zakat authority) to request for zakat, Disclosure on newly introduced list of recipients introduced within each category, for instance, travelling includes the students who are studying, is strongly recommended to disclose with the mean value of 4.9. Therefore, it can be summed that the information on distribution is strongly recommended to disclose since the mean value ranges from 4.7 to 4.9.

Section G: Statement on Cash flow

No.	Description	Mean
1.	Cash inflows from each source of income (e.g salary, business)	4.7
2.	Cash outflow of zakat distribution for each category	4.8
3.	Cash outflow of remuneration for board of trustees	4.7
4.	Cash outflow of operating activities (detail on each major activity)	4.9
5.	Net cash inflow or outflow for the year	4.6
6.	Opening cash balance at the beginning of the year	4.5
7.	Ending cash balance at the end of the year	4.8

The findings of Section G provide the important of information disclosure on cash flow of zakat institutions. Cash flow information is strongly recommended to disclose since collection and distribution of zakat is by cash. The recommended disclosure includes the breakdown of cash inflow and outflows as well as the opening and closing balances. Thus, this section strongly suggests since the mean value is from 4.5 to 4.9.

**CONCLUSION**

Zakat is one of the pillars of Islam. It is religious obligation for the qualified Muslims to pay zakat since it is the right of the poor to receive it. Since it plays a important role in Islam, zakat institutions which are taking responsibility to collect and distribute the zakat should be accountable for the tasks taken and part of duty is to

provide the transparent disclosure in the annual report. Hence, this research finds that it is essential to have a comprehensive guideline on best practices of financial accounting and reporting for zakat institutions and in addition, the zakat institutions are strongly recommend to disclose the information on accounting policy and changes and board of trustees, risk management, statement of internal control, important highlights, on zakat collection and distribution and statement of cash flow. It is expected that the findings of this research will help the respective regulating bodies to come out with the comprehensive reporting guideline and for the zakat institutions; they should be able to use this finding as a basis of disclosure in order to gain more public confidence. In the case of the public, they will be able to understand and appreciate the role of zakat institutions.

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