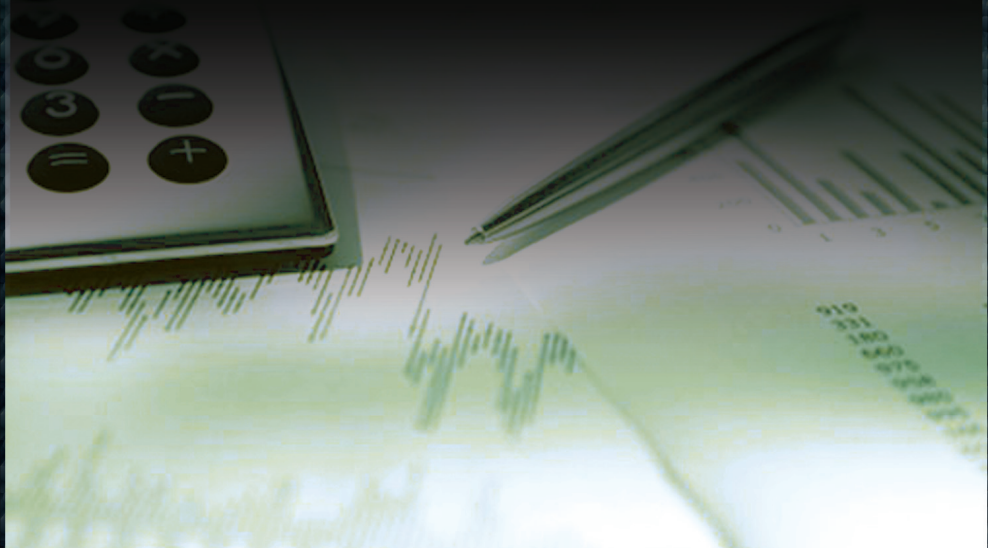




# **GOVERNANCE AND SHARIAH AUDIT IN ISLAMIC FINANCIAL INSTITUTIONS**

MUSTAFA MOHD HANEFAH  
ZURINA SHAFII  
SUPIAH SALLEH  
NURAZALIA ZAKARIA



**GOVERNANCE  
AND  
SHARIAH AUDIT**

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**IN ISLAMIC FINANCIAL INSTITUTIONS**



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# LIST OF ABBREVIATIONS

AAOIFI	Accounting and Auditing Organisation of Islamic Financial Institutions
AGC	Audit and Governance Committee
ASIFI	Auditing Standards for Islamic Financial Institutions
BAC	Board Audit Committee
BIMB	Bank Islam Malaysia Berhad
BNM	Bank Negara Malaysia
BOD	Board of Directors
CEO	Chief Executive Officer
DCR	Displaced Commercial Risk
GSIFI	Governance Standards for Islamic Financial Institutions
IAH	Investment Account Holder
ICM	Islamic Capital Market
IFIs	Islamic Financial Institutions
IFRS	International Financial Reporting Standards
IFSB	Islamic Financial Services Board
IIFS	Institutions offering only Islamic Financial Services excluding insurance institutions
IRR	Internal Rate of Return
ISCU	Internal Shariah Compliance Unit
ISRU	Internal Shariah Review Unit
MFRS	Malaysian Financial Reporting Standards
OECD	Organisation for Economic Co-operation and Development
PER	Profit Equalisation Reserve
PLS	Profit and Loss Sharing
PSIA	Profit Sharing Investment Account
ROA	Return on Asset
SA	Shariah Audit
SAC	Shariah Advisory Council
SC	Securities Commission
SCI	Statement of Comprehensive Income
SCR	Shariah Committee Report
SFP	Statement of Financial Position
SGF	Shariah Governance Framework
ShC	Shariah Committee
SOP	Statement of Principle
SR	Shariah Review
SSB	Shariah Supervisory Board
SSBR	Shariah Supervisory Board Report
SSC	Shariah Supervisory Council
TR	Technical Release



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# FOREWORD

Governance and Shariah Audit in Islamic Financial Institutions is written as a textbook for Final Year students of all programmes undertaking the course Al-Tadqiq Al-Shari'e (MGA3033). I would like to take this opportunity to congratulate the writers for their perseverance and persistent effort in completing this first edition of Governance and Shariah Audit module.

This textbook is the first one in Malaysia as the practice of Shariah audit is still new and evolving locally and even at the international level. It contains essential readings that cover the topic of governance and the process and practice of Shariah Audit in Islamic Financial Institutions (IFIs). This textbook is divided into five (5) parts, Corporate Governance, Shariah Governance, Risk Management, Shariah Audit and Review and lastly, Shariah Audit Processes.

This textbook does not only provide students with current knowledge of the local regulatory framework for Shariah governance, but also exposes students to the international standards and guidelines for comparison purposes. Practical examples of the IFIs' application of the relevant standards and guidelines are also provided to students to have a better understanding on the topics discussed. This textbook also contains discussions on Bank Negara Malaysia's latest guideline on Shariah Governance Framework for Islamic Financial Institutions that is effective for all IFIs in Malaysia to adopt by 1 January 2011.

It is hoped that this module would aid students in their quality learning effort towards successful preparation of their examination. As this textbook provides comprehensive knowledge in the area of Governance and Shariah Audit in IFIs, it will prepare the students as Shariah Auditors if they were to become one.  
Good luck in your studies.



**DR. ASMADDY HARIS**

Dean

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# PREFACE

This textbook is intended for final year students who have some background in the operations of Islamic Financial Institutions (IFIs). It is also helpful for other readers who wish to have a comprehensive understanding on the Shariah governance concept and structure as well as the processes involved in the Shariah Audit in IFIs. This textbook contains discussion on relevant standards and guidelines issued by local and international regulators /standard setters. Each chapter is written in a way that will assist students to have an overall picture of the governance structure as well as the Shariah Auditing processes even for beginners.

This book is divided into five sequential parts as follows:

## **PART 1: CORPORATE GOVERNANCE**

**Chapter 1: Corporate Governance: Islamic Perspectives** introduces the students to the concept of corporate governance in general. Then, the chapter discusses on the Shareholder Theory and Stakeholder Theory giving emphasis from the Islamic perspectives.

## **PART 2: SHARIAH GOVERNANCE**

**Chapter 2: Principles for Shariah Compliance Guidelines** explains the foundations of Islamic teaching and the philosophies of Islamic economy. Additionally, it also elaborates on general principles of *Muamalat*, among others is freedom, transactions without riba, good manners, justice and many more. This chapter also explains the primary and secondary sources of Shariah. Lastly, the chapter discusses the main rules of Shariah in *Fiqh Muamalat*.

**Chapter 3: Shariah Governing Bodies and Governance** highlights various local regulators whose responsibilities are to oversee the operations of Islamic financial institutions. It also discusses the relevant guidelines issued by regulators such as the Bank Negara Malaysia (BNM) and Securities Commission (SC). In addition, this chapter also provides a comparison between regulatory body and international standard setting body that issue standards in relation to governance, accountability and audit for IFIs such as International Financial Services Board (IFSB) and Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI).

**Chapter 4: Shariah Governance Framework for Islamic Financial Institutions** provides an overview on important internal governance mechanisms such as Board of Directors, Shariah Committee, Management, Shariah Review, Shariah Audit and Shariah Research. This chapter highlights the line of reporting and the main responsibilities of the each of these internal mechanisms or organs in accordance to the Shariah Governance Framework of BNM.

**Chapter 5: Shariah Committee Report** outlines the main purpose and content of the Shariah Committee Report (SCR) in accordance to the BNM's guideline. This chapter also provides comparison on the requirements of reporting by BNM against AAOIFI's standard for such report. There is a move towards harmonization on the content of this report which assists stakeholders to have a better understanding on the Shariah compliance of IFIs.

### **PART 3: RISK MANAGEMENT IN ISLAMIC FINANCIAL INSTITUTIONS**

**Chapter 6: Risk Management and Mitigation** gives an overview on the importance of risk management in IFIs. This chapter introduces the concept of three line of defense approach in risk management processes. The students will also be exposed to the different types of risk that is related to the management of IFIs and the risk management techniques to mitigate such risks that is based on the international guideline issued by IFSB.

### **PART 4: SHARIAH AUDIT AND REVIEW**

**Chapter 7: Shariah Review and Audit** introduces the definitions, concepts and framework as outline in the AAOIFI, IFSB and Shariah Governance Framework (Bank Negara Malaysia, 2010). It provides understanding on the differences between Shariah Review and Shariah Audit. This chapter also highlights the area of responsibilities for internal auditors and external auditors in conducting Shariah audit.

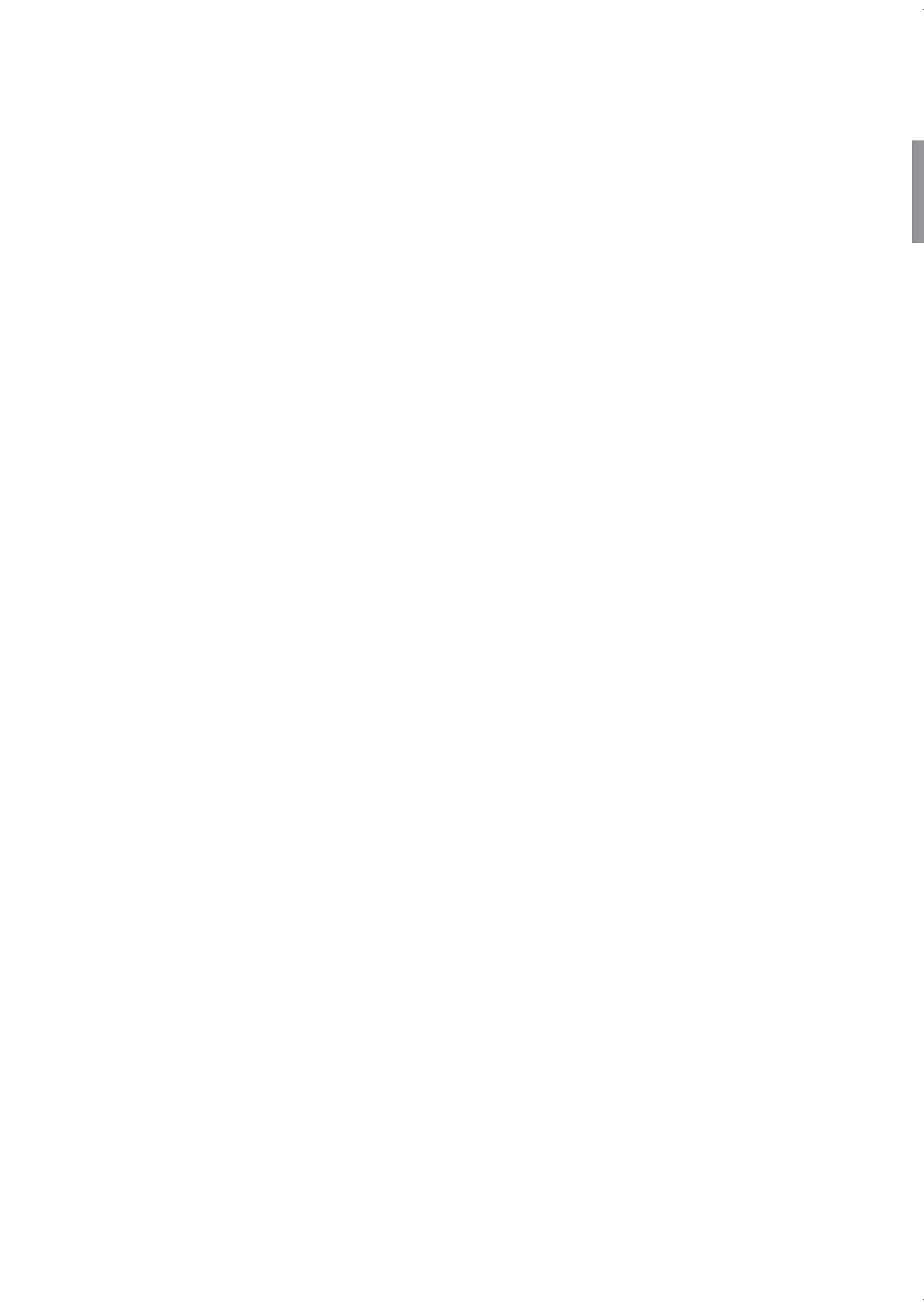
### **PART 5: SHARIAH AUDIT PROCESSES**

**Chapter 8: Audit Planning** provides the reader an overview of the overall processes in Shariah audit. This chapter also highlights the materiality indicator in Shariah audit practices. In addition, it also provides views on internal control for Shariah compliance in the IFIs. At the end of the chapter, samples of Shariah audit program are provided as a reference during conducting Shariah audit.

**Chapter 9: Audit Scope** provides the students the extended scope and components in Shariah audit practices. The scope identified is comprehensive and robust covering the overall operations of the IFIs. The scope covers wide areas other than stipulated in the Shariah Governance Framework (Bank Negara Malaysia, 2010). The extended scope of audit develops an insight into the overall processes in Shariah audit.

**Chapter 10: Financial Reporting of Islamic Financial Institutions** presents a simplified and straight forward explanation on the main financial reports that is included in the IFIs financial statements. The explanations are based on local accounting standards issued by Malaysian Accounting Standards Board and BNM's guidelines. In addition, this chapter also compares the financial statement requirements and disclosures of international IFIs that follow AAOIFI's financial accounting standards.

**Chapter 11: Audit Report** basically identifies the main purpose and content in the Audit report. It also provides comparison between the content of audit report required by BNM and AAOIFI. It also highlights the differences between Independent Auditors' Report and Shariah Committee Report.



# CHAPTER 1

## **CORPORATE GOVERNANCE: ISLAMIC PERSPECTIVES**

### **Learning Objectives**

1. Discuss the importance of corporate governance in an organization.
2. Elaborate on the concept of shareholders' wealth from the Islamic perspective.
3. Summarise the concept of directors' responsibilities from the Islamic perspective.

## **1.1 BACKGROUND**

Lately, directors' responsibilities in protecting shareholders wealth have been given much attention in the corporate governance literature compared to two decades ago. This is mainly due to the increasing number of corporate failures worldwide and also in Malaysia. Factors linked to corporate failures include mismanagement, frauds, lack of accountability, transparency and unethical behaviour by the directors and managers. In this chapter, directors' responsibilities to protect shareholders wealth are discussed in a wider perspective including perspectives from Islam. Policy makers, regulators, professional bodies and the government can use Islamic values that are enshrined in the Shariah to improve accountability, transparency and trustworthiness in company directors and managers. This chapter outlines the benefits to managers, shareholders and regulators if Islamic values and principles are made compulsory in the directors training programs. Conforming to Shariah and religious practices will ensure directors are trustworthy, accountable, responsible and ethical because they are not only responsible to the shareholders, but also to all stakeholders and above all, Allah (SWT).

## **1.2 INTRODUCTION**

Directors' knowledge and experience in managing the company's financial affairs and protecting the shareholders wealth are essential for the success of a corporation. They are also expected to discharge their fiduciary duties and responsibilities according to the laws and regulations of Malaysia. It is one of the core elements of corporate governance enshrined in the Malaysian code of corporate governance. Corporate governance, on the other hand, has been defined in many ways. According to the International Finance Corporation (2005), corporate governance refers to the structures and processes for the direction and control of companies. Corporate governance concerns the relationships among the management, Board of Directors (BOD), controlling shareholders, minority shareholders and other stakeholders. The Organisation for Economic Co-operation and Development (OECD) defines it as the set of relationships between a company's management, its board, its shareholders and other stakeholders.

The main objective of corporate governance is to ensure that the direction of the company is in line with its objectives and there is an element of control in the organization. For more than two decades, the importance of corporate governance has been published in many local and international journals. Its importance gained momentum after the Enron scandal in the USA. Following Enron, many other scandals in the USA and other countries, for example, Parmalat in Italy and Transmile Bhd. in Malaysia in 2007 were due to mismanagement and frauds committed by the managers, directors and even the external auditors. The global economic crisis which resulted from the USA's banking woes in 2007, mismanagement and fraud and less government control has called for more ethical conduct and good corporate governance on the part of the

## **11.4 CONCLUSION**

The ability to identify audit findings, communicate and determine the audit conclusions is one of the skills that add the most value to a management system audit. After the final conclusions have been drawn up, it is necessary to discuss audit follow-up activities if there is a Shariah nonconformity or Shariah noncompliance. For a third-party audit, which is the external audit, the follow-up might be the responsibility of the Shariah department or internal audit department and might not involve external auditors. For internal audits, the same auditor or an auditor from the same audit program department might conduct a follow-up audit to verify the Shariah non-compliance was corrected. Based on that it will reduce the risk of Shariah non-compliance operations in the IFIs and increase the reliance of the stakeholders on the performance and conformity to Shariah principles.

## **DISCUSSION QUESTIONS**

1. State and discuss the main purpose and content of Audit Report.
2. Compare and contrast the content of audit report required by BNM and AAOIFI.
3. What are the types of audit opinion?
4. Differentiate between an Auditor Report and a Shariah Committee report.
5. What happens after the final conclusions have been drawn up by the auditors?

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# GOVERNANCE AND SHARIAH AUDIT

IN ISLAMIC FINANCIAL INSTITUTIONS

This textbook is designed to give a basic understanding of Shariah governance structure and Shariah Audit in Islamic financial institutions (IFIs). The practice of Shariah Audit is still new and evolving locally and more so at the international level. This book contains topics such as corporate governance from the Islamic perspectives before elaborating further on the concept of Shariah governance structure in Islamic financial institutions. It also discusses the importance of risk management in IFIs. Later chapters elaborate on concepts and provide analysis on significant differences between Shariah Audit and Shariah Review. A number of chapters are dedicated to provide an overview of the Shariah Audit processes, which covers audit planning, audit scope and the audit report. This textbook not only provides students with current knowledge of the local regulatory framework for Shariah governance, but also exposes students to the international standards and guidelines for comparison purposes. Practical examples of the IFIs' application of the relevant standards and guidelines are also provided to students to have a better understanding on the topics discussed. All lecturers and students of Islamic banking, finance, accounting and auditing will find this book very useful.

