



CONSULTATION PAPER NO. 79

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**SHARI'A GOVERNANCE AND ACCOUNTING AND AUDITING
STANDARDS FOR ISLAMIC FIRMS AND SECURITIES**

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Why are we issuing this paper?

1. The DFSA proposes to:
 - (a) make changes to the accounting and auditing standards applicable to Islamic Financial Business, Islamic Funds and Islamic Securities; and
 - (b) add guidance to the Shari'a governance Rules applicable to Authorised Persons conducting Islamic Financial Business.

Who should read this paper?

2. The proposals in this paper would be of interest to:
 - (a) Authorised Persons conducting or intending to conduct Islamic Financial Business in or from the DIFC;
 - (b) Persons making or intending to make an Offer of Islamic Securities in or from the DIFC;
 - (c) Fund Managers and Trustees of Islamic Funds; and
 - (d) Advisors, especially those providing accounting and auditing services, to the Persons listed above.

How is this paper structured?

3. In this paper, we set out:
 - (a) the background to the proposals;
 - (b) the proposed changes to the accounting and auditing requirements for Islamic firms and Securities; and
 - (c) the proposed enhancements in relation to additional matters the Governing Body should take into account in the case of Islamic firms.

How to provide comments?

4. All comments should be in writing and sent to the address or email specified below. If sending your comments by email, please use the Consultation Paper number in the subject line. You may, if relevant, identify the organisation you represent in providing your comments. The DFSA reserves the right to publish, including on its website, any comments you provide, unless you expressly request otherwise at the time of making comments.

Comments to be addressed or emailed to:

Consultation Paper No. 79
Policy and Legal Services
DFSA
PO Box 75850
Dubai, UAE

Email: consultation@dfsa.ae

Tel: +971(0)4 3621500

What happens next?

5. The deadline for providing comments on the proposals is **25 November 2011**. Once we receive your comments, we shall consider if any further refinements are required to these proposals. We will then proceed to enact the changes to the DFSA's Rulebook. You should not act on these proposals until the relevant changes to the law and DFSA Rulebook are made. We shall issue a notice on our website telling you when this happens.

Terminology in this paper

6. In this paper, defined terms are identified throughout by the capitalisation of the initial letter of a word or of each word in a phrase and are defined in the Glossary Module (**GLO**). Unless the context otherwise requires, where capitalisation of the initial letter is not used, the expression has its natural meaning.

A. Background

7. As part of its rolling review of the regulatory framework within the DIFC, the DFSA has reviewed its Shari'a governance requirements (which are currently based on Accounting and Auditing Organisation for Islamic Financial Institutions (**AAOIFI**) governance standards), taking into account the Islamic Financial Services Board (**IFSB**) governance standards issued over the period 2006 to 2009. As part of this review, the DFSA has also considered the current requirement for Islamic firms to comply with AAOIFI accounting and auditing standards.
8. The review, which involved informal consultation with industry stakeholders, aimed to ensure that the DFSA's Shari'a governance standards applicable to Islamic Institutions and Islamic Windows remain appropriate in light of the new international standards, and also of developments in the industry. Furthermore, the review considered whether the DFSA should continue to require Islamic Institutions and Islamic Windows to comply with AAOIFI accounting and auditing standards.

B. Changes to Accounting and Auditing Standards

Background

9. The principal accounting standard setter internationally is the International Accounting Standards Board (**IASB**). The IASB develops the International Financial Reporting Standards (**IFRS**). The DFSA specifies the use of IFRS for conventional firms, and is a member of the Asian-Oceanian Standard-Setters Group (**AOSSG**), a grouping of accounting standard setters in the Asian-Oceanian region which promotes the use of IFRS and contributes to their development. AOSSG has published a research paper on financial reporting issues relating to Islamic finance¹. Malaysia uses IFRS, with some additional "technical releases" for Islamic finance.
10. AAOIFI, of which the DFSA is also a member, was established to prepare and promulgate accounting and auditing standards for Islamic financial institutions. It has also published Shari'a and governance standards. The DFSA currently mandates the use of AAOIFI accounting and auditing standards for Islamic Financial Business, as do the Central Bank of Bahrain and the Qatar Financial Centre Regulatory Authority.

Informal Consultation

11. The DFSA became aware of industry concerns that the AAOIFI standards, which had originally been based on those of the IASB, were diverging from them as the IFRS developed. This, it was suggested, created reporting inconsistencies and difficulties for firms or groups undertaking both conventional and Islamic business. The DFSA therefore conducted two rounds of informal consultation. The first involved industry practitioners in the DIFC and their advisers. In general, the view expressed was that there was

¹ "Financial Reporting Issues relating to Islamic Finance": <http://www.aossg.org/submissions-and-publications/aossg-research-papers>

no fundamental problem in using IFRS for Islamic finance transactions, though some interpretations needed to be made.

12. The second round involved representatives from accounting firms, international banks, and regulators, including representatives of the Malaysian Accounting Standards Board. Its conclusions were broadly similar to those of the first consultation, with industry representatives noting that they would in any event need to report their Islamic finance activities under IFRS for group consolidation purposes.

Proposed Changes

13. In the light of this, the DFSA now proposes a change in accounting standards applicable to Islamic Financial Business, Islamic Funds and Islamic Securities from AAOIFI to IFRS (with a consequential change in auditing standards from those of AAOIFI to those of the International Auditing and Assurance Standards Board). However, the DFSA considers that some additional disclosures are necessary to give a clear picture of certain types of business, notably Profit Sharing Investment Accounts and Takaful, and to provide a degree of transparency and certainty around fundamental matters under Shari'a such as Zakah.
14. It is therefore, proposed to subject Islamic Financial Institutions, Islamic Windows, Islamic Funds and Islamic Securities to the same accounting and auditing standards as their conventional counterparts, but to specify additional disclosures.
15. We are therefore proposing to delete certain Rules currently mandating the use of AAOIFI accounting standards. See amendments to Rule 7.2.1 and 7.2.2 of the Islamic Finance Rules Module (**IFR**) (Appendix 1), 8.2.1 of the General Module (**GEN**) (Appendix 2), Rules 5.1.5 and 5.1.7 of the Markets Rules (**MKT**)² (Appendix 3) and Rule 9.2.1 of the Collective Investment Rules (**CIR**) (Appendix 4).
16. We also propose to replace the current IFR Chapter 4 with provisions specifying the disclosures additional to those in IFRS which we consider are necessary to ensure that concerns previously addressed by AAOIFI standards are transparently dealt with under IFRS. Authorised Persons operating an Islamic Window will note that a similar approach has been taken in IFR Rule 3.8.3(1).
17. Domestic Funds which are Islamic will be subject to CIR Rule 9.2.1 similarly to conventional Funds with an additional requirement to include specific disclosures in prospectuses of Private and Public Funds relating to how earnings prohibited by Shari'a will be disposed of and the person with whom the responsibility for Zakah will lie (see IFR Rules 6.5.1 and 6.6.1). We have also taken this opportunity to correct a technical mistake in CIR Rule 9.2.1 introduced during the last round of amendments made to CIR Rules in July

² Further to Consultation Paper No. 75 relating to proposed changes to the Markets Law Regime, the Markets Law 2004 will be replaced with the Markets Law 2011 and the OSR will be replaced with the Markets Rules. All references to MKT are to the version currently under consultation.

2010 when the IFRS had been inadvertently omitted as an acceptable accounting standard for Domestic Funds.

18. Minor amendments have been made to the statement required to be included in a Prospectus for Islamic Securities to reflect changes being made for Securities more generally. (See Consultation Paper 75 - Proposed Changes to the Markets Law Regime.)
19. Auditors of Authorised Persons conducting Islamic Financial Business, will be subject to the same Rules as those applicable to Auditors of conventional firms. These can be found in Chapter 8 of GEN.
20. Finally, we recognise that a change in accounting and auditing standards will require some time to be implemented. We have therefore included transitional Rules in GEN Chapter 10 which permit Islamic Financial Institutions and Islamic Windows to continue to operate under the current accounting and auditing regime for a period of 2 years after the new Rules come into effect.
21. The DFSA will of course consider applications for a waiver of the new Rules from Persons wishing to comply instead with the AAOIFI accounting and auditing standards.

Issues for consideration

1. Do you have any concerns or comments about our proposed changes to the accounting and auditing standards for Islamic firms, Islamic Funds and Islamic Securities?
2. Do you consider that the additional disclosure requirements are clear and workable? If not, what improvements would you suggest?
3. Do you disagree with the transitional arrangements made? If so, what other arrangements would you suggest?

C. Shari'a governance additional guidance

Background

22. The DFSA's overall approach to Shari'a governance is that it is a Shari'a systems regulator rather than a Shari'a regulator. That is, it requires Islamic firms to have a properly constituted Shari'a Supervisory Board (SSB), systems and controls to ensure that the firm's Islamic business is conducted in accordance with the decisions of that SSB, and associated disclosure requirements. It does not itself seek to mandate or oversee decisions on Shari'a matters. In some other jurisdictions, the regulator is a Shari'a regulator, and may constitute its own Shari'a board to oversee the regimes in Islamic firms. In other jurisdictions, the regulator has no involvement at all in Shari'a compliance.
23. The DFSA does not propose to change its fundamental approach to Shari'a governance. It has, however, considered whether any changes are needed to its regime in the light of:

- (a) international standards developments, particularly in the IFSB and AAOIFI;
 - (b) industry experience and development, for example the increased presence of Shari'a consultancies; and
 - (c) the practice of other regulators.
24. This review also involved informal consultation with industry practitioners and their advisers, and their views have been taken into account in the proposals that follow.

International standards developments

25. Since the DFSA's current Shari'a governance Rules were introduced, there have been a number of new standards issued or proposed by the Islamic finance standard setters. The DFSA has reviewed its requirements with these in mind.

IFSB governance requirements

Governance Committee

26. A key element of the IFSB standards is that an Islamic bank should set up a Governance Committee to coordinate and integrate the governance policy framework of the Islamic firm as set by its Board of Directors. The purpose of this Governance Committee is to lessen the burden on the audit committee, and in particular, to ensure that investment account holders' interests are properly monitored and protected where their investments are commingled. A similar recommendation is made for Takaful operators, with an eye to the possible conflicts of interest between policyholders and shareholders.
27. This requirement is one which, so far as the DFSA is aware, has not yet been adopted in any other jurisdiction. It was not favoured by any of those to whom we spoke in our informal consultation. It is also not in line with the DFSA's approach to general corporate governance standards for Authorised Firms. In general, the DFSA expects the Governing Body of an Authorised Firm to take the responsibility and ownership to determine, in light of the nature, scale and complexity of the firm's business and governance structure, what committee's are appropriate to support the Governing Body in the effective discharge of its overall responsibilities.
28. The DFSA therefore does not propose to mandate the creation of a Governance Committee.

Disclosures

29. Another key element of the IFSB principles is disclosure. In general, most of the disclosures recommended by the IFSB are already mandated in DFSA Rules. These include disclosures about the SSB and Shari'a governance, and some of the accounting disclosures to be specified in the (new) IFR Chapter 4.

30. Some of the disclosures, for example about risk management are akin to the quantitative and qualitative disclosures required under Pillar 3 of the Basel Accord. For most firms, these will be considered by the DFSA when it comes to implement Basel III requirements, a project for which is already under way. Similar disclosures for Takaful firms will be considered when similar requirements are considered for conventional insurance firms as part a revision of our prudential regime for insurance which is currently scheduled for 2013.

AAOIFI's proposed New Governance Standards

31. AAOIFI issued a Consultation Paper (no.8) on the Proposed New Governance Standards containing a 'Professional Code of Conduct for SSB members' in April 2011. This draft code sets out detailed standards relating to matters such as the number of positions an SSB member can hold, minimum (75%) member attendance at meetings, remuneration policy and other matters.
32. These proposals seem to cover, for SSBs, the same ground covered by international standard setters for Governing Bodies, which the DFSA has now reflected as proposed best practice standards applicable to the internal governance of an Authorised Firm (see under Consultation Paper No. 77).
33. We note that AAOIFI's proposals are still under discussion and may well be amended following the public consultation. In addition, they are cast as a professional code rather than proposals for implementation by regulators. The DFSA therefore proposes to await the final version before considering whether it should implement any of the proposals.

Proposed enhancements

34. In addition to reviewing the international standards, we discussed as part of our informal consultation whether any other changes should be made to our Shari'a governance framework. In respect of the general corporate governance framework for Islamic firms, we are proposing to provide guidance to clarify that the Governing Body must ensure that the SSB and various committees of the Governing Body work closely to promote effective Shari'a compliance taking into account the rights and interests of stakeholder groups such as investors whose investments are comingled with the firm's capital.
35. In line with proposed amendments to corporate governance and remuneration standards applicable to Authorised Persons (see Consultation Paper No. 77) which require adequate measures to be taken by Authorised Persons to ensure that the roles and responsibilities of its Governing Body and senior management are clearly defined, documented and communicated internally, we propose in this paper to introduce guidance to IFR Rule 3.3.1 relating to the role of the SSB in the corporate governance of an Authorised Person conducting Islamic Financial Business.
36. We are also taking the opportunity to make minor changes to the Glossary Module (**GLO**) in respect of the definitions of "Islamic Financial Business", "Islamic Financial Institution" and "Islamic Window".

Issues for consideration

4. Do you have any concerns or comments about our proposed added guidance to the Shari'a governance standards?