Research in Corporate and Shari'ah Governance in the Muslim World: Theory and Practice

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Part II

Corporate Governance and Role of Islamic Audit and Accounting

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Chapter 9

The Role of Good Corporate Governance and Accounting in Islamic Financial Institutions

Murniati Mukhlisin and *Leny Nofianti*

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Islamic banking offers a different paradigm from conventional banking. From a corporate governance (CG) viewpoint, it embodies a number of interesting features, since equity participation and profit-and-loss sharing arrangements form the basis of Islamic financing. These financial arrangements imply different stakeholder relationships and governance structures. They are distinct from the conventional model since depositors have a direct financial stake in the bank's investment and equity participations. In addition, the Islamic bank is subject to an additional layer of governance since the suitability of its investment and financing must be in strict conformity with Islamic law and the expectations of Muslim community (Saidi, 2009, chapter 33).

In December 2006, the Islamic Financial Services Board (IFSB) published the "Guiding principles on corporate governance for institutions offering only Islamic financial services (excluding Islamic insurance (*takaful*) institutions and Islamic mutual funds)" and has set up a working group to address the implementation issues. In December 2008, IFSB published the *Guiding Principles on Governance for Islamic Collective Investment Schemes*. In the following year (December 2009), IFSB published the *Guiding Principles on Shari'ah Governance Systems for Institutions*.

9.1. IFSB Principles and AAOIFI Governance Standards

The IFSB document sets out seven guiding principles of prudential requirements in the area of CG for institutions offering only Islamic financial services (IFSs) (excluding (1) Islamic insurance (*takaful*) institutions; and (2) Islamic mutual funds). The guiding principles are divided into four parts:

(1) General governance approach of IFS;
(2) Rights of investment account holders (IAH);

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(3) Compliance with *shari'ah* rules and principles; and
(4) Transparency of financial reporting in respect of investment accounts.

The guiding principles are designed to help IFS establish and implement effective CG practices. The guiding principles are applicable to commercial banks, investment banks, finance houses and other fund-mobilizing institutions that offer only financial services and products complying with *shari'ah* rules and principles, as determined by the respective supervisory authorities.

A number of CG issues are of equal concern to all institutions offering financial services, whether IFS or others. The IFSB acknowledges that many bodies that are concerned with the promotion of good corporate governance (GCG) have issued codes of CG best practices, which have been widely accepted as the international standards, and would be relevant and useful for IFS. On this premise, the guiding principles do not intend to reinvent the wheel by proposing a wholly new CG framework. Instead, the guiding principles aim to complement the existing internationally recognized standards of GCG by particularly addressing the specificities of IFS.

The IFSB in its guiding principles places focus on IAHs and protects their rights. Conceptually, under the principle of *mudarabah*, IAHs as *rabb al-mal* bear the risk of losing their capital invested by the IFS as *mudarib*. Effectively, this means that IAH's investment risk is similar to that of the shareholders of IFS who bear the risk of losing their capital as investors in the IFS. However, the IFS as *mudarib* owes a fiduciary duty to the IAH under the *mudarabah* contract, which is parallel with their duty to their shareholders. In this context, the IFS as *mudarib* refers both to their management and shareholders, not the management alone.

To ensure that a national, public sector, small and medium enterprise, and international sector CG framework is consistent with international best practices, the framework should incorporate the Organization for Economic Cooperation and Development (OECD) principles and the Bank for International Settlements (BIS) guidelines.

The guidelines issued by the BIS, 'Enhancing corporate governance for banking organisations,' builds on a paper originally published by the committee in 1999, as well as the OECD principles for corporate governance. The intent is to help ensure the adoption and implementation of sound corporate governance practices by banking organisations world wide, whether conventional or *Shari'ah* compliant. The BIS guidelines focus on: (1) the roles of boards of directors and the important role of independent directors, and senior management; (2) effective management of conflicts of interest; (3) the roles of internal and external auditors, as well as internal control functions; (4) governing in a transparent manner, especially where a bank operates in jurisdictions, or through structures, that may impede transparency; and (5) the role of bank supervisors in promoting and assessing sound corporate governance practices (Saidi, 2009).

Regulatory and CG framework consists of the following:

- The OECD principles of CG.
- BIS guidelines.

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- IFSB guiding principles on CG for institutions offering IFSs 2006.
- Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) accounting, auditing and governance standards (for Islamic financial institutions, IFIs).
- IFSB published standards, including guidance on key elements in the supervisory review process of institutions offering IFSs (excluding Islamic insurance (*takaful*) institutions and Islamic mutual funds).
- IFSB guiding principles on governance for Islamic collective investment schemes.
- IFSB guiding principles on *sharī'ah* governance systems for institutions.
- Banking sector specific laws/codes/guidelines.
- Listed companies regulatory authorities laws, rules, and regulations.
- Small and medium enterprises/rural bank sector specific laws/codes/guidelines.
- Stock exchange listing rules and regulations.
- Government company rule and regulation.

From AAOIFI (2018) it is reported that AAOIFI has issued 100 standards on accounting, auditing, governance, ethical, and the *sharī'ah* governance pronouncement. The AAOIFI explains the role of the audit and governance committee as being responsible for overall monitoring of business covering internal control, compliance with the *sharī'ah* rules and principles, and adherence to code of ethics. Since 2008, AAOIFI has revised the accounting, auditing, and governance standards for Islamic financial institutions to take account of the changes in international accounting, auditing standards, and their impact on financial institutions.

9.2. CG Framework for Islamic Financial Institutions

The Cadbury Report-1994 in the United Kingdom identified three fundamental principles of CG: openness, integrity, and accountability (public sector counterpart is the Nolan Report-1995 that listed seven principles of public governance) (Osisioma, 2013). There is no generally accepted authoritative governance framework, but at least some items can be identified such as the following ones:

(1) Create a framework for oversight and accountability through the respective roles and responsibilities of the board and executive officers.
(2) Structure the board in a manner that adds value, comprised of directors who are competent, independent, objective, committed, and possessing sound judgment. Board interaction, board size, and board committees must be geared to lend effectiveness to board operations.
(3) Attract and retain effective directors; continually strive to improve board's performance – training and increasing member awareness, improving access to information and advice, smoothening board processes and work-flows, and regularly assessing performance.
(4) Promote integrity, ethical and responsible behavior through compliance with laws, regulations, and adoption of ethical whistle-blowing program.
(5) Recognize and manage actual and potential conflicts of interest.

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(6) Recognize and manage risk – establishing a sound framework for improved risk oversight and management at the board level.
(7) Maintain a high-value authority matrix – ensuring properly defined, approved, and clearly communicated authority–responsibility relationships between the board and management to guarantee efficient and effective management of resources and affairs of the company.
(8) Oversee strategy and its implementation – coordinating the strategy development process, implementation process, and related annual plan and budget.
(9) Oversee the organization's performance – monitoring performance in the best interests of the company and shareholders.
(10) Approve *significant transactions and events* – ensuring that they are supportive of the organization's strategic direction.
(11) Oversee and evaluate the internal and external audit function – the board through its audit committee should appoint, monitor, and evaluate the external auditor while ensuring that the internal audit activity remains on course and be relevant.
(12) Oversee and evaluate internal and external legal counsel – to ensure that the best interests of the organization are served.
(13) Put in place a management succession plan – reviewed, refreshed, and maintained to ensure the continuity and future of the organization (Rossiter, 2011).

According to Shanmugam & Zahari (2009), an Islamic CG framework has been developed by regulatory bodies and/or central banks in various countries to facilitate good governance practices in Islamic financial institutions. The important components of the framework consist of board of directors, the *shari'ah* supervisory board, regulatory bodies, and external auditors. The framework provides standards and guidelines that are in accordance with *shari'ah*; addresses the intermediary and multifaceted roles of Islamic financial institutions; seeks to ensure accountability, transparency, and an adequate division of power among stakeholders; and seeks to avoid conflicts of interest.

Islamic banks operate on the principle of profit-and-loss sharing. Thus, the funds contributed by IAHs are more than deposits; they are, in part, equity investments. IAHs lack some of the rights that a shareholder enjoys. However, they are a type of equity holders, like shareholders, with residual claims to their share of the bank's assets (Archer, Karim & Al-Deehani, 1998).

An Islamic CG framework should encompass the interests of all stakeholders, including the fair treatment of minority shareholders and IAHs in Islamic banks, as is encouraged in the Islamic faith under the concept of *taqwa* (righteousness). The governance framework should also encourage transparency and disclosure regarding decision making in all the areas of an institution's professional competence, which is of paramount importance to IAHs because their funds are normally pooled together with those of shareholders. The framework prescribes disclosure rules, firewalls to protect against conflicts of interest, and sanctions for breaches (Fawzeyyah, 2009).

The governance structures of Islamic financial institutions are distinguished from conventional governance structures by the addition of a *shari'ah* advisory

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Table 9.1: Comparative Scenario in a Conventional Financial Institution and *Shari'ah* Governance.

Functions	Typical Financial Institutions	Additions in IIFs
Governance	• Board of directors	• *Sharī'ah* board
Control	• Internal auditor	• ISRU
	• External auditor	• External *sharī'ah* review
Compliance	• Regulatory and financial compliance officers, unit, or department	• ISCU (Internal *Sharī'ah* compliance unit)

Source: IFSB (2009).

body. Usually, each Islamic financial institution has its own in-house religious advisers who compose the *shari'ah* supervisory or advisory board and whose responsibility is to ensure that the institution's business practices and products conform to the Islamic law. The existence of such board mitigates the institution's exposure to fiduciary and reputational risks related to Islamic standards of compliance, which, in turn, boosts the confidence of Muslim shareholders/stakeholders in the institution. Islamic CG practices may require the composition of the *shari'ah* advisory body to be disclosed and all *fatwa* (religious opinions) issued by the advisory body to be published. Such public disclosures strengthen stakeholders' confidence in the credibility of the institution's assessment of its *shari'ah* compliance (Fawzeyyah, 2009). The *sharī'ah* governance system complements the existing governance, control and compliance functions within the IIFS. Comparative scenario in a conventional financial institution and *shari'ah* governance is shown in Table 9.1.

Islamic financial institutions have a duty to ensure the compliance of *shari'ah* principles in all aspects of their products, instruments, operations, practices, and management which will be achieved by the establishment of a proper *shari'ah* governance framework. Thus, the *shari'ah* supervision plays an essential role in the governance of Islamic financial institution and forms part of the principal component of the *shari'ah* governance framework (Hamza, 2013). One of the roles of the *shari'ah* supervisory board is to advise the Islamic financial institution on *shari'ah* matters to ensure conformity with *shari'ah* rules in its operations at all times, endorsing and validating relevant documentations pertaining to the products and services of the Islamic financial institutions. The ideal role of *shari'ah* supervision involves *ex ante* and *ex post* aspects of *shari'ah* governance, and these include *shari'ah* pronouncement, supervision, and review (Hasan, 2011).

9.2.1. Shari'ah Governance

The implementation of GCG in Islamic banks is part of Islamic spirit. The bottom line is that the spirit of responsibility, obligation, openness, and fairness through devotion and submission to Allah (SWT) and through equalization of capabilities, knowledge, information, and appreciation. This spirit serves as the basis for CG in Islamic bank, including in providing financing for Islamic business.

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For Islamic banks, implementation of GCG requires a *shari'ah* supervisory board, in addition to the audit committee etc., as an independent body in the institution appointed, for example, with the approval of the National *Shari'ah* Board, Indonesian Council of Ulama, in the case of Indonesia (Mukhlisin, Hudaib & Azid, 2015).

According to Lewis, M. K., & Algoud, L. M. (2001), it is necessary for Islamic banking to act seriously in the enforcement of GCG as opposed to conventional banks. First, Islamic banks have a duty to abide by the principles of *shari'ah* (*shari'ah* compliance) in carrying out its business. Hence, the *shari'ah* supervisory board plays an important role in the governance structure of Islamic banking. Second, potential occurrence of information asymmetry is very high in Islamic banking industry due to agency problem.

This is related to the level of accountability and transparency on the use of customers' and shareholders' funds. Therefore, the problem of representation of IAHs in GCG mechanisms becomes a strategic problem that must also get attention of Islamic banks (Archer & Karim, 1997). Third, from the perspective of corporate culture, Islamic banking should be doing the cultural transformation in which the values of Islamic business ethics are internalized into the practice of Islamic banking business (Hasan, 2009).

Islamic GCG is different from conventional GCG, as argued by Hasan (2009, p. 1):

> Islamic corporate governance model in Islam has its own unique features and presents distinctive characteristics in comparison with the western concept of the Anglo-Saxon and the European models. It combines the element of *tawhid*, *shura*', *shari'ah* rules and maintains the private goal without ignoring the duty of social welfare.

Along with the risks faced by conventional banks, Islamic banks face additional *shari'ah* risk. The management of Islamic banks should minimize these risks through implementation of GCG in order to improve the performance of Islamic banks. As such, risk awareness in Islamic banking is one factor that can facilitate the implementation of CG in Islamic banks.

Due to the importance of GCG implementation, the bankers are required to observe at all times the principle of banking prudence in providing financial services to the community. As regulators, Bank Indonesia and Financial Services Authority in Indonesia must be able to perform the assessment and implementation of GCG in Indonesian Islamic banks. Bank Indonesia's Regulation No. 8/4/PBI/2006 dated January 30, 2006 concerning implementation of GCG for commercial banks and its changes as stated in Bank Indonesia's Regulation No. 8/14/PBI/2006 dated October 5, 2006 later updated in the Bank Indonesia's Regulation No. 11/33/PBI/2009 dated December 7, 2009 and Bank Indonesia's circular letter No. 12/13/DPbs dated April 30, 2010 on the implementation of GCG for Islamic banks and *shari'ah* business units confirm that the implementation of GCG in the banking industry should be always based on OECD's five

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basic principles: transparency, accountability, responsibility, independency, and fairness. However, Abu-tapanjeh (2009) argues that the application of GCG presented by OECD is suitable for conventional banks but not for Islamic banks as dimensions in Islamic GCG have wider scope.

Bhatti and Bhatti (2010) proposes a model of ICG that reconciles the objectives of *shari'ah* law with the stakeholder model of corporate governance. It argues that this may be viable due to the emphasis that *Shari'ah* laws place on property and Islamic financial contractual rights. The article also discusses a model of ICG that is consistent with principles outlined by the Organisation for Economic Co-operation and Development as well as *Shari'ah* law. Such a model of corporate governance would encourage capital formation, foster strong markets, and encourage judgment and transparency, which are all principles central to *Shari'ah* laws.

Previous studies have attempted to link principles of Islamic GCG with leadership of Rasulullah (SAW) and Khulafahul Raashideen (Nofianti, Mu'at, Miftah, Rahmi & Irfan, 2013). Islam apparently has become a reference for GCG in the world. Twenty important principles relevant to Islamic GCG are explained by Nofianti et al. (2013) as: *Siddiq* (honesty), *amanah* (fulfillment of trust), *tabligh* (transparency and openness), *fathonah* (intelligence), *tawazun* (balance), *mas'uliyah* (accountability), *akhlaq* (moral and integrity), *adalah* (justice), *hurriyah* (independence and responsible freedom), *ihsaan* (professional), *wasathan* (fairness), *ghirah* (spirit/passion), *idarah* (management), *khilafah* (leadership), *aqidah* (trust and confidence), *ijabiyah* (positive thinking), *raqabah* (supervision), *itqan* (continues improvement), and *zuhud* (no worldliness).

Based on the above, we argue that Islamic principles can help implement the practice of GCG and can be used as reference for the best GCG in Islamic banking industry.

9.3. The Role of Islamic-based Accounting to Support GCG Practices

It is worthwhile that during the early period of its development, Islamic banks worked with in-house advisers and financial auditors to ensure the *shari'ah* compliance of the accounting treatment of their business transactions (Karim, 1990). Islamic Development Bank (IDB) and many other Islamic banks agreed to prepare accounting standards for Islamic banks during their joint meeting held on March 27, 1987 in Istanbul. Later on, Islamic accounting standards were discussed in a conference held on September 7–8, 1987 at IDB-Jeddah (Al-Rashed, 1987). Initially, Islamic banks opposed the existing international standards, as they could not serve the need of the industry. Consequently, each Islamic bank reported its activities using different measurement and recognition methods. This could hinder the development of Islamic banks, as the investors might not be able to interpret the performance of Islamic banks appropriately. Therefore, setting up of an independent body to formulate the accounting standards for Islamic Banks was considered urgent. With the support of Islamic banks, Financial Accounting Organization for Islamic Banks and Financial Institutions (FAOIBFI) was then established on February 26, 1990 in Algiers and registered in Bahrain in 1991.

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FAOIBFI at that time consisted of 22 unpaid part-time board members representing Islamic banks and other stakeholders (*shari'ah* scholars, practicing accountants, academics, and regulatory bodies) and 17 unpaid part-time members sitting in the supervisory committee (Karim, 1995). The formation of this body might not be well represented by all the stakeholders of Islamic banks at that time, that is, independent *shari'ah* scholars who possess knowledge on Islamic governance, and regulators who possess knowledge of political enforcement as both are required in formulating strategies to promote such international standards.

Holthausen (2009) argues that enforcement of law effects the financial development of countries, and accounting standards affect financial reporting outcomes. The countries with strong enforcement are likely to have regulations that are more stringent than countries with weak enforcement of financial reporting standards. We observe that lack of execution strategy in the beginning of the establishment may be the first reason as to why AAOIFI accounting standards have not become the sole reference for IFIs. Other reason may be lack of focus on further development of accounting standards. Later on, FAOIBFI changed its name to AAOIFI in 1995 to accept a wider scope of responsibility. Since then AAOIFI has been releasing standards about not only accounting and *shari'ah* but also about auditing, governance, and ethics. AAOIFI is now a known international Islamic autonomous not-for-profit corporate body that prepares accounting, auditing, governance, ethics, and *shari'ah* standards for IFIs. AAOIFI is supported by institutional members including central banks, Islamic financial institutions, and other participants from the international Islamic banking and finance industry. Further, AAOIFI (2018) states its objectives as follow:

1. To develop accounting and auditing thoughts relevant to IFIs.
2. To disseminate accounting and auditing thoughts relevant to Islamic financial institutions and its applications through training, seminars, publication of periodical newsletters, carrying out and commissioning of research, and other means;
3. To prepare, promulgate, and interpret accounting and auditing standards for IFIs;
4. To harmonize the accounting and auditing standards adopted by IFIs.

In setting these objectives, AAOIFI considered two available options, i.e., formulating objectives with reference to Islamic principles and its teachings and considering them with contemporary accounting thought, or borrowing contemporary thought and testing it with *shari'ah* principles and accepting those which are consistent and rejecting those which are not. At the end, majority of accounting academics and practitioners, *shari'ah* scholars, Islamic bankers, and officials in central banks agreed on the second option. There was no specific argument on why the second approach was opted, nevertheless, all scholars unanimously stated that both approaches were acceptable (Karim, 1995). This may be due to two reasons: (1) The practitioners at that time were not aware of Islamic accounting that could be derived from *shari'ah*, therefore the second approach was considered convenient, hence expedited the approval from the central banks; and

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(2) it could be due to time consideration as building and formulating the Islamic accounting from scratch with scarcity of experts would have been difficult. Zaher and Hassan (2001) refer this approach as a *hybrid way* where Islamic banks adopt in-between the paradigm (Islamic) and conventional versions. Because of its simplicity, this approach was then followed by other countries such as Malaysia and Indonesia, with their accounting for IFIs modified from the accounting conventional standards; see, for instance, PSAK 59, (*Pernyataan Standar Akuntansi Indonesia*/Statement of Islamic Accounting Standards), the first financial reporting standards formulated for Islamic banks in Indonesia in 2002. It is a mix of AAOIFI standards and the existing International Accounting Standard (IAS)-like accounting standards. Malaysia started with AAOIFI standards and then reached a consensus that accounting standards for IFIs must follow the standards endorsed by Malaysian Accounting Standards Board (MASB), which is equivalent to IFRS (IAS-Plus, 2018). However, a specific standard endorsed by the MASB and termed as, for instance, MASB i-1: Presentation of Financial Statements of Islamic Financial Institutions. This is a reference for IFIs to prepare their financial reporting. Siswantoro and Ibrahim (2012) argue that the MASB has excluded both *qard* and *zakah* from the reporting components of IFIs as an effort to reflect the standards following the IFRS.

In 1993, FAOIBFI/AAOIFI released its first standards for IFIs. To date, AAOIFI has issued 86 standards for IFIs covering areas of accounting, auditing, ethics, governance, and *shari'ah*. AAOIFI claims that all leading IFIs across the world have adopted its standards. They further claim to have introduced a progressive degree of harmonization of Islamic GCG. AAOIFI official website reveals that the Kingdom of Bahrain, Dubai International Financial Centre, Jordan, Lebanon, Qatar, Sudan, and Syria have adopted its standards, and Australia, Indonesia, Malaysia, Pakistan, Kingdom of Saudi Arabia, and South Africa have issued guidelines based on AAOIFI's standards. Table 9.2 shows a list of accounting standards that have been issued by AAOIFI from 1993 to 2015.

The above discussion suggests that the role of Islamic accounting is required to support the implementation of GCG practices in IFIs. For instance, transparency in disclosing activities of Islamic banks will only be ensured by adopting appropriate financial reporting that is familiar with Islamic banking activities.

AAOIFI provides Islamic accounting standards to ensure that IFIs disclose their financial information accordingly. Nevertheless, AAOIFI has no power to enforce its standards. For instance, Islamic banks in Malaysia, Indonesia, and the United Kingdom are not required to comply with the AAOIFI standards (Wan Abdullah et al., 2011). For Indonesia, Islamic Banking Act No. 21 released on July 16, 2008 states a compulsory reference for all Islamic banks to follow financial reporting standards issued by the Indonesian Institute of Accountants. In Malaysia, Section 169 of the Companies Act 1965 as amended in 2007 requires all companies registered under this act (including the IFIs) to prepare their annual financial statements based on the approved accounting standards issued by MASB. After full IFRS adoption on January 1, 2012, direction of MASB for IFIs in Malaysia seems to follow IFRS (Siswantoro & Ibrahim, 2012).

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Table 9.2: AAOIFI Standards.

No.	Financial Accounting Standards (FAS)	Year	Topic of Standard
1.	FAS 1	1996	Presentation and disclosures (first issuance in 1993)
2.	FAS 2, 3, and 4	1993	Modes of financing (*murābahah*, *mudārabah*, and *mushārakah*)
3.	FAS 5	1993	Disclosure of bases for profit allocation between owners' equity and IAHs
4.	FAS 6	1993	Equity of IAHs and their equivalent
5.	FAS 7 and 8	1993	*Salam* and parallel *salam*, *ijārah*, and *ijārah* transactions
6.	FAS 9	1993	*Zakah*
7.	FAS 10	1993	*Istisnā'*
8.	FAS 11	1993	Provision and reserves
9.	FAS 12, 13, 15, and 19	1993	Insurance companies (in the revision process since 2012)
10.	FAS 14 and 17	1993	Investment funds and investment
11.	FAS 16	1993	Foreign currency transactions
12.	FAS 18	1993	IFSs offered by conventional financial institutions
13.	FAS 20	1993	Deferred payment sale
14.	FAS 21	1993	Transfer of assets
15.	FAS 22	1993	Segment reporting
16.	FAS 23	1993	Consolidated financial statements
17.	FAS 24	1993	Contributions in Islamic insurance companies
18.	FAS 25	2011	Investment in *sukuk*, shares, and similar instruments, amended from Investment in Associates (1993)
19.	FAS 26	2013	Investment in real estate
20.	FAS 27	2014	Investment Accounts
21.	FAS 30	2017	Impairment, credit losses and onerous commitments
22.	FAS 28	2018	Murabahah and Other Deferred Payment Sales
23.	FAS 31	2018	Investment Agency (Al-Wakala Bi Al-Istithmar)
24.	FAS 35	2018	Risk Reserves
25.	FAS 33	2018	Investment in Sukuk, shares and similar instruments
26.	FAS 34	2018	Financial Reporting for Sukuk-holders

Source: AAOIFI (2015).

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9.4. Conclusion

The discussion in this chapter elaborates IFSB principles and AAOIFI governance standards to show the effort in developing GCG for IFIs and compares Islamic GCG framework for IFIs with conventional framework. It also elucidates several *shari'ah* principles that enrich the current GCG principles. It suggests that Islamic-based accounting is a crucial element to support the implementation of GCG practices, especially in IFIs.

Currently, all IFIs are in dilemma whether to follow AAOIFI, IFRS, or their local standards. Further question would be that: if there is no uniformity of accounting standards used by IFIs in the world, can Islamic accounting play its role to strengthen the implementation of GCG?

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