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Shari'ah governance system: A need for professional approach⁸⁸

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Abstract

This research paper aims to address one of the most crucial challenges facing Islamic financial institutions. That is, the full compliance of the IFIs in its product and activities with Shari'ah rules and principles, as it has been seen in the cases of some Sukuk development. In the light of full compliance issues, there is a need to apply a professional approach to the Shari'ah governance system. It has been noticed that transparency, market discipline of IFIs cannot be underestimated and non-compliance is a reason for reputation risk that can trigger the IFIs failure and cause systemic risk and instability. This reputation risk can be minimized by putting in place professional approach to the Shari'ah governance system. This paper will focus on the need to apply professional approach to Shari'ah governance by analyzing the two stages of Shari'ah governance process: (i) ex-ante compliance, and (ii) ex-post compliance. The ex-ante Shari'ah compliance is basically the internal Shari'ah review that supervises, monitor and control tasks that take place upon and during implementation of the verdict of Shari'ah Supervisory Boards. These activities include making sure that the IFIs comply with the Shari'ah rules and principles while designing the contracts and agreements. With both design and compliance activities being performed by the same Shari'ah experts, each role has its own professional requirements. However, the paper will explain the need for professional approach in the ex-post Shari'ah governance process which requires thorough and comprehensive Shari'ah audit to review bank's operation and check the transactions that took place after the execution of the contracts in ensuring the implementation of Shari'ah board decisions by the bank's management. The SSB opinion may be compared to the Auditor's report included in the conventional accounts. Finally, this paper will recommend IFIs to adopt professional approach in Shariah governance system in order to enhance internal Shari'ah review and external Shari'ah audit processes.

Key words:

Shari'ah governance, Sukuk development, Ex-ante & ex-post process, Challenges, Shariah Advisor.

Introduction

As Islamic finance continues to attract global attention, the area of *Shari'ah* Governance also becomes increasingly analyzed and scrutinized by stakeholders across the industry. With all due respect to *Shari'ah* experts/scholars who have played a significant role and made tremendous contributions for the development of the industry, there is still a perception that *Shari'ah* experts generally have not undergone any robust and transparent tests on their credibility and integrity as normally undertaken by other finance professionals such as lawyers, accountants and bankers who are regulated by their respective professional bodies and bound by specific professional ethics.

⁸⁸ The views expressed in this paper are those of the author and do not necessarily represent the views of ISRA and its management.

Certainly this is not the fault of the *Shari'ah* experts, as there are no legal or professional requirements for them to do so, because to be a professional you need to have a standardized framework from the regulatory authorities. Hence, steps need to be taken to lend more credibility to *Shari'ah* experts and confirm their high integrity through a set of common and transparent minimum best practices which *Shari'ah* experts would observe throughout the *Shari'ah* Governance process such as in the issuance of *Shari'ah* pronouncement/resolution, as well as in conducting the *Shari'ah* audit/review. It is worth noting that a *Shari'ah* Governance system which improve the credibility and integrity of *Shari'ah* experts/scholars addresses not only governance concerns but also risk management issues. In Islamic finance, it has been known that *Shari'ah* non-compliance is part of operational risks of IFI. Therefore, this paper will explain in details the following points

1. Definition of Shari'ah governance

Shari'ah governance is a very critical area in Islamic financial institutions and is no less important than is corporate governance to any institution. It is the mechanism which determines the compliance of any particular Islamic business or financial institution. The significance of *Shari'ah* governance transpires via its role of ensuring the confidence of Islamic finance industry in the eyes of the stakeholders. This is crucial, considering that compliance with *Shari'ah* rules and principles is the *raison d'être* of the IFIs. In addition, history has shown that improvement in the aspect of *Shari'ah* governance can assist the speedy and better growth of the Islamic finance industry.

The IFSB-10 has defined the *Shari'ah* Governance System "as a set of institutional and organizational arrangements through which a IFIs ensures that there is effective independent oversight of *Shari'ah* compliance over the issuance of relevant *Shari'ah* pronouncements, dissemination of information and an internal *Shari'ah* compliance review"⁸⁹.

The definition above illustrates the extensive duties that need to be performed by *Shari'ah* supervisory Board; it is understood from the above definition that duty of SSB is to oversight and supervise the *Shari'ah* compliance of the Islamic financial institutions, as such, their competence is essential to forming a robust *Shari'ah* board. This definition also implies that the institution of the *Shari'ah* board is crucial to the *Shari'ah* governance system as an authoritative body ensuring *Shari'ah* compliance.

The AAOIFI Governance Standards No. 1 has defined *Shari'ah* board as "an independent body entrusted with the duty of directing, reviewing and supervising the activities of IFIs for the purpose of *Shari'ah* compliance, and issuing legal rulings to pertaining to Islamic banking and finance". A similar definition is given by the IFSB-10 where it refers to "a body comprised of a panel of *Shari'ah* scholars who provide *Shari'ah* expertise and acting as special supervisors to the institutions". In carrying out this duty, the *Shari'ah* board needs a clear framework and structure to ensure its effectiveness, particularly in the aspects of its independence, binding force of its rulings, objectivity and full mandate. On this basis, any formal or informal arrangement as to how the *Shari'ah* board is directed, managed, governed and controlled for the purpose of *Shari'ah* compliance is also part of the *Shari'ah* governance system⁹⁰.

Table: 1.

Functions	Typical Financial Institution	Exclusive to IFIs
Governance	Board of Directors	<i>Shari'ah</i> Board
Control	Internal Auditor / External Auditor	Internal <i>Shari'ah</i> review Unit / External <i>Shari'ah</i> Review Unit
Compliance	Regulatory and Financial Compliance officers, unit or department	Internal <i>Shari'ah</i> compliance Unit

⁸⁹ See IFSB-10 (December, 2009) Guiding Principles on Shariah Governance Systems for Institutions offering only Islamic financial services, pp 2-4. A key characteristic of independence is the ability to exercise sound judgment after fair consideration of all relevant information and views without influence from management or inappropriate outside interests. The IFSB-3 discussed this at length, and among other things requires that the professionalism and independence of the *Shari'ah* board must be upheld with the highest respect.

⁹⁰ International Shariah Research Academy for Islamic Finance (ISRA); (2011). Islamic Financial System: Principles & Operations; p.702.

Shari'ah governance is a unique kind of governance in financial architecture as it is concerned with the Shari'ah legal aspects of the overall activities of IFIs. To illustrate the rationale of the Shari'ah governance framework, the table below provides an illustration as to how Shari'ah governance complements the existing corporate governance framework in IFIs.

2. The Shari'ah Governance Process

The utmost important element of professionalism for Shari'ah governance refers to its process. The Shari'ah governance process represents the instrumental functions of the Shari'ah board as part of the institution of corporate governance of IFIs. This sub-section provides a brief explanation on the Shari'ah governance process and this includes attributes of the Shari'ah board with respect to the function of Shari'ah compliance process, Shari'ah coordination, Shari'ah compliance review and Shari'ah report⁹¹. There are two processes to the Shari'ah Governance; these processes are the ex-ante process and the ex-post process of Shari'ah governance. However, each process can also be divided into two stages.

2.1. The internal process of Shari'ah Governance

There are two crucial aspects of internal process of Shari'ah governance for IFIs to be verified for the purpose of good Shari'ah governance of the IFIs, which is inception and conceptualization of an Islamic product, structuring the rules and principles in according with Shari'ah, and legal documentation procedures.⁹² All these two aspects of internal process will be summarizing in the following details;

2.1.1 Issuance of Fatwah (pronouncements)

Issuance of relevant Shari'ah pronouncements/resolutions: "Shari'ah pronouncements/resolutions" refers to a juristic opinion on any matter pertaining to Shari'ah issues in Islamic finance, given by the appropriately mandated Shari'ah board.⁹³ In jurisdictions where there is a central authority such as the national Shari'ah board or Fatwa Council, that central authority has the power to issue such pronouncements/resolutions, resulting in the Shari'ah board at the IIFS usually focusing only on ensuring that the IIFS is compliant with the pronouncements/resolutions issued by the central authority.⁹⁴

Once it is decided that a *Shari'ah* pronouncement/ resolution should actually be implemented, it becomes a "*Shari'ah* ruling" (*hukm al-Shar'i*) with full legal effect that binds the IIFS.⁹⁵ The Shariah ruling means the commandment from Allah related the act of the subjects through a demand or option or through a declaration.⁹⁶ A *Shari'ah* pronouncement/resolution shall be issued only through appropriate due processes, which, amongst others, should involve rigorous deliberation among members of the *Shari'ah* board over any proposed *Shari'ah* compliant products or transactions that require a *Shari'ah* endorsement, as well as detailed scrutiny of the legal contracts and other documents relevant to the products or transactions.

The disclosure of the process leading to Shari'ah pronouncement and related information needs to be the cornerstone of Shari'ah governance. These issues may not have received sufficient

⁹¹ International Shariah Research Academy for Islamic Finance (ISRA); (2011), Islamic Financial System: principles & Operations; p.714.

⁹² See more details: Zurina Shafii & others, (March 2010). Management of *Shariah* Non-Compliance Audit Risk in the Islamic Financial Institutions via the Development of *Shariah* Compliance Audit Framework and *Shariah* Audit Programme, published by Kyoto bulletin of Islamic Area studies, pp 8-9

⁹³ In this respect, the *Shari'ah* board should make it clear to the IIFS whether it is issuing a pronouncement/resolution, recommendation or other remarks, so that there will be clear understanding of the *Shari'ah* board's instructions thus facilitating appropriate implementation of the instructions.

⁹⁴ Although sometimes the power of the central *Shari'ah* authority may not totally preclude the pronouncing of resolutions by the *Shari'ah* board at the IIFS level, usually it remains less of their focus as there will be a common understanding for the *Shari'ah* board at the IIFS level not to contradict or depart from any pronouncement/resolution issued by the central *Shari'ah* authority.

⁹⁵ Of course, the binding legal effect of a *Shari'ah* pronouncement/resolution is also subject to the relevant national legal and regulatory framework. However, in practice, the *Shari'ah* rulings are implemented by embedding them into the legal documentation of Islamic financial transactions; hence, they would generally bind the contracting parties, including the IIFS, under the existing law of contracts.

⁹⁶ See: Imran Khan Nyazee, (2003). Islamic Jurisprudence. Malaysia: Academe art and printing services. P 46-47.

attention either from IIFS themselves or their regulators and supervisors.⁹⁷ Therefore, policies need to be put in place that would ensure adequate disclosure, terms of both quality and ease of retrieval, such as through IFI websites and annual reports. Of particular importance would be, *inter alia*, the SSB annual report and its fatwa. Informing IFI's stakeholders on the composition, powers, competence, and decision-making of SSBs would also enhance the transparency of the process leading to Shari'ah pronouncement.

2.1.2 Internal Shariah review

Dissemination of information on such Shari'ah pronouncements/verdicts to the operative personnel of the IFI who monitor the day-to-day compliance with the Shari'ah pronouncements/resolutions vis-à-vis every level of operations and each transaction. Such a task would normally be undertaken by a designated "internal *Shari'ah* review unit/department (ISRU)", or at least an internal *Shari'ah* compliance officer who is part of the IFI's compliance team. The IFI shall equip the ISRU with the appropriate compliance-monitoring skills and relevant knowledge of the *Shari'ah*— for example, by assembling a team of staff with the two different skill-sets. The IIFS should also ensure that the ISRU is separate and independent from the business units and departments. It also carries the potential of creating a conflict of interest. It may tempt the board members to give verdicts that are more profitable for the banks but not in keeping with the spirit of the *Shari'ah*. To overcome this problem, it is necessary to adopt some effective measures. One of these is to make full transparency mandatory with respect to the products allowed by their *Shari'ah* boards. The risk of getting a bad reputation should help induce the *Shari'ah* boards as well as the banks to be on their guard.

Figure 1: Aspects of the Internal (ex-ante) process

	Average Score	Not Important (Score - 1)		Slightly (Score-2)		Moderately (Score - 3)		Very Important (Score - 4)		Extremely Important (Score - 5)		TOTAL	
		No	%	No	%	No	%	No	%	No	%	No	%
To appoint a reputable and credible organ of <i>Shari'ah</i> governance, whether in the form of a <i>Shari'ah</i> Board or a <i>Shari'ah</i> advisory firm or individual scholar	4.56	-	-	-	-	1	1	20	27	50	68	71	97
The <i>Shari'ah</i> governance system covers the ex-ante processes, namely fatwa-making and compliance checks at the product development stage	4.32	1	1	-	-	4	5	28	38	38	52	71	97
For the organ of <i>Shari'ah</i> governance to have more than one <i>Shari'ah</i> scholar	4.01	3	4	-	-	14	19	17	23	36	49	70	96
To appoint a reputable and credible organ of <i>Shari'ah</i> governance, in the form of an internal <i>Shari'ah</i> department	3.86	7	10	3	4	7	10	22	30	32	44	71	97
For the organ of <i>Shari'ah</i> governance to have a mix of more experienced and less experienced <i>Shari'ah</i> scholars	2.86	7	10	13	18	27	37	15	21	7	10	69	95
For the organ of <i>Shari'ah</i> governance to have <i>Shari'ah</i> scholar from different nationalities, or trained in different schools of jurisprudence	2.82	15	21	5	7	26	36	17	23	7	10	70	96

⁹⁷ See: Wafik Grais & Matteo pellegrini, (2006), Corporate Governance and Shariah Compliance in Institutions offering Islamic Financial Services, pp 21-22

For the purpose of professionalism in the internal (ex-ante) process of Shariah governance the Islamic Financial Services Board (IFSB) has conducted a survey in 2008.⁹⁸ As shown in *figure 1*, out of the six processes mentioned, “the appointment of a reputable and credible organ of Shari’ah governance, whether in the form of a Shari’ah Board or a Shari’ah advisory firm or individual scholar” is ranked highest with an average score of 4.56, followed by “Shari’ah governance system covers the ex-ante processes, namely fatwa-making and compliance checks at the product development stage”, with an average score of 4.32. IFI seems to consider it is least important “For the organ of Shari’ah governance to have Shari’ah scholar from different nationalities, or trained in different schools of jurisprudence” as the average score is 2.82.

It will help standardize the products to the extent to which it is possible. Some differences of opinion are bound to remain. This may, however, be healthy for the financial system because it will promote innovation and provide different alternatives for doing business instead of imposing a rigid conformity. Transparency should, however, be made mandatory so that the bank’s clients and depositors know which alternative the bank has adopted. This will also help raise market discipline by enabling the bank’s customers to choose for themselves a bank whose operations are in their opinion more *Shari’ah* compliant. Since professionalism is necessary for the creation of an international Islamic financial market, it is imperative to apply professional approach at the level of not only individual countries but also where IFIs exist.

2.2. The External (Ex-Post) Process of Shari’ah Governance

Islamic financial institutions are required to operate in the *Shari’ah* compliant manner. This is discharged through a report signed by the *Shari’ah* Supervisors of the financial institutions that the company is operating under the *Shari’ah* requirements. *Shari’ah* audit framework is the frame of reference to be used by the *Shari’ah* Supervisors to audit the financial statements of Islamic financial institutions before they can decide that the operation of the business is performed in the manner not contradicts the *Shari’ah*. At current, the practice in the banking and *takaful* industry is that the *Shari’ah* Advisor depends on the work of internal auditors or via the voluntary appointment of external *Shari’ah* auditors to audit the financial statement and determine that the financial statements reflect the compliancy of their operations with the *Shari’ah*. This creates the need for audit framework for *Shari’ah* auditors, internal or external to work with. *Shari’ah* auditors will be better off in term of being able to conduct audit in a standardized and efficient manner with a detailed audit program for all *Shari’ah* compliant products.

The IFSB survey (2008)⁹⁹ explicitly recommended that there is a need to apply professional approach to the external process of Shariah governance. As shown in *figure 2* below, out of four listed processes, the highest ranking aspect in the ex-post process is “the Shari’ah governance system covers the ex-post process, namely periodical internal and external audit (such as by external auditor or supervisory authority) and reporting” with an average score of 3.96. The second ranked aspect is “for other professionals such as lawyers, accountants and economists to assist and advise the organ of Shari’ah governance, especially on legal and financial issues”. IFI seems to accept that it is least important “For the organ of Shari’ah governance to be restricted in serving a limited number of clients-IIFS, to ensure their effort is more focused, more time is spent on each assignment and to avoid conflicts of interest”, as the average score is only 3.45.

⁹⁸ See for more details: IFSB (2008). Survey report on Shariah Governance Systems, pp 8-9.

⁹⁹ See for more details: IFSB (2008). Survey report on Shariah Governance Systems, pp 8-9.

Figure 2: Preferred aspects of external process

	Average Score	Not Important (Score - 1)		Slightly (Score - 2)		Moderately (Score - 3)		Very Important (Score - 4)		Extremely Important (Score - 5)		TOTAL	
		No	%	No	%	No	%	No	%	No	%	No	%
The <i>Shari'ah</i> governance system covers the ex-post process, namely periodical internal and external reviews (such as by external auditor or supervisory authority) and reporting	3.96	3	4	-	-	6	8	32	44	28	38	69	95
For other professionals such as lawyers, accountants and economists to assist and advise the organ of <i>Shari'ah</i> governance, especially on legal and financial issues	3.77	-	-	-	-	7	10	31	42	26	36	64	88
For the organ of <i>Shari'ah</i> governance to mandate and delegate some of its functions to the internal <i>Shari'ah</i> compliance officers	3.48	5	7	2	3	12	16	31	42	17	23	67	92
For the organ of <i>Shari'ah</i> governance to be restricted in serving a limited number of clients-IIFS, to ensure their effort is more focused, more time is spent on each assignment and to avoid conflicts of interest	3.38	8	11	5	7	15	21	31	42	12	16	71	97

2.2.1. Internal Shari'ah Audit

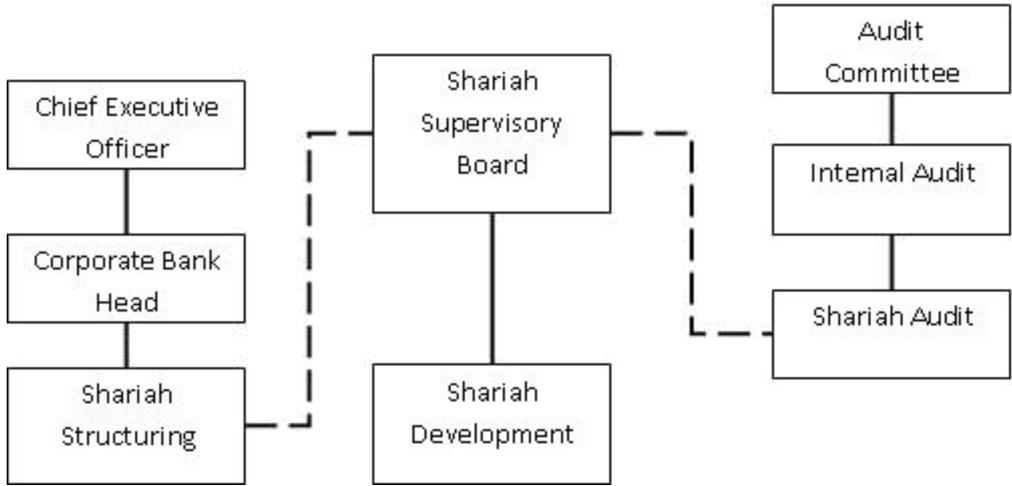
An internal Shari'ah compliance review/audit for verifying that Shari'ah compliance has been satisfied, during which any incident of non-compliance will be recorded and reported, and as far as possible, addressed and rectified. IFSB-3 sets out that *Shari'ah* pronouncements/ resolutions issued by the *Shari'ah* boards should be strictly adhered to. The internal *Shari'ah* review would therefore be assigned to someone adequately trained in *Shari'ah* compliance review/audit, so that he or she would have a competent grasp of the process.

While the ISRU is part of the IFI's compliance team, the internal *Shari'ah* audit unit (ISAU) may be established to function in a similar manner to the IIFS's internal audit team. The major difference is that while the internal auditor will usually report to the Audit Committee, the ISRU shall report to the *Shari'ah* board. Where appropriate, the internal *Shari'ah* review reports shall require or recommend the management of the IFI to address and rectify any issues of *Shari'ah* compliance.

2.2.2 External Shariah Audit

An annual Shari'ah compliance review for verifying that the internal Shari'ah compliance review has been appropriately carried out and its findings have been duly noted by the Shari'ah board. The *Shari'ah* board who issued the *Shari'ah* pronouncements/resolutions can take charge of this process, having received feedback and reports from the ISRU. Alternatively, this task may be assigned to an appropriately competent external auditor or external *Shari'ah* firm.

The *Shari'ah* advisory firm that carries out the *Shari'ah* compliance review/audit shall produce reports, indicating whether the IFI has complied with *Shari'ah* requirements throughout the financial year. Where appropriate and if deemed necessary, there could be two sets of reports produced: a general statement of compliance that should be included in the annual report of the IFI; and a more detailed account of compliance work undertaken addressed specifically to the supervisory authorities. The graph below summarizes the *Shari'ah* Audit structure.



Source: the World Bank.
Figure 3: Shariah Audit structure.

3. Shariah Governance System: A Need for Professional Approach

In the survey conducted by IFSB have explicitly show that there is a need for stardand setting body to have in place regulation for professional Shariah governance systems. An overwhelming majority of 92% (67 out of 73) of the Islamic Financial Institutions (IFIs) believe that there is a need for a of professional approach for the Shari’ah scholars working in these institutions. As shown in Exhibit 4, 37% (25 out of 73) of the IFIS identified the National Fatwa Council and a self-regulatory body for the Islamic finance industry to be the preferred body to prescribe such a code. Meanwhile, 36% (25) of the IIFS preferred self-regulatory organisation (SRO)¹⁰⁰. Some minority (3 - 6%) of the IIFS opt for other bodies, namely, the Minister of Religious Affairs and AAOIFI, to be given the mandate to prescribe such professional code for Shari’ah Governance.

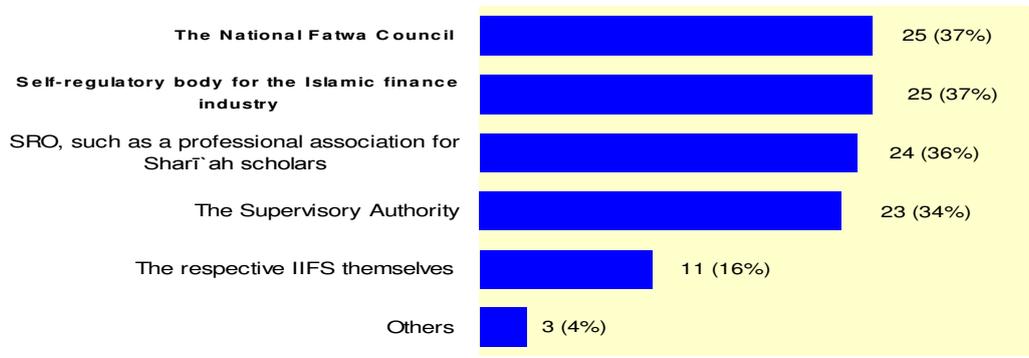


Figure 4:

According to the auditing standard for Islamic financial institution No 1 (ASIFI 1), “ The objective of an audit of financial statements is to enable the auditor to **express an opinion** as to whether financial statements are prepared, in all material respects, in accordance with the Shari’ah

¹⁰⁰ See for more details: IFSB (2008). Survey report on Shariah Governance Systems, p 13.

Rules and Principles, the accounting standards of all Accounting and Auditing Organization for the Islamic Financial Institutions (AAOIFI) and relevant national accounting standards and practices in the country in which the financial institution operates". However, Shariah auditing can be defined:

"as a systematic process of obtaining sufficient and appropriate evidence to form an opinion as to whether the subject matter corresponds with the criteria/requirements of Shariah rules, which is broadly accepted and report to stakeholders thereon".¹⁰¹

The phrase used in expressing the auditor's opinion is "give a true and fair view"¹⁰². This definition has been narrowly constructed as an expression of opinion on the truth and fairness of the financial statement from any Islamic financial institution and regardless of which institution, the institution as a whole must be audited not only the financial statements. The whole institution includes objectives, processes, personnel, financial and non financial performances are subjected to auditing from an Islamic perspective¹⁰³.

The SSB opinion may be compared to the Auditor's report included in conventional annual accounts. The output of a conventional financial statements audit includes the production of an Auditor's Opinion which can, in certain situations, include an emphasis of matter paragraph. External audit reports are based on the relevant Auditing Standards and regulations. In the conventional audit the types of audit opinions found within the annual financial statements include¹⁰⁴:

- Unqualified opinion:

That the financial statements give a true and fair view and are prepared in accordance with the applicable financial reporting framework.

- Qualified opinion:

Where an unqualified opinion cannot be given but disagreement or scope limitation is not material or pervasive to the extent an adverse opinion or disclaimer needs to be issued.

- Adverse opinion:

Where disagreement is material and/or pervasive and require disclosure.

- Disclaimer:

Where scope limitation is so material and pervasive that sufficient appropriate evidence could not be obtained and an opinion on the financial statements cannot be expressed.

An emphasis of the matter paragraph is normally placed after the opinion paragraph and is defined in the International Standard on Auditing 706 as "a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements.

This paper recommends enhancement of AAOIFI Governance Standard 1) the format of the Shairah audit report that is to be included in the financial statements of the IFIs. The Annual Report of the SSB is a mechanism that can empower a SSB. AAOIFI, IFSB and other regulatory bodies should consider developing Standard or Guidance Notes on incorporating additional categories into the Report, such as qualifying opinions on compliance and matters of Shariah Emphasis.

Qualified Compliance

For cases of qualified compliance a range of opinions could be developed to reflect different levels of qualified compliance. For example a qualified Shariah opinion might be issued when there are one or two instances of a breach in Shariah compliance. The report could state that the areas being audited are Shariah compliant but with certain exceptions. These exceptions might sometimes be the result of regulatory requirements when operation within secular environments (for e.g. the compulsory utilization of the government deposit insurance which is not based on Takaful scheme, or highlight the use of a particular structure like using bay inah and Tawarraq).

¹⁰¹ Shahul Hameed Mohamed Ibrahim; (2009), Reporting of Islamic Financial Transactions, Malaysia: the Global University in Islamic finance (INCEIF), p 529.

¹⁰² Shahul Hameed Mohamed Ibrahim; Accounting and Auditing for Islamic Financial Institutions; chapter 16, page 416.

¹⁰³ Abdul Rahim Abdul Rahman (2011); enhancing the integrity of IFI in Malaysia: The case for the Shariah audit framework; ISRA international journal of Islamic finance; Vol. 3, Issue pp 141 – 142.

¹⁰⁴ See: ISRA & IFC. 2012. Enhancing Shariah Assurance. Malaysia: International Shariah Research Academy for Islamic finance (ISRA), p 14.

Matters of Shariah Emphasis

Other factors that the SSB has identified as of concern could be disclosed in a paragraph similar to an emphasis of the matter paragraph in the Report. The SSB might incorporate within the Report areas that SSB considers the management of an IFI has not sufficiently addressed. For example there may be concerns that management has failed to improve product design and is over-reliant on contentious structures that may not be aligned with the objectives of Shariah.

On the occasion the SSB could allow, by exemption, certain 'grace' periods to utilize certain less favourable structures on an assurance from management that they will be converted within an agreed period of time. Reporting where these exceptions lie and detailing where the 'grace' periods are close to expiry could be made as an emphasis of the matter¹⁰⁵.

4. Conclusion and Recommendations

This research paper concludes that, there is a need to apply professional approach to Sharī'ah governance system which include the Shari'ah audit in order to ensure that all activities and operations carried out in the IFI do not contravene the Shari'ah rules and principles.

- The first scope of Shari'ah audit is the audit of the financial obligations of the Sukuk. The audit of the financial transactions is needed to ensure that the transactions are recognized, measured and reported accurately and reflect the rights and obligations arising from the various Shari'ah financial contracts. The adherence to best practices should consider the existing international Shari'ah standards.
- Secondly, Shari'ah audit should undertake a systematic examination of policies and procedures of the Sukuk development, such as product manuals, operational processes, contracts, etc. Thirdly, Shari'ah audit needs to examine the organizational structure of the *Sukuk* as well as looking to ex-post process of Shariah governance to ensure their feasibility to undertake Shari'ah-compliant activities. This will include the availability of qualified staff with a sufficient knowledge of Shari'ah to support the operations of the IFIs.
- For Shari'ah audit to be effectively undertaken there is a need for Shari'ah auditors that understand the business of the IFIs, including the nature of contracts used for different types of Islamic financial services. An audit program will then need to be identified and developed for the key auditing processes to be undertaken, the objective of each activity and the techniques to be used (including sampling techniques) in order to achieve each audit objective.
- The Islamic financial industry does not currently fully and systematically undertake *Shari'ah* audit. Even though the products and services are approved by the *Shari'ah* Committee, no systematic auditing has been comprehensively undertaken to ensure proper *Shari'ah* compliance. In the absence of proper guidelines to undertake *Shari'ah* audit, many IFIs have difficulties in properly planning, executing and reporting *Shari'ah* audit.
- Islamic banks and financial institutions have been set up with an aim to achieve the objectives of an Islamic economic system and to move away from interest-based banking system. In this relation, the Shari'ah Supervisory Boards have given permission to the Islamic banks to introduce Shari'ah compliant products to the investors with the hope that the banks will gradually distance themselves from interest-based enterprises, thereby creating a Shari'ah-compliant investment environment for the investors.
- The AAOIFI has resolved that the Shari'ah Supervisory Boards should go beyond the role of advising and approving the structures of the IFI activities. In this relation, it is believed that Shari'ah experts and the Shari'ah Supervisory Boards have a more significant role to play. They should be involve in the internal and external process of Shari'ah governance, they should structure, assist in the drafting of, review and approve the documentation for Shari'ah-compliant transactions in order to ensure the adequacy of compliance and to enhance the certainty, consistency and transparency of enforcement of such transactions. The relevant Shari'ah provisions should be precisely and adequately incorporated in the relevant contracts so that such contracts may be enforceable in a purely secular jurisdiction. Further, Shari'ah Supervisory Boards should continue to oversee the implementation and operation of the relevant product so as to ensure that it complies with all respects of the Shari'ah principles up to its maturity.

¹⁰⁵ Shahul Hameed Mohamed Ibrahim; Accounting and Auditing for Islamic Financial Institutions; chapter 16, page 419.

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