

Prudence in Managing and Reporting The Shariah Non-Compliant Income by Malaysian Islamic Banks

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ABSTRACT

Understanding Shariah Non-Compliance Incidents (SNC) is critical to all key functions of Islamic banks. Prudence in managing and reporting the SNC is critical to the bank because the key functions have to decide on matters related to issues of Shariah Non-Compliances (SNCs). One of the issues of SNCs is the Shariah Non-Compliant Income (SNCI), which should be deducted from the income of Islamic banks. This SNCI has to be reported in the banks' annual reports by the Shariah Committee of the bank. Two sets of semi-structured interview questions were developed for this study, the first set was designed for the banks' key functions, and the second set for the Shari'ah scholars represented by the Shari'ah Committee (SC) and the Shari'ah Advisory Council (SAC) of BNM. The data were collected from the three types of Islamic Banking Institutions (IBIs) through purposive sampling. In-depth interviews are the primary source of information for data collection. The data were transcribed and analysed using Atlas. ti eased by 'The Six Phases of Reflexive Thematic Analysis' to provide a coherent and compelling interpretation of grounded data. Financial reporting is one of the evidence that the bank's function is seen as accountable, transparent, and prudent in complying with the Shariah principles and regulatory requirements of the regulator. The study adds to the very limited literature on the end-to-end process of managing and reporting SNCI. The findings are thought to be worthwhile because previous studies failed to highlight such evidence on prudence in the process of managing and reporting Shariah Non-Compliant Income by Islamic Banks in Malaysia.

Keywords: Prudence; Non-Compliant Income; Islamic Banks; Financial Reporting; Accountability

INTRODUCTION

The relevant key functions in the IBs are expected to exercise their responsibility prudently in matters related to compliance with Islamic principles. Prudence is the exercise of caution when making judgments under conditions of uncertainty (Pelger, 2019). In which, the central element of Shari'ah governance is primarily and essentially the man who adheres to the Shari'ah rulings. In the context of this study, the Stewardship theory (Donaldson and Davis, 1991) is used to explain the stewardship roles of the key functions in IBs with the stewardship principles of accountability, transparency and disclosure, competency, independence, and confidentiality exercised by the key functions in managing the SNCI. This study proposes the prudence principle be infused into the Stewardship theory due to it has the potential to reflect the end-to-end process of managing and reporting the SNCI.

Prudence Principle in Financial Reporting

The conceptual framework for financial reporting has prescribed the concept of prudence prior to 1989. The working group such as International Accounting Standard Committee (IASC) and International Accounting Standard Board (IASB) are responsible for the effort to develop the criteria for good reporting characteristics aiming at providing information to assist multiple stakeholders in the economic decision-making. Table 1 shows the chronological effort of the working group to inculcate prudence in the conceptual framework for financial reporting.

Table 1: Prudence and Conceptual Framework for Financial Reporting

Year	Conceptual Framework for Financial Reporting	Prudence Concept/ Principle
April 1989	Framework for the Preparation and Presentation of Financial Statements (the Framework) was approved by the IASC Board.	Prudence is defined as 'the exercise of caution when making judgments under conditions of uncertainty' as a sub-component of reliability in
July 1989	Framework was published.	Conceptual Framework 1989
April 2001	Framework adopted by the IASB.	(Pelger, 2019).

September 2010	Conceptual Framework for Financial Reporting 2010 approved by the IASB.	The characteristic of prudence was eliminated from the Conceptual Framework (Pelger, 2019).
March 2018	Conceptual Framework for Financial Reporting 2018 (the Framework) published.	The reintroduction of prudence during the IASB's Conceptual Framework revision in 2012–2018 (Pelger, 2019). Prudence is the exercise of caution when making judgements under conditions of uncertainty. [Conceptual Framework for Financial Reporting 2018 para 2.16]

Source: Pelger, 2019

The inclusion of the prudence principle in the stewardship theory while managing and reporting the SNCI by the key functions in IBs would be a new perspective for this study. It is especially relevant with the reborn of stewardship and prudence in the conceptual framework for financial reporting by International Financial Reporting Standards (IASB, 2018a; Pelger, 2019).

Prudence and Reporting of Shariah Non-Compliant Income (SNCI)

Information presented in the financial statement should faithfully represent the actual situation of the business entity, where information should be complete, neutral, and free from error (Ahmad et al., 2020). Neutrality is always supported by the exercise of prudence, where caution is the essence of prudence when making judgments under uncertain conditions. Prudence is one of the principles in the fundamental qualitative characteristics of useful information that will guide users to make economic decisions making based on their information needs which are presented in the financial reports. The exercise of prudence does not allow for the understatement of assets or income or the overstatement of liabilities or expenses (Ahmad et al., 2020). There should be substance over form, any off-balance sheet items should be appropriately disclosed (ICGN, 2017). It is a mistake to assume that Islamic banks do not need to institute prudent corporate governance just because the Islamic value system equitably protects the rights of stakeholders (Chapra and Ahmed, 2002).

Prudence in the reporting of Shari'ah Non-Compliance incidents either the reporting of Shari'ah Non-Compliance event or Shari'ah Non-Compliant Income is helpful to guide the users to make economic decision making. As asserted by Alatassi and Letza (2018), the more prudent approach to banking used by Islamic banks could be used as a model for Western banks and thereby deliver a more sustainable future. Furthermore, the approach would boost the public and multiple stakeholders' confidence in banks. In fact, prudence is also important in Shari'ah governance similar to its exercise in corporate governance that urges greater accountability, enhancing transparency, timely disclosure of information, prudent decision making, good management of resources, and employment of the right code of conduct among the company directors and managers (Abas, 2017). Nothing separates these elements from the Islamic moral codes (Abas, 2017).

Prudence in Complying with The Shariah Requirement

In matters related to compliance, prudence is highly required with Shariah compliance Shariah requirement. Table 2 showcase the duty of the institution to ensure compliance with the Shariah requirement as guided in the Financial Services Act 2013 (BNM, 2013).

Table 2: Shariah Compliance Requirement

Duty of Institution to Ensure Compliance with Shari'ah

Section 28:

- (1) An institution shall at all times ensure that its aims and operations, business, affairs, and activities are in compliance with Shariah.

- (2) For the purposes of this Act, a compliance with any ruling of the Shariah Advisory Council in respect of any particular aim and operation, business, affair, or activity shall be deemed to be a compliance with Shariah in respect of that aims and operations, business, affair, or activity.

- (3) Where an institution becomes aware that it is carrying on any of its business, affair or activity in a manner which is not in compliance with Shari'ah or the advice of its Shari'ah committee or the advice or ruling of the Shariah Advisory Council, the institution shall—
 - (a) immediately notify the Bank and its Shari'ah committee of the fact;
 - (b) immediately cease from carrying on such business, affair or activity and from taking on any other similar business, affair or activity; and

(c) within thirty days of becoming aware of such non-compliance or such further period as may be specified by the Bank, submit to the Bank a plan on the rectification of the non-compliance.

(4) The Bank may carry out an assessment as it thinks necessary to determine whether the institution has rectified the non-compliance referred to in subsection (3).

(5) Any person who contravenes subsection (1) or (3) commits an offence and shall, on conviction, be liable to imprisonment for a term not exceeding eight years or to a fine not exceeding twenty-five million ringgit or to both.

Source: BNM, 2013

The uncertain circumstances that exposed the banks to the potential risk of Shariah non-compliance, require the key functions to act prudently within their best knowledge and experience to mitigate such risk. Furthermore, a specific implementation strategy that works in one organizational context might not work in another entailed a proactive role by the top managers to confront a specific problem to decide (Willemsen et al., 1999).

PROBLEM STATEMENT

The Shari'ah interpretation of SNC incidents under the Shari'ah compliance system in IBs varies between IBs. Therefore, this study purports to understand how prudence is applied in the process of managing and reporting the Shariah Non-Compliant Income by IBs in Malaysia. The perspective of the key functions from both the banks' key functions and the Shariah scholars will be obtained to further understand such incidents. It leads to the consideration of the prudence principle in the Stewardship theory as the key functions are accountable for discharging their responsibilities concerning SNC matters.

In this regard, the key functions have to make decisions based on their knowledge and experience of the anticipated risk in the SNC matters. It is believed that the Stewardship theory and prudence principle enable the key functions to effectively and efficiently discharge their responsibility ultimately for Allah, besides their responsibilities to the banks and the multiple stakeholders.

METHODOLOGY

In this study, the researcher developed the instrument for the interview by applying the three steps in the instrumentation process; (1) create the theoretical model (2) produce the interview questions (3) conduct a validity test of the questions (Abdullah, 2019). There were two sets of semi-structured interview questions developed in this study, where the first set was designed for the IBs' key functions and the second set for the Shari'ah scholars represented by the Shari'ah Committee (SC) and the Shari'ah Advisory Council (SAC) of BNM.

The instruments were adapted from various studies and issues on the reporting and disclosure of Shari'ah Non-Compliance (SNC) incidents debated by various researchers (Jalil et al., 2019; Omar and Hassan, 2019; Shafiai and Engku Ali, 2019; Tong, 2017; Rosman et al., 2017; Hassan et al., 2017; Shafii and Zakaria, 2013). The items of instrument were then developed according to the research objectives of this study and based on the experience of the researcher as a course lecturer for financial accounting and reporting. The data were then collected from ten interviews conducted with the ten participating IBs and four Shariah scholars.

The research process started with an extensive research review, followed by an exploratory study of the three types of Islamic banking institutions (IBIs) through purposive sampling (Md Nor, 2009) in order to compare the process of managing and reporting SNCI between IBIs. Interview data as the primary source of information were later analyzed using Atlas. ti. This study applied 'The Six Phases of Reflexive Thematic Analysis' developed by Braun et al. (2018) for multiple case studies, aiming to provide a coherent and compelling interpretation of the data grounded in the data.

FINDINGS AND DISCUSSIONS

From the analyses conducted, the patterns of codes and themes were compared and matched with the proposed underpinning theory. The pattern was found to be consistent with the underpinning theory (Denzin and Lincoln, 1994; Yin, 2002). The study discovered an emerging theme from the analyzed data of interviews that are believed to be a new contribution to the Stewardship theory in Islamic banking.

Infusing prudence in the stewardship role of the key functions is believed to be able to fulfill a greater demand by shareholders, multiple stakeholders,

and the public at large for greater transparency and accountability from the corporate leaders, which this study intends to address. The following responses recorded from the two groups of the key functions, support the infused of prudence in the stewardship role of the key functions.

i. The Bank's Key Functions

"When we know there is a Shari'ah issue, then we will request for complete information from business unit because in Shari'ah risk management, it is our responsibility to investigate." (R1IB01)

"Depend on who detect the source of incident, if the incident picked up by audit, then audit will follow-through until the disposal as advised by the SC." (R2IB02)

"So, meaning that when there is Shari'ah issue everyone knows what they need to do ...IO (Incident owner/business unit) also know what to do...normally, incident owner (IO), operational risk (SRM), Shari'ah review, Shari'ah advisory, Shari'ah audit – they are the one who detect the Shari'ah issue." (R1IB03)

"In detection, everyone is involved, start from the detection of issue ... once he detects even potential SNC, they will stop transaction, stop everything (R1IB04)

"Before come to SNCI, the process how the bank identifies the SNCE is somehow complicated...what events or scenario that constituted as SNCE...that is the first issue that all the banks faced." (R2IB06)

"SNC event starts with potential SNC event identification. There are 3 parts how we can determine the SNC event intervention, its either (1) comes from Shari'ah department who received the issue from any business unit (2) Shari'ah audit or Shari'ah risk... audit will bring the issue for further review. Shari'ah audit will review, Shari'ah dept also will review. After the identification of SNC we will follow our SOP on what to do, and (3) as a result of our own process of review." (R1IB10)

It was agreed by the bank's key functions that the detection process is considered complicated for all IBs. It can either come from the findings of SR, from the audit findings by the auditor and SA, or from the self-check by the IO. The Qualified Shariah Officer (QSO) who is normally led by the Head of SR or in some banks the Chief Shari'ah Officer (CSO), will finalize the SNC issue based on his knowledge and experience in which prudence is his main concern to decide on the issues detected as Potential SNC or non-SNC. The decision on potential SNC later will be tabled to the SC for a final

decision as either Actual SNC or non-SNC. The issue needs to be prudently handled by the key functions as steward to the bank, multiple users, and the regulator, in which the regulator requires the bank to report the potential SNC and actual SNC through the (Operational Risk Integrated Online Network) ORION platform.

The Shari'ah scholars, comprised of the Shariah Committee (SC) and the Shariah Advisory Council (SAC) have their own views on the detection of SNCI.

ii. The Shari'ah Committee (SC)

From the lens of the SCs, they believed that:

"It is impossible to audit everything. When transactions could be retrieved, full population audit is possible using computer assisted audit techniques (CAAT). Unless the transactions are all in the database." (SCB01)

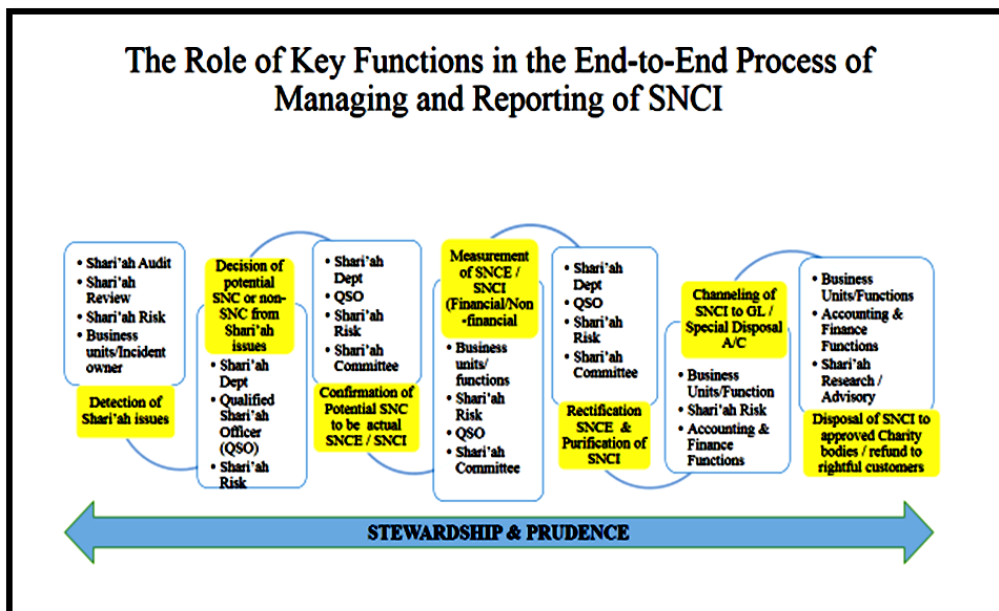
"Because when comes to IB, they practice 2 ways of detecting Non-Compliance: one is through review, another is thru audit...it is sort of redundant...from what I heard...Malaysia go for 2 layers...review and audit. The crucial part is the identification... Risk is very difficult to identify. Yes for Shari'ah compliance to functions (Review, Audit, Research and Shari'ah Risk) but the main functions is audit and review addressing SNC issues with the support of Shari'ah Risk and Research....When it comes to maqasid Shari'ah, the point that is relevant to the muamalat is...protection of property la...may be by detecting the SNC...that will protect the property of customers from being tainted by this activity...The way in identifying the SNC might be go back to the prudence. Prudent in identifying the SNC.... I think that at the ealisest stage everything they put potential...potential ...potential...I think they need to do the parameters." (SCB02)

"Process of detecting SNC must be good and effective specifically...No.1, IBs are not Maksum (never doing wrong) we are not free from any (wrongdoing), they are just like we are, but they are very prudent because when they found that something non-compliant, the money goes to charity...not utilize it. This part however not been highlighted very much...Review need to claw back...claw back where is wrong, which area need for enhancement, it is supposed to be like that. But the mentality of review is, because they don't want any issues...hoping there is no Shari'ah issues...haahahh...that's their mentality." (SCB03)

All the SCs were of the opinion that the identification or detection process is the most crucial task to the SR and SA. Making decisions on potential SNC and actual SNC is more crucial. The detection requires prudence where

parameters and technology application will ease the process. One of the SC, who is also an ex-SAC claimed that IBs are actually very prudent in detecting SNCI but this was not highlighted very much in many studies. Figure 1 showcase the role of the key functions in the overall process of managing and reporting the SNCI, with the infused of prudence in the stewardship role of the key functions.

Figure 1: The Role of the Key Functions in the Overall Process of Managing and Reporting of SNCI



iii. The Shari'ah Advisory Council (SAC)

The SAC opined that:

"This is a problem they thought they can keep the problem under the carpet, and when it was discovered, it become too little and too late at the end of the day." (SCR01)

"I can say we are not detecting SNC only but anything on risk....and in fact if we report, it describes the effectiveness of the system, because we can identify... for what reason to hide under the carpet?? That is the importance of the Shari'ah Adviser role, he will ask ... and keep asking until the truth (SNCs) is revealed...In addition, we are open if there is client who wants to send a letter... maybe we will be able to detect from there." (SCR02)

The SAC revealed that there were cases where the detector tried to hide the SNC issues from findings. This is the importance of the role of the SCs to ask and request further information until the truth is revealed. Again, prudence is the main concern in this process. SR and SA are very important roles in the control functions of IBs, they are complementing each other in detecting such breaches, risks, and non-compliances that occur in IBs. For instance, SA is placed on the third line of defense after SRM and SR. To further improve the role of SA, the SAC proposed some necessary improvements as they commented:

“In my case, SCs will request a Shari’ah audit report at least quarterly to us, that means 4 times a year ... whatever you report ... it could be more yea, it could be more, but at least quarterly you have to report on I what are you doing, what findings and whatnot.” (SCB03)

“So, they just want to see what rectification and control he (IB) has done so that SNC does not happen again.” (SCR02)

“The problem of compliant, the problem of auditing in my perspective, our current auditing at the moment is not that comprehensive enough, we just can take care the biggest work portion of it...The performance of the auditors themselves in terms of their qualification, in terms of how many years have they involved in the Shari’ah audit for example, how good are they to audit the Shari’ah compliant and also the effort to measure the performance of the other stakeholders from the BODs to the CEO.” (SCR01).

“This audit is real, he has to look at the documents. This review means ... aaa ... expectations have not yet come true until seen. In the middle of the process, we usually ask for a review... audit will see ... then the review will repair the document after we find the problem...If there are many samples, we will look at the manpower too... If the staff is skilled... and it does not need many SA, he can detect the SNC... but if they are new, then we may need to have many SA.” (SCR02).

Both the Shari’ah scholars (the SC and the SAC) agreed that the bank’s key function is managing the SNCI issues with prudence. They would be able to smell and detect the SNCs, risks, and breaches to the compliance system of the IBs based on their experience and knowledge in the industry. The Shariah scholars revealed that there were cases where the SR hide the review findings and, in some cases, the job scope of SA was not comprehensive enough for the detection process. They believed that the role of the bank’s key functions will continue to shine in the future with the use of technology applications to ease the bank’s key functions’ tasks and processes.

CONCLUSION

This study proposed prudence is to be infused in the stewardship roles of the key functions (the bank's key functions and the Shari'ah scholars) as practiced by the Islamic banks in Malaysia. Stewardship theory had been introduced as a means of defining relationships based upon other behavioral premises (Donaldson and Davis, 1991) in which managers were not motivated by individual goals, but rather were stewards motivated by the objectives of their principals. Stewardship theorists assumed a strong relationship between the success of the organization and the principal's satisfaction. A steward protected and maximized shareholders' wealth through the firm's performance, because, by so doing the steward's utility functions were maximized (Davis et al., 1997).

Besides the five principles of stewardship: accountability, transparent disclosure, competency, independence, and confidentiality that are being practiced by the Malaysian IBs, prudence should be also considered to be infused with the stewardship theory to reflect the overall implementation of managing and reporting the SNCI. This is evident and supported by the current study, in which the emerging code, prudence was recognized from the data provided by the interviewees. Thus, the study indicates that prudence should be inculcated in the six principles of the stewardship theory, particularly in the Islamic finance industry.

For future research, it is suggested that due to this study being unable to get the view of the Shari'ah Auditors (SA), future researchers can interview the SA and all the key control functions to get their views concerning the managing and reporting of SNCI. This would indicate collective views of the key control functions supported by Shariah Research and Advisory (SRA) with regards to the managing and reporting of SNCI in the Islamic banks. On the other hand, the same study can also be conducted in other industries that comply with Shariah, for instance, the Takaful industry, Waqf institutions, and Shariah-based businesses for various samples of the study.

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