



## THE ROLE OF KEY FUNCTIONS IN MANAGING AND REPORTING THE SHARIAH NON-COMPLIANT INCOME (SNCI) IN MALAYSIAN ISLAMIC BANKS

NORHANIZAH JOHARI

Department of Accounting and Finance  
Faculty of Management and Muamalah  
Kolej Universiti Islam Antarabangsa Selangor  
norhanizah@kuis.edu.my

NAWAL KASIM

Faculty of Accountancy, UiTM Shah Alam  
Accounting Research Institute (ARI)  
nawal120@salam.uitm.edu.my

NOR AISHAH MOHD ALI

Faculty of Accountancy, UiTM Malacca  
aishah72@melaka.uitm.edu.my

ROSHAYANI MOHD ARSHAD

Accounting Research Institute, UiTM  
roshayani@ari.uitm.edu.my

### ABSTRACT

Effective risk management is an essential component in sustaining business growth and profitability. To be competitive in the industries, every bank must establish strategic risk management guidelines to exercise effective control in minimizing risk management failures. This is where the control functions are essential in exercising their roles with the advice of the Shariah Committee and approved by the board. This study is mainly to explore the roles of key functions in managing and reporting of Shariah Non-Compliant Income (SNCI) in Islamic banks in Malaysia. Data were gathered from in-depth interviews from the key functions of 10 participating IBs, and review analysis of two policy documents on the Financial Reporting for Islamic Banking Institutions and Shariah Governance Policy 2019. It is interesting to note that purification measures of SNCI need further attention due to little guidelines from the regulator. The findings may benefit multiple users.

**Keywords:** Governance, Key functions, Shariah Non-Compliant Income, Financial Reporting.

*Submitted: 08/02/2021*

*Accepted: 01/04/2021*

*Published: 01/07/2021*

### INTRODUCTION

Islamic banking is a part of the Islamic financial system besides the Islamic capital market, Takaful, Al Rahn (pawnbroking), and other Shariah-compliant companies. The objective of Islamic banks (IBs) is to structure products that have similar risk-return features to conventional products. The products and services offered must follow the Maqasid al-Shariah,





which requires the Islamic banks, apart from the maximization of profit, considering the justice as well as the welfare of society (Chapra, 2000). The development in products and services exposes the banks to additional risks as compared to conventional banking products. As indicated by Ahmed (2014), the risks inherent in Islamic modes are complex and need to be recognized and mitigated by the Risk Management Unit of the respective Islamic Financial Institutions (IFIs). SNC risks can potentially arise when there is a mistake made in the documentation process in dealing with a certain contract (Omar & Hassan, 2019). Due to the uniqueness of the business model of Shariah compliance on its management and business operations, they are obliged to the regulatory objective of promoting end-to-end Shariah compliance (Ahmed, 2014). This Shariah compliance is addressed by the Shariah Governance which consists of a set of institutional and organizational arrangements through which IFIs ensure that there is effective independent oversight of Shariah compliance over the issuance of relevant Shariah pronouncements, dissemination of information, and an internal Shariah compliance review' (IFSB, 2009). It is further regulated in Section 28 of the Islamic Financial Services Act 2013 (IFSA, 2013) which states that any Shariah Non-Compliance (SNC) matter is considered an offense or breaches of the Shariah law.

To ensure IBs are complying with the Shariah principles and Shariah governance system, the role of key functions is very crucial to IBs, particularly in managing and reporting the SNC incidents. At this juncture, the role of Shariah Risk Management (SRM), Shariah Review (SR), and Shariah Audit (SA), the control functions in IBs is critical in detecting, deciding, managing, and reporting any SNC incidents that occur in IBs. These control functions assisted by the Shariah Research and Secretariat (SRS) are supported by the Shariah Committee (SC) appointed by the bank to fulfill their responsibility to the bank on matters related to the IB's business operations and activities including compliance with the regulatory requirement of BNM. Their roles are documented in BNM policy documents mainly to strengthen the oversight accountabilities in the implementation of the Shariah governance policy (SGP, 2019). Being objective and independent, the SC urges to reinforce a sound decision-making process and robust internal control functions for effective management of Shariah non-compliance risks (SNCR), (BNM, 2019b). Therefore, the roles of control functions and SRS with the supervision of the SC, in line with the active roles of the board and the senior management in IBs, would be excellent evidence of a strong Shariah compliance risk culture within IFIs.

One of the outcomes of Shariah compliance risk culture in Islamic Banking Institutions (IBIs) is the detection of Shariah Non-Compliance (SNC) incidents of SNC Event (SNCE) and Shariah non-compliant Income (SNCI). Failure to manage the SNCR effectively may result in invalidation of contracts, where the income from the invalid contract (if any) known as SNCI must be channeled for charity purposes (BNM, 2019a; Shafiai & Engku Ali, 2019). In most IBs, this SNCI is under the custody of the SRM unit in which one of the roles of the SRM is to monitor income which cannot be recognized as a result of the Shariah non-compliant activities. Hence, mitigating the probability of recurrence of SNC incidents in the future is required (Chik & Shairy, 2013). In this regard, BNM has mandated the reporting and disclosure requirement for SNC incidents that include the SNCE and SNCI in the Financial Reporting for Islamic Banking Institutions. IBs are required to disclose: (i) the nature of Shariah non-compliant activities; (ii) amount of Shariah non-compliant income; (iii) number of non-Shariah compliant events occurring during the year; and (iv) rectification process and control measures to avoid recurrence of such Shariah non-compliant activities (BNM, 2019a).

As indicated by Khalid, (2017) in the Islamic Finance Outlook Report 2016, he found that one of the biggest threats facing IBs is firstly the Shariah compliance issues to be the internal threat and secondly, the regulatory issue as an external threat. In IFI, management of non-compliance issues is crucial to IBIs as an assurance that customers' faith and confidence





towards Islamic banking and finance are well-safeguarded (Omar & Hassan, 2019). This is supported by Yusof & Mohd Ali (2019) who commented that any SNC must be managed prudently, and relevant measures must be put in place to avoid any re-occurrence(s) upon the detection of any SNC issues. By having the above points in mind, this study purports to explore how the key functions or functions executing their responsibilities in managing and reporting of Shariah Non-Compliant Income (SNCI) in Malaysian Islamic Banking Institutions (IBI). Furthermore, the study also intends to explore the key functions' role in complying with the regulatory requirement by the regulator on SNCI. To embark on this study, in-depth semi-structured interviews were conducted with the 10 participating IBs, and two policy documents on SGP 2019 and Financial Reporting for IBI, 2019 were reviewed. Both methods of data collection are carried out to understand further how the key functions are responsible for handling the process of managing and reporting the SNCI in IBIs in Malaysia.

Therefore, this study is embarked to accomplish the following objectives:

- (1) to explore the regulatory requirements for the disclosure of the SNCI in Islamic banks in Malaysia.
- (2) to investigate the key functions' role in managing and reporting the SNCI in Islamic banks in Malaysia.

## LITERATURE REVIEW

The central element of corporate governance is primarily and essentially man, as the director, the manager, the shareholder, the auditor, the stakeholder, or even the regulator (Abas, 2017). And, it is similar to Shariah governance (SG), in which the key components of SG are the people and process (Hassan, 2017). Shariah governance is very relevant to the stewardship theory, in which the key functions are responsible and accountable to discharge their responsibility to the multiple shareholders, stakeholders, and the bank's management (Grais & Pellegrini, 2006; Menyah, 2013; Obid & Naysary, 2014; Abas, 2017), through their reporting in the annual report of the bank every year; (Arshad & Zain, 2017). A review of past studies indicates that most of the studies on SNC incidents that include the Shariah Non-Compliant Income (SNCI) and Shariah Non-Compliance event (SNCE), focuses on the reporting output of neither SNCE and SNCI in cumulative or individually. This study however focuses on the people component that is represented by the roles and responsibilities of the key functions and the process component represented by the process of managing and reporting of the SNCI in IBs in Malaysia.

### Regulatory Requirement

To highlight the important role of the people as the key functions in IBIs, the Bank Negara Malaysia (BNM) has mandated their roles and responsibilities in the policy documents of the Shariah Governance Framework 2010, SGF 2010 (BNM, 2010), and Shariah Governance Policy 2019 (BNM, 2019b). All these regulatory initiatives are meant to create a resilient and organized process for identifying, measuring, monitoring, and controlling SNC risks thus, promoting end-to-end Shariah compliance in the industry (Masruki et al., 2020a; Yang Amri, 2020). However, the regulatory initiatives will only succeed, if the key functions can execute those processes effectively and they should be transparently reported with the guidance of the regulator. This reporting requirement greatly depends on the ability of the staff at all relevant levels to identify whether a particular matter or incident has any potential element of SNC (Yusof & Mohd Ali, 2019).





## **Roles and Responsibilities of the Key Functions**

The key functions in this discussion focused on the key functions under the Shariah control functions and Shariah Research and Secretariat (SRS) at the bank's level. They comprise the Shariah Risk management (SRM) unit, Shariah Review (SR), and Shariah Audit (SA) assisted by the SRS. With a structured process of SNC, it enables the officer(s) handling the SRM function to gather sufficient relevant facts hence ensure comprehensive and effective deliberation in Shariah Committee meeting (Yusof & Mohd Ali, 2019). As mandated by the regulator in SGP 2019, the control functions have to work closely with individual business units, in which they must be sufficiently independent of the business lines and must not be involved in revenue generation activities (BNM, 2019b). Therefore, the roles of these key functions are identically important for the banks to emphasize the impact of the transaction and the activities throughout the organization.

## **Managing and Reporting the Shariah Non-Compliant Income**

The study is performed with the belief that the processes of managing the SNC incidents influence the reporting of SNCI in the annual report of IBs. It is deemed relevant to the dearth of study on the end-to-end processes of managing and reporting the SNCI starting from the identification of the Shariah issues up to the disposal of SNCI for charitable purposes. By providing valid and accurate information about SNC incidents in the bank's reporting internally and externally, it indicates the effectiveness in integration between the control functions and SRS under Shariah governance. Besides, it also indicates the efficiency of the oversight arrangement of the risk management, compliance, and internal audit of the organization (Hanefah et al., 2020; BNM, 2019b). The disclosure of all information and activities would be an advantage to the IBs, as well as to the public that could influence the public to review the activities of the company and attract the public as the potential customers (Md Zain & Shafii, 2018). Therefore, the goal congruence in the reporting can be achieved by both parties.

## **RESEARCH METHODOLOGY**

This study was carried out by (1) conducting in-depth interviews with the 10 participating IBs, and (2) reviewed the two policy documents of (i) the Financial Reporting for Islamic Banking Institutions 2019 (BNM, 2019a), and (ii) the Shariah Governance Policy 2019 (BNM, 2019b). A review of these two policy documents was to identify any changes or updates on the disclosure requirements of SNCI by the regulator. Although the study on SNCI is not a new debate in the industry, the managing and reporting of SNCI are believed to be the first in the studies, which offers a new insightful perspective of SNCI from the scarce literature in writing and practice.

## **FINDINGS AND DISCUSSION**

### **(A) A Review of SGP 2019 and Financial Reporting for IBI, 2019**

#### ***The Internal Key functions***

The internal key functions of SNC incidents in this study represented by the key functions at the bank's level as illustrated in Figure 2. This level comprised of the board, the management, and senior management; and the control functions (SRM, SR, and SA) and complemented by





the Shariah research and secretariat (SRS) of the bank. The discussion will be focusing on the key functions under the control function who are involved with the end-to-end process of identification of Shariah issue until the refund of SNCI to the affected customers or disposal to the approved charitable organization. In practice, these key functions at the bank's level comprise all IB staff at all units, the business units, and support functions, the control functions (SRM, SR, and SA), SRS, the management, and senior management of the IB. They are all responsible for the board. For an IBI, this hybrid system can be represented by the three or four levels of defense on risk control and monitoring system (depending on IBs) practices by all IBs in Malaysia. One of the most challenging issues of risk control and monitoring of IB operations is the occurrence of SNC incidents that will reflect the banks neither financially nor non-financially. SNC incident arises from any Shariah issues of non-compliance detected from the end-to-end activities, processes, and operations of the bank (Omar & Hassan, 2019; Yang Amri, 2020). It is started with the detection of Shariah issues, confirmation of the issues to be potential or actual SNC before it is finalized as Shariah Non-Compliance Event (SNCE) or Shariah Non-Compliant Income (SNCI). The actual SNCI originated from the SNCE that exposes the bank to invalidation of IBs income therefore, it must be excluded from the bank's income. The components of key functions in the Shariah control function is as illustrated in Figure 1 overleaf:

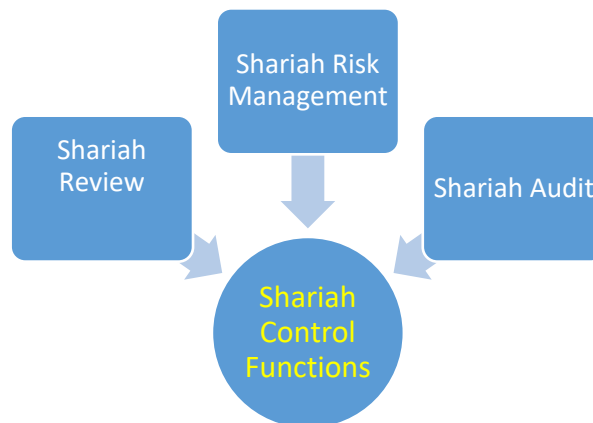


Figure 1: Component of Shariah Control Functions in IBI  
(Source: SGP 2019, BNM 2019b)

The role of control functions (SRM, SR, and SA) supported by SRS are very critical to the process of managing the SNC incident until it is deliberated and tabled to the SC for further decisions. The control functions have to work very closely with the business units, upon the detection of Shariah issues after the SR and SA process or a self-check embark on by the business unit itself. The Shariah issue raised needs to be communicated to the SRM and Qualified Shariah Officer (QSO) before it is decided as potential SNCs by the QSO or a Chief Shariah Officer (CSO). The communication between the control functions and SRS, the Shariah department, and the business unit must be closed and intact for effective communication with the assistance of the SC and as blessed by the board until SNCE is rectified and SNCI is purified and disposed of.

Figure 2 overleaf, shows the involvement of the level of key functions that is the main focus of this study. Meanwhile, Table 1 outline the roles and responsibilities of the related key functions in managing and reporting the SNCI in IBs in Malaysia.



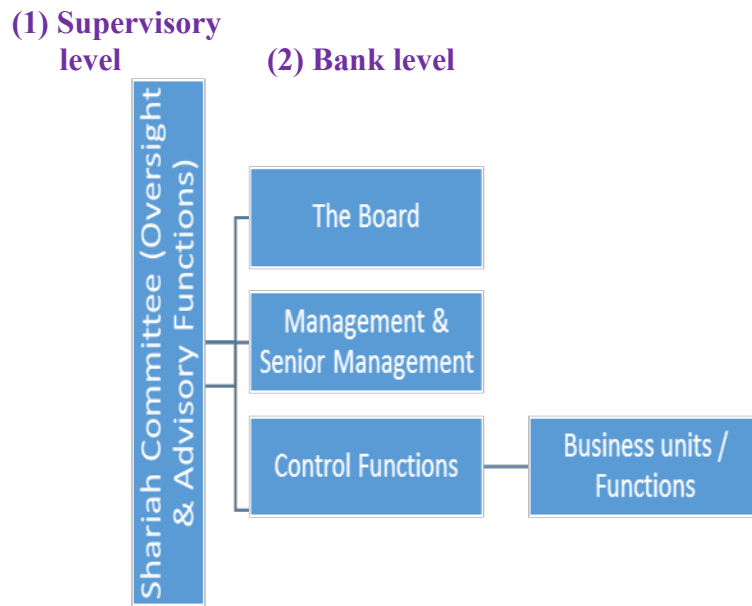


Figure 2: The two levels of key functions in IBI  
(Source: Author)

***The Role and Responsibilities of the Key functions as Mandated by the SGP 2019***

Table 1: The roles and responsibility of the key functions in IBIs  
(Source: SGP2019, BNM 2019b)

No.	Name of Key function	Role and responsibility
1.	Senior Management	<ul style="list-style-type: none"> <li>Responsible for planning, directing or controlling the activities of an authorized person or a financial holding company including the chief operating officer, members of decision-making committees and other persons performing key functions such as risk management, compliance, internal audit or other functions as may be specified by the Bank under section 57 of the IFSA.</li> <li>Undertake control functions under Shariah governance shall have direct and unimpeded access to the Shariah committee for effective performance of such control functions.</li> </ul>
2.	The Board	<ul style="list-style-type: none"> <li>Oversee the implementation of the internal control framework to prevent Shariah non-compliance and any rectification measures to resolve incidents or circumstances that may result or have resulted in Shariah non-compliance.</li> <li>Oversee the performance of senior management and other officers entrusted to implement Shariah governance framework such that the board is satisfied that the measures of their performance are aligned with Shariah governance objectives.</li> <li>Promote a sound corporate culture which reflects the importance of adhering to Shariah requirements in product development and marketing, strategy formulation, business operations, risk</li> </ul>





		management practices and other aspects that promote end-to-end compliance with Shariah.
3.	Shariah Research & Secretariat (SRS)	<ul style="list-style-type: none"> <li>The secretariat has the responsibility to provide operational support for effective functioning of the Shariah committee, through;               <ol style="list-style-type: none"> <li>(1) coordinating communications and disseminating information among the Shariah committee, the board and senior management,</li> <li>(2) ensuring proper dissemination of decisions or advice of the Shariah committee within the IFI,</li> <li>(3) reporting to the board and Shariah committee on a timely basis any potential or actual Shariah non-compliance events.</li> </ol> </li> </ul>
4.	Shariah Risk Management (SRM)	<ul style="list-style-type: none"> <li>A function that systematically identifies, measures, monitors and reports Shariah non-compliance risks in the operations, business, affairs and activities of the IFI.</li> </ul>
5.	Shariah Review (SR)	<ul style="list-style-type: none"> <li>A function that conducts regular assessment on the compliance of the operations, business, affairs and activities of the IFI with Shariah requirements.</li> <li>Report to the board, Shariah committee and senior management regularly on Shariah non-compliance issues and findings</li> </ul>
6.	Shariah Audit (SA)	<ul style="list-style-type: none"> <li>Shariah audit refers to a function that provides an independent assessment on the quality and effectiveness of the IFI's internal control, risk management systems, governance processes as well as the overall compliance of the IFI's operations, business, affairs and activities with Shariah.</li> <li>Communicate results to the board and Shariah committee through an audit report, detailing the audit findings and recommendations for rectification measures, as well as the auditee's responses and action plans.</li> </ul>

The key functions are complementing one another to uphold their stewardship responsibility to the board, the bank, and to the multiple stakeholders besides the public at large. From the list of roles shown in Table 1, the regulator has guided their expectations on the qualification and competency of the key functions for the bank to effectively exercise a good compliance culture in the business. Shariah compliance culture refers to how an IFI instills and promotes the behavior of compliance with Shariah in its aims and operations, business, affairs, and activities (BNM, 2019b). To exercise compliance function responsibilities, besides having a sound understanding of relevant Shariah requirements, they should be competent in performing the Shariah roles and functions to comprehend requisite knowledge applicable to Islamic financial business. The roles started with the identification of Shariah issues and findings until the rectification measures. However, the regulator has not spelled out clearly who is responsible for the purification and disposal of SNCI. Therefore, further investigation is necessary to better understand the roles of key functions in the end-to-end process of managing and reporting until the SNCI fund has been purified and channeled for charity purposes.





### *The Reporting Requirement of SNCI for Islamic Banking Institutions*

Another document reviewed was the Financial Reporting for Islamic Banking Institutions issued by the BNM in 2018 and 2019 (BNM, 2018a; 2019a). Related information on SNCI to be reported by the key functions, were summarized in Table 2 below:

Table 2: Financial Reporting Requirement or Islamic Banking Institutions by BNM  
 (Source: BNM, 2019a)

Year issued	Name of Documents	The Clause
February 2018, September 2019	Financial Reporting for Islamic Banking Institutions Part B Section 11.6 (c)	<p>In the case of an Islamic banking institution, income derived from Shariah non-compliant activities which may alternatively be disclosed under the Director’s Report or Shariah Committee’s Report. An Islamic banking institution shall disclose additional information (as specified under the Operational Risk Integrated Online Network (ORION) for guidance on treatment of Shariah non-compliant items) regarding:</p> <ul style="list-style-type: none"> <li>(i) nature of Shariah non-compliant activities;</li> <li>(ii) amount of Shariah non-compliant income;</li> <li>(iii) number of non- Shariah compliant events occurring during the year; and</li> <li>(iv) Rectification process and control measures to avoid recurrence of such Shariah non-compliant activities.</li> </ul>

It is the Shariah Committee’s (SC) responsibility, to ensure that their independence in disclosing (i) the nature of Shariah non-compliance activities; (ii) amount of Shariah non-compliant income; (iii) number of non-Shariah compliant events occurring during the year; and (iv) rectification process and control measures to avoid recurrence of such Shariah non-compliant activities is among their main concern. This information should be disclosed either, under the Director’s Report or the Shariah Committee Report (BNM, 2019a). The issuance of the policy documents indicates that the regulator is keen on improving the disclosure and transparency of the SNCI in the financial reporting of IBIs. This is to ensure that the financial statements are drawn up to give a true and fair view of the state of affairs, consistent with the fiduciary and statutory duties of the board as persons responsible for managing the affairs of the IFI. Hence, the board shall be satisfied that a sound financial reporting structure is in place to ensure the integrity and credibility of the published financial statement.

Although there are newly released regulations in SGP and Financial Reporting for Islamic Banking Institutions in late 2019, there is no clear cut of parameters on the management and purification of SNCI due to lack of regulation by the regulator. Section 11.21 of the document has generally stated that “an IFI shall disclose sources of donations/charities funds (for example, gharamah amount, Shariah non-compliance income, and shareholder’s fund) and uses of such funds (for example, distribution to the poor, education fund).” The disposal of SNCI for charity or refunded to the rightful customers as proposed by the Shariah control functions is subject to the approval by the SC and blessed by the board. It may lead to conflict in the management of SNCI funds, especially for charitable purposes. It is believed that a clear cut on the parameter and guideline on purification by the regulator will improve the end-to-end





process of managing and reporting SNCI in a meaningful way. Clear guidance by the regulator creates better transparency by the bank and better understanding to the stakeholders, shareholders, and the public, who are always concerned against the Shariah compliance system of the bank.

Reporting the activities in the annual report allows the customers to review and evaluate the level of assurance in the banking operation (Shafiai & Engku Ali, 2019). It clarifies the significance of the banking sectors to provide a confidence level among stakeholders towards the capability of the institutions. Furthermore, Shariah's governance practice, transparency, and disclosure of the required information have particularly important impacted the cost of capital, reputation, investors' decision, and stock prices (Haqqi, 2014).

### **(B) In-depth Semi-structured Interviews with 10 participating IBs**

In-depth interviews were conducted with 15 informants from 10 participating IBs from August 2019 until December 2019. The informants were ranges from an assistant manager up to the head of the unit under the Shariah control functions. They are directly involved in managing and reporting the SNC either as SR, SRM, SA, or SRS. When asked about the definition of SNCI, the following informants responded:

*“In simple language is an income that the bank cannot recognize... due to shariah non-compliant event for example due to breach of contract and so forth.” (R1IB01).*

*“SNCI is derived from Shariah Non-Compliance transactions. SNCI actually comes from SNCE issues.” (R1IB09)*

*“SNC event emerged from any potential SNC event identification.” (R1IB10)*

They were asked further on the key functions involved in detecting the SNC incidents and SNCI, the following informant alleged that:

*“We have Shariah Review, Shariah Audit... We can say mostly the findings come from these two functions, because they will check whether the process is correct or not” (R2IB02)*

In addition to the above questions, the informants were also asked about the detection process executed by the relevant key functions in the bank. The following informants indicated that:

*“It is depend on who detect the source of incidents, if the incidents picked up by audit, then audit will follow-through until the disposal as advised by the SC.” (R2IB02)*

*“so meaning that when there is Shariah 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), Shariah review, Shariah advisory, Shariah audit – they are the one who detect the Shariah issues.” (R1IB03)*





And finally, when the informants were asked about the reporting process of SNCI, the following informant (R1IB01) clarified that:

*“Of course, for reporting, we will follow exactly the ORION policy document, we have the SOP on how do we report that SNCI, later I will show a graph. Because this thing we do have to have a complete process... there is SOP for managing of SNCI and reporting of SNCI. Once we detect potential Shariah issue, risk controller will register the defect within  $t + 3$  working days upon detection. After that SRM investigates, based on this defect, we have the actual internal reporting, the deputy CFO will conquer the PSI, then further assessment by the SRM team after the confirmation by the CSO and to update in ORION within  $t + 1$  working days. Then we will inform all the management of the bank for example what is the fact case of the event so that the Chief Compliance Officer, Chief Risk Officer, Chief Internal Audit will look into this event.” (R1IB01)*

Those responses indicated that the detection of the Shariah issue originated from the normal process of Shariah review, Shariah audit, and self-checks conducted by the business unit itself. Starting from the detection of Shariah issues, the SNC must be handled and managed by the control functions together with the business unit before its confirmation as actual SNCE and SNCI. Before the issues tabled to the SC, the consent of the SRM and the QSO on these potential SNC issues will be gathered. Once the issues have been approved as potential SNC by the QSO, a report guided by the Operational Risk Integrated Online Network (ORION) (BNM, 2018b), within the stipulated timeline will be accelerated to the BNM by the SRM. Later, the SC will decide whether the issue is a potential SNC or actual SNC or operational issue with further justification by the business function and QSO. Potential SNC may require further investigation or could be decided as a non-potential case, whereas actual SNC requires rectification. The SC, with his best knowledge and experience, has to draw his decision and advise the control functions on the rectification plan as approved by the board and management of the bank.

However, it is interesting to find out that both of the reviewed documents did not state the purification measures of SNCI. The interview conducted has given the researcher new insight that the purification measures are subject to the bank's best practice and self-regulated internal policy. That is the flexibility granted by the regulator to the bank. As explained by R1IB01 and R1IB08 respectively:

*“SNC income is purified by the bank for the charity purpose... it is not to itemize one by one in detail. Importantly in managing SNCI we list down the approved recipients or the target recipient to whom the SNCI fund will be disposed-off.” (R1IB01)*

*"Invalid contract would bring financial impact to the bank. So we have to purify the income we earned from invalid contract by purifying the non-compliant income (SNCI). The principle can still be collected, only the invalid profit part we have to purify. We will derecognize the SNCI by either (1) remove it from our GL income and park in suspense account called SNC account while waiting for disposal, or (2) refund.” (R1IB08)*





The researcher believes that the purification strategy between IBs would be different due to it is unregulated in the policy documents of the regulator. Thus, the parameter and measures on this purification could vary between banks. There could be reasons for this flexibility. However, in the opinion of the researcher, the purification measure should be regulated by the regulator to better promote uniformity and transparency in reporting. The study proposes the phases written in italic (as per Table 3) to be included in the related policy documents so that the multiple stakeholders and users are aware that the bank has prudently taken necessary action for purification of SNCI and should de-recognized from the income of the bank. This information is value relevant to the multiple stakeholders, users, and public at large and included in the external reporting rather than only internally reported. The data obtained from the informants summarized into a process flow in Table 3 overleaf.

Table 3: The Process Flow of Managing and Reporting of SNCI by the key functions in IBIs  
 (Source: Author)

INPUT	INTERNAL REPORTING	OUTPUT	CORRECTIVE ACTIONS	EXTERNAL REPORTING
OUTCOME FROM THE SHARIAH REVIEW/ SHARIAH AUDIT/ BUSINESS UNIT OR FUNCTIONS (THE OUTCOME OF SHARIAH NON-COMPLIANCE RISK)	<b>Detection of:</b> 1) Potential Shariah Issue(s) form normal review or audit process 2) Potential Shariah Non-Compliance (SNC) event(s): <ul style="list-style-type: none"> <li>• Financial</li> <li>• Non-financial</li> </ul>	<b>Identification of:</b> 1) Actual SNC event confirmed by the Qualified Shariah Officer (QSO) and approved by Shariah Committee (SC) as either: <ul style="list-style-type: none"> <li>• Financial (SNCI)</li> <li>• Non-financial (SNCE)</li> </ul> <b>(To be reported by the SRM to the regulator through the ORION platform)</b>	<b>Corrective Actions:</b> 1) <b>Rectification:</b> Non-financial SNC event i.e. re-execution of <i>aqad</i> etc. (rectification plan depending on nature of SNCE) <b>(To be reported by the SC to the regulator through the ORION platform)</b> 2) <i>Purification of SNCI through the purification strategy is either refund to the rightful customer's OR, channel for the charitable purposes OR, channel to the Baitulmal.</i>	<b>Reporting:</b> Report and disclose SNC matters in the Annual Report, by disclosing: <ol style="list-style-type: none"> <li>1) The Nature of SNC</li> <li>2) Amount of SNCI</li> <li>3) No. of SNC event</li> <li>4) Rectification and control measures (as per regulator's requirement in Financial Reporting for Islamic Financial Institutions, Part B Section 11.6(c), BNM 2018)</li> </ol>





## CONCLUSION AND RECOMMENDATIONS

The findings from the review of policy documents indicated that every function is complementing one another in managing and reporting the SNCI. Communication between control functions with the support of SRS is crucial in the deliberation and escalation of the decision to the SC, the board, and the regulator (BNM). In this study, relevant SNCI information was obtained from the control functions and SRS of 10 IBs under study. However, this information excluded the SA responses due they were unable to be interviewed during the interview sessions and, that becomes the limitation of this study. On the other hand, clear flows of process and parameters on SNCI can be realized with clear guidance by the regulator.

Compliance with the Shariah principles strengthens the brotherhood and co-operation among the contracting parties, developing justice in the economy and igniting strength in spiritual and moral values besides preserving the Maqasid Al-Shariah. BNM mandated all Islamic banks operating in Malaysia to ensure that their operations, transactions, activities, and products are following the prescribed Islamic principles together with the statutory guidelines crafted by them. Without a good Shariah compliance framework or guidelines, IB may fall into unlawful operations that will lead to non-compliance issues as a result of the disputes in the Shariah principles. Although a few findings from similar studies indicated that IBs were adhering to the BNM minimum requirements with little differences in the implementation process (Omar & Hassan, 2019; Yang Amri, 2020), improvement to purification guidelines is essential due to the claims that it is less regulated (Hanefah et al., 2020; Abdul Ghani, 2019). As indicated by Yunus et al. (2017), the Non-Halal is prohibited in Islam hence, the disposal for charity is required. In this case, the rectification of SNCE is compulsory and, SNCI purification is obligatory in Islam so that the non-compliant income will be disposed of for charitable purposes to benefit the beneficiaries (BNM, 2018a; 2019a).

The purification of SNCI has been debated by traditional Muslim Jurists and contemporary Muslim scholars in their valuable works. In which Islam delineates rules for purifying the non-Shariah property and, it is not explained in great detail as it is left to the Muslim scholars' *ijtihad* (Yunus et al., 2017). It is where the judgment of the SC of the IBs is crucial in determining the parameter for SNCI meant for purification. This study proposes that the regulator set a guideline on parameters and measures for purification and, the information needs to be disclosed in the financial statements to promote uniformity and transparency in the reporting of SNCI. The current studies propose that the bank clearly stated the Purification of SNCI through the purification strategy is either; refund to the rightful customer's OR, the channel for charitable purposes OR, channel to the Baitulmal, to reflect transparent disclosure of SNCI in the annual reports. It is relevant to the findings of Masruki et al., (2020a) that indicate more disclosure would attract more Muslim investors.

The key functions that are responsible for the SNCI, disposal processes should also be specified in the policy documents. Therefore, the multiple stakeholders and users are aware that the bank has prudently taken necessary action to purify and de-recognize the SNCI from the income of the bank. It is due to upholding trust, maintaining integrity, exercising transparency and accountability, prudent management, maximizing returns, and the concern for the environment are related to the moral and ethical dimension of managing a company's business (Abas, 2017). By providing clear guidance on the measures and parameters on purification, it is believed that it would contribute to credible reporting, besides attracting other potential users to banking with IBs. Thus, the sustainability of the IBs in the market will be assured with the best practice of governance. For future research, it is believed that the responses from the SA should also be included with regards to the managing and reporting of





SNCI in Islamic banks in Malaysia, to comprehensively represent the perspectives of the control functions in IBs and supported by the SRS.

## REFERENCES

- Abdul Ghani, N.A. (2019). A Mixed Method Approach on Policy, Legal and Regulations of Non-Shariah Compliant Income in the Islamic Banking Industry: The Case Study of Malaysia. Published PhD Thesis University of Bolton, March 2019.
- Abas, Z. (2017). Understanding Prudence Corporate Governance: An Alternative Approach. SHS Web of Conferences 34, 04005 (2017), FourA 2016
- Ahmed, H. (2014). Islamic banking and Shariah compliance: A Product Development Perspective. *Journal of Islamic Finance*, 3 (2). pp. 15-29.
- Arshad, R. & Zain, N.M. (2017). Performance Measurement and Accountability of Waqf Institutions in Malaysia, SHS Web of Conferences 36, 00005 (2017) 2016 ICGA. DOI: 10.1051/shsconf/2017360000
- BNM (2010). Shariah Governance Framework for Islamic Financial Institutions, BNM/RH/GL\_012\_3
- BNM. (2013a). Islamic Financial Services Act 2013. Bank Negara Malaysia (Kuala Lumpur: BNM. (Available: [http://www.bnm.gov.my/documents/act/en\\_ifsa.pdf](http://www.bnm.gov.my/documents/act/en_ifsa.pdf))
- BNM (2018a). Financial Reporting for Islamic Banking Institutions, BNM/RH/PD 028-71
- BNM. (2018b). Operational Risk Integrated Online Network (ORION) Policy Document. 22 June 2018
- BNM (2019a). Financial Reporting for Islamic Banking Institutions, BNM/RH/PD 033-9
- BNM (2019b). Shariah Governance, BNM/RH/PD 028-100.
- Chapra, M. U. (2000). *The Future of Economics: An Islamic Perspective*. Leicester: The Islamic Foundation.
- Chik, M.N & Shairy, M.Z.M. (2013). Managing Shariah Non-Compliance Risk in Islamic Banking: Current Practice and Challenges Ahead, *Proceeding International Convention on Islamic Management 2013*.
- Grais, W. & Pellegrini, M. (2006). Corporate Governance and Shariah Compliance in Institutions Offering Islamic Financial Services. World Bank Policy Research Working Paper 4054, November 2006
- IFSB, (2009). Guiding Principles on Shariah Governance systems, <http://www.ifsb.org> (accessed May 2020).
- Hanefah, M.M., Kamaruddin, M.I.H., Salleh, S., Shafii, Z. & Zakaria, N. (2020). Internal Control, Risk and Shari'ah Non-Compliant Income in Islamic Financial Institutions. *ISRA International Journal of Islamic Finance Emerald Publishing Limited*. 0128-1976 DOI 10.1108/IJIF-02-2019-0025
- Haqqi, A. R. A. (2014). Shariah Governance in Islamic Financial Institution: An Appraisal, 11:112, 112–113. <https://doi.org/ISSN 1985-7497>
- Hassan, R., Othman, A.A. & Ibrahim, M.N.O.A. (2017). Shariah Risk Management Process for Islamic Financial Institutions in the Context of Shariah Governance Framework 2010, *UUMJLS* 8, 1-15 (2017)
- Khalid, M. (2017). Sector Report, *Islamic Finance News 2017 Annual Guide*
- Masruki, R., Mohd Hanefah, M., & Dhar, B.K. (2020). Shariah Governance Practices of Malaysian Islamic Banks in the Light of Shariah Compliance. *Asian Journal of Accounting and Governance* 13: 91–97 (2020). ISSN 2180-3838 (<http://dx.doi.org/10.17576/AJAG-2020-13-08>).





- Md Zain, S.N. & Shafii, Z. (2018). The Impact of Shariah Governance to Financial and Non-Financial Performance in Islamic Financial Institutions (IFIs): A Literature Survey, *International Journal of Islamic Business*, December 2018, VOL 3 ISSUE 2, Page 27-40, eISSN: 0127-662X
- Menyah, K. (2013). Stewardship Theory. In *Encyclopedia of Corporate Social Responsibility*. Eds. Samuel O Idowu, Nicholas Capaldi, Liangrong Zu & Ananda Das Gupta. pp 2322-2328.
- Obid, S. & Naysary, B. (2014). Toward a comprehensive theoretical framework for Shariah governance in Islamic financial institutions. *Journal of Financial Services Marketing* (2014) 19, pp. 304–318.
- Omar, H. N. & Hassan, R. (2019). Shariah Non-Compliance Treatment in Malaysian Islamic Banks. *International Journal of Management and Applied Research*, Vol. 6, No. 4, pp. 220-233. <https://doi.org/10.18646/2056.64.19-016>
- Shafiai, S. & Engku Ali, E.R.A. (2019). The Need for Credible Reporting of Shariah Non-Compliance Event by Islamic banks in Malaysia. *e-Proceedings The 2nd Islamic Management Development Conference 2018*, E-ISBN: 978-967-0314-59-4
- Yang Amri, M.S. (2020). Reporting of Shariah Non-Compliance Events: The Case of Some Islamic Financial Institutions in Malaysia, (<https://ifikr.iSRS.my/columns/post/159/reporting-of-Shariah-non-compliance-events-the-case-of-some-islamic-financial-institutions-in-malaysia>)
- Yunus, S.M., Kamaruddin, Z. & Embong, R. (2017). *International Journal of Academic Research in Business and Social Sciences* Vol. 8, No. 11, Nov, 2017, E-ISSN: 2222-6990.
- Yusof, Y & Mohd Ali, A. (2019). Sharī'ah Non-compliance Classification and the Materiality Parameter: The Approaches Adopted by Prudential BSN Takaful Berhad, ISRS RESEARCH PAPER 111/2019.

