

# Strengthening the Shariah Governance Structure in Islamic Cooperative Sector

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## Abstract

This study aims to review the strength of Shariah governance in the cooperative sector. This study used a sample of 10 representatives from cooperatives, some from small, medium, and large cooperatives. They have 3–5 years of experience working in cooperatives. The sampling method was chosen for those who work in Islamic cooperatives as the study want to go deeper on Sharia governance. This study uses qualitative and thematic analysis methods in analyzing the data and is divided into three categories: Shariah audit, Shariah review, and Shariah risk. The results of the study prove that there is a deficiency on the part of the Suruhanjaya Koperasi Malaysia (SKM) in providing appropriate guidelines for auditing conducted in cooperatives. Shariah review is still at an early stage to be practiced in cooperatives, but there are cooperatives that have already conducted Shariah review. Specifically, Shariah audits and reviews are two of the important factors that will strengthen the Shariah governance structure in the cooperative sector. In addition, Shariah risk is also one of the important elements in strengthening Shariah governance to reduce Shariah non-compliance that may be faced by Islamic cooperatives. However, the research findings for Shariah risk are few because Shariah audits and reviews are still in their early stages. The findings of this study show that cooperatives and cooperative's management need to work hand in hand to further strengthen the Shariah governance structure on the part of cooperatives, considering that cooperatives are still at an early stage in Islamic finance.

**Keywords:** Shariah Governance, Islamic Cooperative Sector, Shariah Audit, Shariah Review

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## Introduction

Today, a Shariah governance structure needs to be implemented due to the Islamic financial sector's rapid development. The instruments used to meet the specific requirements of Shariah governance in each sector is guideline. Shariah audit, Shariah risk, and Shariah review play big part of crucial elements in Shariah governance structure. The Bank Negara Malaysia (BNM), IFSB and AAOIFI currently issue Shariah governance standards, while SKM has published GP 28 Garis Panduan Tadbir Urus Syariah as a tool for cooperative sector refer to in operating based on Shariah governance. The guidelines apply to cooperatives that conduct banking, credit, financing or Ar-Rahnu (Islamic pawn broking) operations based on Shariah principles. Additionally, the goal of the Shariah guideline for governance in cooperative is (GP 28) issued on July 1, 2015, to ensure Shariah compliance in cooperatives as governance structure that adhere to Shariah is different from the conventional framework. Shariah governance incorporate with other Shariah elements to ensure Shariah compliance.

The study enables Islamic cooperatives to comprehend the components required for more effective Shariah governance. It may provide some cooperatives with knowledge regarding how to improve their Shariah governance structure as they already have Shariah governance and audit in place. The deficiencies discovered in the process of Shariah governance might be helpful for management or Suruhanjaya Koperasi Malaysia (SKM) to look into and improve in the future. In addition, the study could give cooperatives still in the planning stages of their implementation an overview of some requirements that could be established for their Shariah governance structure. Another objective is that Shariah governance is believed to be the main mechanism by which Islamic cooperatives can ensure Shariah compliance in their operations, internal environments, and services. In short, the study objective is to identify elements that can strengthen Shariah governance in Islamic cooperative which are Shariah audit, Shariah review and Shariah risk.

## Literature Review

Cooperatives face some issues and challenges in developing the Shariah Governance. Due to lack of knowledge and Shariah rules and regulations, the cooperative's execution of Shariah rules in the governance is still lacking (Shafii, Samad, & Rochania, 2019). Some cooperatives already implement and execute Shariah governance, while there are quite numbers of cooperatives that still not develop Shariah governance in the cooperatives. Any organization, including cooperatives, must have effective governance in order to accomplish their objective for which it was formed. Implementing relevant laws, regulations, and necessary Shariah guidelines shows that SKM governs and supports their cooperative. The establishment of Shariah governance does not come from only one entity but it involves formation of Shariah Committees, Board management positions, Internal Audit, and management. Each of the components has its own role in implementing Shariah governance in cooperative institutions. In order to develop Shariah governance, SKM must support cooperatives to strengthen the Shariah governance structure in the cooperative sector. Shariah audit, Shariah risk, and Shariah review are important parts of strengthening the Shariah governance structure. Even though some cooperatives are still in the development stage, it can be a reference to cooperatives that want to develop and strengthen the Shariah governance structure in the future.

In Islamic Financial Institutions (IFI), Shariah audit is defined as an independent assessment of the IFI's internal control, risk management system, governance, procedures, operation, business, and overall compliance with Islamic law provided by a function known as

“Shariah audit” (Shariah Governance Policy Document, 2019). The cooperative sector does not have a specific definition of Shariah audit but only Shariah compliance, where it highlights that Islamic financial products based on Shariah, with compliance with pillars and principles established by Syarak, serve as their primary characteristic. Shariah auditors may refer to this principle in conducting Shariah audits in the cooperative sector.

The challenges surrounding Shariah compliance and Shariah governance concern cooperatives that operate according to Shariah principles. SKM published GP 28 in July 2015, *Garis Panduan Tadbir Urus Syariah*, with which all cooperatives with a yearly income of at least RM 5 million are required to comply. To execute, the components in Shariah governance, it involves management committees, the Shariah Committee, and internal audit. Islamic cooperatives will refer to GP 28 *Garis Panduan Tadbir Urus Syariah* and the respective guidelines based on the Islamic product. Comprehensive adherence to Shariah principles will enhance community belief in the Islamic Muamalat system, especially in the cooperative sector (GP 28, *Garis Panduan Tadbir Urus Syariah*). Based on GP 28, it highlights that Islamic Shariah cooperative must follow Shariah principles, and to ensure the Shariah compliance, Shariah audit must be conducted.

One of the essential components of the Shariah governance system is Shariah audit, which performs the independent assurance function that the institutions is adhering to Shariah compliance. Shariah audit itself comprise of few elements in order to execute the audit work, the auditor must prepare the audit framework, audit scope, the competence and independence of Shariah auditor and quality of audit report. Previous study by (Mohamad Puad & Abdullah, 2020) mentioned that an effective Shariah auditing framework is necessary to improve the Shariah audit function and provide an assurance environment for Shariah compliance.

The audit scope must extend to Shariah area since Islamic finance product have to comply with Shariah compliance. In addition, internal Shariah audit include products, contracts and agreements, transactions, policies (Khalid, Yahya, Sarea, & Shaarani, 2021), and financial statement, along with memoranda and articles. An auditor requires strong accounting and Shariah knowledge to be able to understand and complete a Shariah audit. A comprehensive Shariah audit process and scope could additionally enhance Shariah audit findings.

### **SHARIAH AUDIT PRACTICE IN ISLAMIC COOPERATIVE**

In previous study by (Surkery & Yaacob, 2019) stated that current governance in cooperative is accordance with the Shariah principles describe in GP 28. In order to ensure the operation is keep following the Shariah principles, Shariah audit is required to conduct the assessment. On the other hands, (Musa, Shah, & Yaacob, 2018)stated that currently, there is limited Shariah related reference platform in SKM since SKM lacks in providing Shariah division or an experience auditor. The cooperatives may find difficulties in handling the Shariah audit since in regulatory level, there is lacking in Shariah reference. However, SKM mentioned in GP 28, to outsource or appoint Shariah advisor to supervise and consult on Shariah issues and audit in their respective cooperative. This can assist the cooperative sector to have an experience and competence Shariah expert to monitor, advice and perform audit work on Shariah related matter.

Some of the cooperatives may execute the Shariah governance while few are still in the process of developing Shariah governance. Shariah governance in cooperative is still in developing stage, however few cooperatives start to implement Shariah governance and refer

to Islamic Financial Institutions mechanism. It is necessary to established both Shariah governance and Shariah audit as forms of regulation in order to provide people with confidence and prevent allegations of misconduct from parties who contradict with the cooperative operation (Asia Alkharib, Se Yaacob 2016)

### **SHARIAH REVIEW**

As being conducted in IFI, Shariah review is an operation that regularly evaluates whether the IFI's operations, businesses, affairs, and activities comply with Shariah regulations (SGPD 2019). The Shariah review role must determine, evaluate, and keep tract of whether the IFI's business operations and activities are compliant with Shariah, report update to board, Shariah Committee and senior management on Shariah non-compliance issues and findings, inform them of the most recent development in legal and regulatory requirements in Islamic finance and ensure that officers of an IFI receive adequate training and guidance on Shariah governance. Previous study by (Itam, Hasan, & Alhabshi, 2017) mentioned that Islamic Financial Institutions subject to a more rigorous process of Shariah governance as compare to the Islamic cooperatives, that is more flexible for the requirement.

In cooperative, there is no practice on Shariah review yet since the cooperative still at developing stage of Shariah governance and Shariah audit. However, there are some big cooperative that operate under banking, they have Shariah review from the banking. The process of Shariah review can be adapted in Islamic cooperative slowly once the cooperative implement Shariah Governance and able to recruit and appoint Shariah reviewer in the cooperative. The Shariah Governance Framework requires that Internal Shariah reviews and Shariah audits must carried out on a regular basis in order to assess the level of Shariah compliance (Shafii et al., 2013)

In short, cooperative does not develop Shariah review yet but implement Shariah governance by performing Shariah audit. Few of the cooperative starting to outsource for Shariah officer to audit and review Shariah element in the operation.

### **SHARIAH RISK**

A Shariah risk in Islamic cooperative sector also refers to the prohibition of elements such as riba, maysir (gambling), and gharar (uncertainty) in any transaction that takes place. A Shariah risk is one of the operational risks since a cooperative will face the risk of financial loss as a result of Shariah non-compliance activities. According to Shariah Governance Policy Document, Shariah risk management is a process that systematically identifies, quantifies, monitors, and reports risk of non-compliance with the Shariah in the operation, business and activities. The officers who perform the Shariah risk management must at least have the knowledge on Shariah requirements applicable to the operation. In IFI, the Shariah risk management has been done since SGPD published, however in cooperative still looking at risk but not having proper setup or implementation like Shariah risk management in IFI. Coopeartive must look into Shariah risk in different Islamic product which the objective is still to ensure the Shariah compliance in the institutions. In future, cooperative can have proper execution of Shariah risk management to ensure that institutions can reduce and mitigate the Shariah risk.

### **Methodology**

This research uses a qualitative method as a research approach by conducting an interview session with 10 representatives from cooperatives under SKM. A semi-structured and a short

questionnaire are provided to gather the data for this research. It was developed based on a literature review and upon consulting the experts in the audit at the Islamic cooperative. The interview and questionnaire questions focus on Shariah audit practice, Shariah review function, and Shariah risk. The questions on the implementation of the audit were asked to identify elements to strengthen Shariah governance in cooperative. These questions indirectly correspond to the objective of this research, which to determine the components to strengthen Shariah governance in cooperative. Purposive sampling was used for this study's sampling, and the respondents were those working in Islamic cooperatives but in different sizes of cooperatives, as shown in Table 1 below:

Interviewees	Gender	Size of cooperative	Years of experience work
Respondent 1	Male	Small	3 years
Respondent 2	Male	Small	3 years
Respondent 3	Male	Small	3-5 years
Respondent 4	Male	Small	3-5 years
Respondent 5	Male	Small	3-5 years
Respondent 6	Male	Medium	3-5 years
Respondent 7	Female	Small	3-5 years
Respondent 8	Female	Medium	3-5 years
Respondent 9	Female	Medium	5 years
Respondent 10	Male	Medium	5 years

TABLE 1: List of cooperative's respondents

Data analysis requires examining the data to look at each element of the information gathered. The interview transcripts were analysed for results and findings using a range of data analytic methods. This comprises thematic analysis, content analysis, and interview transcription. The most popular technique for analysing qualitative data from texts with documentation is content analysis.

## RESULTS AND DISCUSSION

### SHARIAH AUDIT PRACTICE

A Shariah audit is an independent assessment of the quality and effectiveness of the cooperative's internal control, risk management system, governance process, and overall compliance of the cooperative's operations, business, affairs and activities with Shariah. The respondents were asked whether Shariah audit is carried out in the cooperative, and about 10 representatives from cooperative mention that their cooperative does not conduct Shariah audit. Few of the respondent that mentioned on non-existence of Shariah audit are coming from small cooperatives, while there are a few medium cooperative that does not conduct Shariah audit.

Table 2 below briefly summarize on the responses from the cooperative:

Response	Reason
"...Our cooperative does not perform Shariah audit because of Shariah officer lack in knowledge and skills in Shariah audit" R2	Lack in knowledge and skills

"We don't conduct Shariah audit because limited guidance and info on executing Shariah audit" R1	Limited guideline on Shariah audit
"No Shariah audit in my cooperative since we don't have expertise" R2	No expertise to conduct Shariah audit
"There is no Shariah governance established with Shariah audit department to perform the assessment" R4	No Shariah governance and no Shariah audit department
"Since hiring a Shariah audit is expensive, cooperative is unable to perform audit" R5	Costing to higher Shariah auditor
"Our cooperative didn't receive the awareness on the importance of Shariah audit in our cooperative" R4	Less awareness on importance of Shariah audit
"Not sure on the Shariah audit in cooperative should be conducted" R5	Less awareness on importance of Shariah audit
"Our cooperative doesn't have enough Shariah auditor to conduct audit, we lack in the human resources part" R6	Lack in Shariah auditor
"Our cooperative doesn't have Shariah certificate yet, so we don't have to conduct Shariah audit" R2	Lack of info and knowledge on Shariah audit
"We don't have enough guideline on the execution of Shariah audit" R4	Lack of guideline in Shariah audit

Table 2: Response from respondent on Shariah audit practice

Based on the above response, some of the cooperative don't conduct audit because of lacking in some areas such as knowledge and experience, guideline and no awareness of Shariah audit. On the other hands, there are cooperative that conduct Shariah audit by monitor periodically, recruit external auditor, appoint specific Shariah officer that will audit Islamic product or audit by Angkasa. In addition, one of the respondents add on to the finding above by saying that:

*"The development of Shariah audit is still at early stage in cooperative sector and we try to conduct audit in our cooperative" R7*

In a similar assertion, respondent stated that:

*"The integrity of the cooperatives on Shariah compliance will be a concern without a Shariah audit" R8*

Another respondent added some comment:

*"We conduct audit to assess on internal controls, risk management procedures, governance procedures, and general operational compliance of the cooperative "R9*

Other respondent also mentioned that, Shariah audit can ensure business operations continue to move steadily forward, the implementation of comprehensive Shariah assessment is achievable. A few cooperative conduct audits because they have the capacity, the Shariah officer to handle and monitor on Shariah parts. One of the cooperatives believe that by conducting Shariah audit, cooperative members should be aware that the institutions complies with Shariah. About 24 of the representatives from cooperative mentioned that they

start to execute Shariah audit by outsource to external auditor or appoint internal Shariah auditor in their cooperative.

However, apart from the discussions above, another respondent viewed the situation differently by saying there are uncertainties about the execution of Shariah audit in their cooperative as per below:

*"I am not sure on Shariah audit in my cooperative because we still don't know the procedure and process to conduct Shariah audit" R1*

There are two respondents comment that the Shariah audit in their cooperative is still under review and checking on the procedure of Shariah audit. Both of them agree as per below:

*"The Shariah audit process is still under progress before performing the Shariah audit" R1 and R5*

Based on the above response, researcher can identify that, the staff in cooperative are unaware on the process of Shariah audit in their cooperative. It is necessary for the cooperative's management to take steps to ensure every employee has an understanding of Shariah compliance and the auditing process in cooperatives.

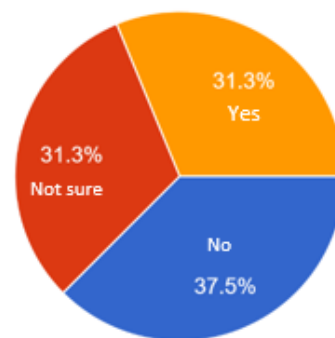


Figure 1: Feedback on the implementation of Shariah audit in the cooperative sector

During the interview, a short survey was sent to respondent to report on the study of Shariah audit in the cooperative sector. Based on the result in Figure 1, only 37.5% of respondents stated that they implement the Shariah audit process in their respective cooperatives. While as many as 31.3% stated that they have not implemented the process yet Shariah audit, the remaining 31.3% are not sure about the implementation of the Shariah audit process in cooperatives.

## SHARIAH REVIEW

A Shariah review discusses the extent to which an institution complies with the rules of Islam in all of its operations. Contracts, policies, transactions, memos, rules and regulations, financial statements, reports, and announcements are all subject to this review. IFI has been practicing Shariah review while in cooperative, but they are still at an early stage of development.

Most of the respondents agree that Shariah review is still at an early stage in the cooperative sector. For instance, the respondent mentioned that:

*"Our cooperative conducts Shariah review, we have a Shariah Review unit in the cooperative to review and give advice" R9*

*“Shariah reviews are conducted by a Shariah panel from Angkasa” R10*

The majority of the cooperative have Shariah units to ensure the operation of cooperatives based on Shariah complies with the rules and regulations. A respondent believes that Shariah review can mitigate Shariah non-compliance risk and that the Shariah review process should be conducted regularly. One of the respondents stated his point on Shariah review by saying that:

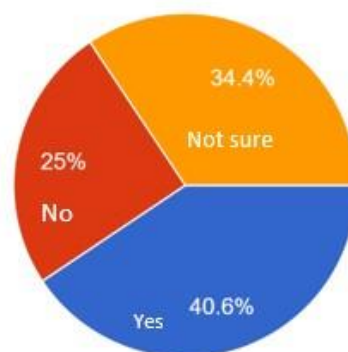
*“The Shariah review process is conducted twice a month in our cooperative to review the activities and products in the cooperative” R9*

A group of respondents that don't have Shariah review functions in the cooperative reveal their own perspectives and opinions on the Shariah review process.

*“Shariah review is under Shariah Committee responsibilities after we appoint them.” R8*

*“Our cooperative doesn't have a Shariah Committee to do Shariah review.” R6*

Two (2) respondents agree that SKM didn't provide a specific procedure to conduct



Shariah audits and reviews. The guidelines GP 28 provided by SKM are too general and do not provide a clear procedure on how to implement Shariah governance.

*“No specific details on Shariah-based business. Therefore, Shariah audit and reviews are not implemented in cooperative” R4 and R2*

One of the respondents added to the criteria above by saying that:

*“We have not yet started using Shariah government parts, but since the establishment of the cooperative, we have been practicing Islamic Shariah in the management every time we are in the cooperative. The Shariah review and Shariah audit have not yet been conducted” R1*

A few of the respondents are still new to Shariah audit and Shariah review development. Improper guidance from the regulator, SKM, may affect the process of Shariah governance implementation. However, among the respondents, those who are currently carrying out a Shariah review are in the majority. They conduct this in order to make sure that the company complies with Shariah. Furthermore, they have the capacity to allocate or outsource an external Shariah auditor.

Figure 2: Feedback on the implementation of Shariah review in cooperative sector

Figure 2 is short survey feedback from respondents on the implementation of Shariah review and Shariah audit. Based on the feedback, only 40.6% of the respondents stated that they implement the Shariah review process (Shariah review) in their respective cooperatives. Meanwhile, as many as 25% stated that they still have not implemented of the process of



Shariah review, and the remaining were not sure of the implementation of the review process in their cooperative.

### SHARIAH RISK

During the interview session, there were limited findings on the risk. Cooperatives must be aware that once they conduct Islamic based business activity, Shariah noncompliance risk is one of the risks that usually occur in Islamic cooperatives. They should have risk assessments for the product in order to reduce and mitigate the risk.

### CONCLUSION

From the perspective of Shariah governance, some of the cooperatives conduct Shariah governance practices. However, implementation of Shariah functions such as Shariah review and Shariah audit is seen to still be at the initial stage of cooperatives. Furthermore, few elements have been identified in the implementation of Shariah governance to strengthen Shariah governance by conducting Shariah audits, Shariah reviews, and Shariah risk. Few parties such as SKM and IKMa are necessary to provide a deep focus on the production of Shariah governance. This includes strengthening the Shariah audit guideline and enhancing Shariah enforcement and regulatory compliance Shariah. In order for any organization, including cooperatives to achieve its goals, good governance is essential. Therefore, after developing the Shariah governance structure in Islamic cooperatives, ongoing action to strengthen Shariah governance is needed to improve cooperative integrity. Shariah audit, Shariah review, and Shariah risk are some of the areas that cooperatives can look into to strengthen the Shariah governance structure among themselves. As a way to ensure the sustainability of the cooperative, appropriate governance must be maintained.

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