Accounting, Auditing & Corporate Governance Standards for Islamic Banks & Islamic Financial Institutions with reference to AAOIFI
About AAOIFI

The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) is an Islamic international autonomous non-for-profit corporate body that prepares accounting, auditing, governance, ethics and Shari’ah standards for Islamic financial institutions and the industry. AAOIFI, established in 1991 and based in Bahrain, is the leading international not-for-profit organization primarily responsible for development and issuance of standards for the global Islamic finance industry. It has issued a total of 100 standards in the areas of Shari’ah, accounting, auditing, ethics and governance for international Islamic finance. It is supported by a number of institutional members, including central banks and regulatory authorities, financial institutions, accounting and auditing firms, and legal firms, from over 45 countries. It’s standards are currently followed by all the leading Islamic financial institutions across the world and have introduced a progressive degree of harmonization of international Islamic finance practices.

AAOIFI Financial Accounting Standards

There are 26 Financial Accounting Standards (FAS) developed by AAOIFI. These standards are described below:

FAS 1: General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions

This standard is applicable to the financial statements published by Islamic banks to meet the common information needs of the main users of such statements and applicable to all Islamic banks regardless of their legal form, countries of incorporation, or size.

This standard covers the following points:

1. General provisions
   I. The complete set of financial statements
   II. Comparative financial statements
   III. Rounding amounts presented in the financial statements
   IV. The form and classification of the financial statements and the terminology used should be easy to understand
   V. Numbering of pages
   VI. Notes of the financial statements

2. General disclosures in the financial statements

3. Presentation and disclosure in each statement
   I. Statement of Financial Position
   II. Income Statement
   III. Statement of Cash Flows
   IV. Statement of Changes in Owners’ Equity or Statement of Retained Earnings
   V. Statement of Changes in Restricted Investments
   VI. Statement of Sources and Uses of Funds in the Zakah and Charity Fund
   VII. Statement of Sources and Uses of Funds in the Qard Fund
4. Treatment of changes in accounting policies
5. Treatment of changes in non-routine accounting estimates
6. Treatment of a correction of an error in prior period financial statements

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<th>FAS 2: Murabaha and Murabaha to the Purchaser Orderer</th>
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<td>This standard aims at setting out accounting rules for recognizing, measuring and disclosing the transactions of Murabaha and Murabaha to the purchase orderer that are carried out by Islamic banks and financial institutions. This standard shall apply to the assets available for sale by Murabaha and Murabaha to the purchase orderer, the revenues, expenses, gains and losses attributable to such an asset as well as Murabaha receivables.</td>
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<td>This standard covers the following points:</td>
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<td>This standard aims at setting out accounting rules for recognizing, measuring and disclosing the transactions of Mudaraba financing that are carried out by Islamic banks and financial institutions. This standard shall apply to Mudaraba financing transactions carried out by the Islamic bank as a provider of funds and the transactions related to the capital provided by the Islamic bank to be used in a Mudaraba, from the time of its inception to the time of its completion.</td>
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<td>This standard covers the following points:</td>
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<tr>
<th>FAS 4: Musharaka Financing</th>
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<tr>
<td>This standard aims at setting out accounting rules for recognizing, measuring and disclosing the transactions of Musharaka financing that are carried out by Islamic banks and financial institutions. This standard shall apply to Musharaka financing transactions carried out by the Islamic bank whether by means of a constant Musharaka or a diminishing Musharaka.</td>
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<tr>
<td>This standard covers the following points:</td>
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<tr>
<td>1. Recognition of the Islamic bank’s share in Musharaka capital at the time of contracting</td>
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<td>2. Measurement of the Islamic bank’s share in Musharaka capital at the time of contracting</td>
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</table>
3. Measurement of the Islamic bank’s share in Musharaka capital after contracting at the end of a financial period
4. Recognition of the Islamic bank’s share in Musharaka profits or losses
5. Disclosure requirements

**FAS 7: Salam and Parallel Salam**

This standard addresses the accounting rules of salam financing and parallel salam transactions. This standard covers the following points:

1. Salam financing shall be recognized when the capital of salam is paid to al-muslim ileihi or when it is made available to him.
2. Parallel salam transactions shall be recognized when the Islamic bank receives the capital of salam.
3. At the time of contracting
   - Capital is measured by the amount paid.
   - Capital provided in kind or benefit shall be measured at the fair value of the asset or the provided benefit.
4. At the end of a financial period
   - Capital is measured at the end of a financial period as stated above in 3.

**FAS 8: Ijarah and Ijarah Muntahia Bittamleek**

This standard aims at setting out accounting rules for recognizing, measuring, presenting and disclosing the transactions of Ijarah and Ijarah Muntahia Bittamleek that are carried out by Islamic banks and financial institutions. This standard addresses the accounting rules relating to Ijarah and Ijarah Muntahia Bittamleek in which the Islamic bank is a lessor or a lessee, including the acquisition of assets for Ijarah, Ijarah expenses, revenues, gains and losses.

This standard covers the following points:

1. Operating Ijarah
   I. Operating Ijarah in the financial statements of the Islamic bank as a lessor
      - Assets acquired for Ijarah
      - Ijarah revenue
      - Initial direct costs
      - Repairs of leased assets
   II. Operating Ijarah in the financial statements of the Islamic bank as a lessee
      - Ijarah expense
      - Initial direct costs

2. Ijarah Muntahia Bittamleek
   - Ijarah Muntahia Bittamleek in the financial statements of the Islamic bank as a lessor
   - Ijarah Muntahia Bittamleek in the financial statements of the Islamic bank as a lessee

3. Sale and leaseback
4. Subleases

**FAS (9): Zakah**

This standard aims at setting out accounting rules for the treatments related to the determination of the Zakah base, measurement of items included in the Zakah base and disclosure of Zakah in the financial statements of the Islamic banks and financial statements.

This standard covers the following points:

1. **Determination of Zakah base**
   
The zakah base shall be calculated by using 2.5% for a lunar calendar year and 2.5775% for a solar calendar year.

2. **Treatment of Zakah in the financial statements**
   
   - Zakah shall be treated as an expense of the Islamic bank and shall be included in the determination of net income in the income statement.
   
   - Unpaid zakah shall be treated as a liability and presented in the liabilities section in the statement of financial position.

**FAS (10): Istimna’a and Parallel Istimna’a**

This standard addresses the accounting rules of Istimna’a and Parallel Istimna’a contracts in the financial statements of Islamic banks relating to measuring and recognizing the costs and revenues from Istimna’a and Parallel Istimna’a, the gains and losses accruing therefrom, and their presentation and disclosure in the financial statements of the Islamic bank.

This standard covers the following points:

1. **Istimna’a costs**
   
   - Istimna’a costs consist of:
     
     a. Direct costs
     
     b. Indirect costs

   - Istimna’a costs incurred during a financial period as well as pre-contract costs shall be recognized in an Istimna’a work-in-progress account and reported under assets in the statement of financial position of the Islamic bank.

2. **Contract costs in parallel Istimna’a**

3. **Istimna’a revenue and profit at the end of a financial period**

4. **Measurement of Istimna’a work-in-progress, Istimna’a costs and treatment of contract losses at the end of a financial period**

5. **Change orders and additional claims**

**FAS (11): Provisions and Reserves**

This standard shall apply to the provisions formed by the Islamic bank to revalue its receivables, financing and investment assets. However, if losses have occurred relating to off-balance sheet items, provisions shall be made for such losses. The standard shall also apply to the reserves set aside by the Islamic bank, either from the mudaraba income, before allocating the mudarib share, or from the profit of investment account holders, after allocating the mudarib share.
1. Provisions
   I. Definition and types of provision
   II. Recognition of provisions
   III. Measurement of provisions
      - Specific provision
      - General provision
   IV. Presentation requirements
      - Specific provision related to each of financing and investment assets shall be deducted from these assets so that they are reported in the statement of financial position at the lower of cost and cash equivalent value.
      - General provision shall be deducted from the total value of receivables, financing and investment assets.

2. Reserves
   I. Definition, types of reserves and the sources from which they should be deducted
      - Profit equalization reserve
      - Investment risk reserve
   II. Recognition of reserves
   III. Measurement of reserves
   IV. Presentation requirements
      - Share of unrestricted investment account holders in the Profit equalization reserve shall be presented under the equity of unrestricted investment account holders and the share of the Islamic bank in this reserve shall be presented as part of reserve under owner’s equity in the statement of financial position.
      - The investment risk reserve shall be presented under the equity of unrestricted investment account holders in the statement of financial position.

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**FAS (14): Investment Funds**

This standard shall apply to funds which are established and managed in accordance with Shari’ah rule and principles and are financially independent of the institutions that establish them.

1. General provisions
   - The complete set of financial statements
   - Comparative amounts in the financial statements
   - The form and classifications of the financial statements
   - Numbering of pages and notes
2. Statement of Net Assets
3. Statement of portfolio investment, receivables and financing
4. Statement of operations
5. Statements of changes net assets or statement of cash flows
6. Statement of financial highlights
FAS (16): Foreign Currency Transactions and Foreign Operations

This financial accounting standard for Foreign Currency Transactions and Foreign Operations is intended to set out the accounting rules for recognizing, measuring, presenting and disclosing foreign currency transactions and foreign operations that are undertaken by Islamic banks and financial institutions.

1. Accounting treatment for foreign currency transactions
   I. Foreign currency transactions other than Mudaraba or Musharaka shall be recognized on the date of the transaction at the prevailing spot exchange rates.
   II. Foreign currency transactions based on Mudaraba or Musharaka contracts.
   III. Amount recognized on the date of receipt of the foreign currency amount.

2. Accounting treatment for the purpose of preparing financial statements
   Monetary assets and liabilities denominated in foreign currencies shall be translated (revalued) into the reporting currency at the prevailing spot exchange rates on the date of the financial statements.

3. Presentation requirements
   I. Foreign exchange differences resulting from transactions attributable to unrestricted investment accounts, whether gains or losses shall be presented in the income statement.
   II. Any differences, whether gain or loss, arising from revaluation of foreign currency monetary assets or liabilities attributable to owners’ equity shall be presented in the income statement.

FAS (18):

Islamic Financial Services offered by Conventional Financial Institutions

This standard shall apply to the institutions which offer Islamic financial services in addition to their conventional financial services.

1. General provisions
   - Institutions offering Islamic financial services through branch either have separate or no separate accounts from conventional branches
   - Institutions managing Islamic investment funds
   - Institutions offering Islamic financial services which either have or do not have separate accounts for these activities, and which offer them either directly through conventional departments or through separate Islamic financial services units.

2. General requirements
   - Institutions offering Islamic financial services shall declare that such services are in compliance with Shari’ah requirements.
   - Appoint a shari’ah supervisory board which shall present a shari’ah report
   - Implement the Governance Standards issued by AAOIFI that relate to the Shari’ah supervisory board.
FAS (20): Deferred Payment Sale

This standard shall apply to: (a) assets available for deferred payment sale, (b) the revenues, expenses, gains and losses relating to these assets, and (c) receivables arising from deferred payment sale transactions.

1. Accounting treatment for assets available for deferred payment sale
   - The assets available for deferred payment sale shall be recognized at the point of contracting.
   - At the point of contracting, assets available for deferred payment sale shall be measured at cost.
   - At the end of financial period, assets available for deferred payment sale shall be measured at their fair value.
   - Assets available for deferred payment sale shall be presented in the statement of financial position under “Investment in assets available for deferred payment sale”.

2. Accounting treatment for revenues and profits of deferred payment sale transactions
   - Revenues from deferred payment sale transactions shall be recognized at the point of contracting.
   - Profits from deferred payment sale transactions shall be recognized on an accrual basis.

3. Accounting treatment for receivables from deferred payment sale
   - Receivable arising from deferred payment sale shall be recognized at the point of contracting and measured at their face value.
   - Receivable from deferred payment sale transactions shall be presented in the statement of financial position, net of deferred profits and provision for doubtful debts.

FAS (21): Disclosure on Transfer of Assets

This standard shall apply to the operations of transferring assets between different investment accounts conducted by institutions. These transfers shall include the following:

1. The transfer of assets from unrestricted investment accounts to restricted investment accounts.
2. The transfer of assets from investment accounts to owners’ equity.
3. The transfer of assets from restricted investment accounts to other restricted investment accounts taking into consideration the differences in restrictions in the accounts.
4. The transfer of assets from investment accounts and owners’ equity to the investment funds and/or special purpose vehicles (SPV).

FAS (22): Segment Reporting

This standard is applicable to a set of financial statements which includes statement of financial position and income statement, prepared and published by Islamic financial institutions. Segment
information is to be presented for each of the parent, subsidiary or associate’s separate financial statements.

**Operating Segment**

- An operating segment may engage in business activities for which it has yet to earn revenues.
- An operating segment is divided into Business segments and Geographic segments.
  - Business segment is a distinguishable component that is engaged in providing an individual product or service or a group of related products or services which may have risks and returns that may be different from those of other business segments.
  - Geographic segment is a distinguishable component that is engaged in providing an individual product or service or a group of related products or services within a particular economic environment.

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<th>FAS (23): Consolidation</th>
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<tr>
<td>This standard is applicable to the consolidated financial statements prepared and presented by an Islamic Financial Institution (IFI) as a parent entity. This standard sets out the principles for determining entities that are subject to be included in the consolidated financial statements of a parent and prescribes the accounting for investment in subsidiaries by parent.</td>
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<tr>
<td>1. Determination and scope of consolidated financial statements</td>
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<tr>
<td>An entity shall be classified as a subsidiary of an IFI if the IFI can exercise control over the investee entity. Control is presumed to exist if an IFI holds, directly or indirectly through its subsidiaries, 50% or more of the voting rights in an entity, unless it can be clearly demonstrated otherwise.</td>
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<tr>
<td>2. Presentation of consolidated financial statements</td>
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<tr>
<td>An Islamic financial institution is required to prepare and present consolidated financial statements, consolidating its own separate financial statements with those of its subsidiaries.</td>
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<tr>
<td>3. Consolidation procedures</td>
</tr>
<tr>
<td>- Consolidated financial statements shall be prepared by combining the financial statements of the IFI with those of the subsidiaries. This shall be carried out through adding like items line by line.</td>
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<tr>
<td>- Intra-group transactions between the IFI and the subsidiaries shall be eliminated.</td>
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<td>- In preparing the consolidated financial statements, the same accounting policy shall be applied to the financial statements that are subject to consolidation and the consolidated financial statements.</td>
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FAS (24): Investments in Associates

This standard is applicable to financial statements prepared and presented by an IFI. This standard sets out the principles for determining entities that are deemed to be associates and prescribes the accounting for investments in associates by parent/reporting entity.

1. Determination of an associate
   An entity shall be classified as an associate of an IFI if the IFI can exercise significant influence on the investee entity. Significant influence is presumed to exist if an IFI holds, directly or indirectly through its subsidiaries, 20% or more of the voting rights in an entity, unless it can be clearly demonstrated otherwise.

2. Accounting treatment for investments in an associate entity
   - The IFI’s investment in an associate shall be initially recognized when the investment is made and included in the financial statements under heading “Investment in Associates”.
   - The IFI’s investment in an associate shall be initially measured at cost.
   - Investment in associated in the separate financial statements of an IFI shall be accounted for either at cost or fair value.

FAS (25): Investments in Sukuk, Shares and Similar instruments

This standard aims at setting out principles for the recognition, measurement, presentation and disclosure of investment in Sukuk, Shares and Similar instruments that exhibit characteristics of debt and equity instruments made by Islamic financial institutions.

1. Classification
   - Each investment is segregated as investment in debt-type instruments and equity instruments.
   - Debt-type instruments are investments that have terms providing fixed or determinable payments of profits and capital to the holder of instrument.
   - Equity-type instruments are investments that do not exhibit features of debt-type instruments and include instruments that evidence a residual interest in the assets of and entity after deducting all its liabilities.
   - Investment in debt-type instruments shall be classified under following categories:
     I. Investment at fair value through income statement
     II. Investments carried at amortized cost
   - Investment in equity-type instruments shall be classified under following categories:
     I. Investment at fair value through income statement
     II. Investments at fair value through equity

2. Measurement
- After initial recognition, all investments shall be subsequently measured in accordance with the initial classification of the investment; i.e., at fair value or amortized cost.

3. Reclassification
   - After the designation, investments in debt-type securities shall not be reclassified not be reclassified into or out of the fair value and amortized cost categories.
   - After the designation, investments in equity-type securities shall not be reclassified not be reclassified into or out of the fair value through income statement and equity categories.

4. Presentation requirement
   - At the end of the financial period, investments shall be presented separately as a line item on the assets side of the statement of financial position.
   - Income and gains/losses from all types of investments shall be presented in the income statement under “Income or gains/losses from Investment”.

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FAS (26): Investment in Real Estate

This standard aims at setting out principles for the recognition, measurement, presentation and disclosure of investment in real estate that is acquired for the purpose of earning periodical income or held for future capital appreciation or both.

1. Definition
   The following terms are used in this standard:
   - Carrying amount
   - Cost
   - Fair value
   - Investment in real estate

2. Recognition
   - Investment in real estate shall be recognized as an asset when and only when:
     I. It is probable that the future economic benefits that are associated with the investment in real estate will flow to the entity.
     II. The cost of the investment in real estate can be measured reliably.
   - An entity evaluates under this recognition principle all its investment in real estate costs at the time they are incurred.

5. Measurement
   - Investment in real estate shall be measured initially at its cost including directly attributable expenditure.

6. De-recognition
   - An investment in real estate shall be derecognized on disposal or when the investment in real estate in permanently withdrawn from use and no future economic benefits are expected from its disposal.

7. Presentation requirement
- At the end of the financial period, investment in real estate shall be presented separately as a line item on the assets side of the statement of financial position.
- Income and gains/losses from investment in real estate shall be presented separately in the income statement or in the notes under “Gains/losses from Investments in real estate”.

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<th>FAS (27): Investment Accounts</th>
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This standard shall apply to on-balance sheet and off-balance sheet, unrestricted and restricted investment accounts managed by Islamic financial institutions (IFI).

1. Definition
An investment account is defined as an account for the holder of an instrument under a Mudaraba or its equivalent representing funds received by the Islamic financial institution for investment on behalf of the other party.

2. Recognition, De-recognition and Measurement
- When an investment account is recognized initially the Islamic financial institution shall recognize it at the fair value of the consideration received at the date on which the contract becomes effective.
- Investment accounts are recognized when they satisfy the following criteria:
  I. Cash or cash equivalent has been received by an IFI under legally enforceable Mudaraba or other similar contract
  II. There are no preconditions to the contract becoming valid.
- Investment accounts are derecognized when they satisfy the following criteria:
  I. Cash or cash equivalents has been returned by the IFI.
  II. The fair value can be determined with reasonable certainty.
  III. Mudaraba or similar contract is terminated and there are no further legally enforceable obligations.

3. Presentation
- Equity of on-balance sheet investment accountholders shall be presented as an independent category in the statement of financial position.

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<th>AAOIFI Auditing Standards</th>
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There are 5 auditing standards developed by AAOIFI. These standards are described below:

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<th>Auditing Standard No. 1: Objective and Principles of Auditing</th>
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The purpose of Auditing standard for Islamic financial institutions is to establish standards and provide guidance on the form and content of the auditor’s report issued as a result of an audit performed by an independent auditor of the financial statements. The auditor report should contain a clear written expression of opinion on the financial statements taken as a whole.
Basic elements of the auditor’s report:
- Title
- Addressee
Auditing Standard No. 3: Terms of Audit Engagement

The purpose of this Auditing Standard for Islamic Financial Institutions (ASIFI) is to establish standards and provide guidance on the appointment of an auditor to audit the financial statements of a financial institution which conducts business in conformity with Shari’ah rules and principles.

The main points are:
- Agreeing the terms of the engagement with the Islamic financial institution (client)
- The auditor’s response to a request by a client to change the terms of an engagement to one that provides a lower level of assurance.

This standard covers the following points:
- Audit engagement letters
- Basic content of the engagement letter
- Objective of the audit of the financial statements
- Management’s responsibility for the financial statements
- Management’s representation
- Scope of an Audit
- Form of Reports
- Fees
- Agreement of the Terms of Engagement
- Audit of components
- Recurring Audits
- Acceptance of a change in Engagement

Auditing Standard No. 4: Testing for Compliance with Shari’ah Rules and Principles by an External Auditor

The purpose of this Auditing Standard for Islamic Financial Institutions (ASIFI) is to establish standards and provide guidance on the subject of testing for compliance with Shari’ah Rules and Principles by an External Auditor in connection with audit of the financial statements of a financial institution which conducts business in conformity with Shari’ah rules and principles.

This standard covers the following points:
- Responsibility of an external auditor for compliance with Shari’ah rules and principles.
- Scope of the auditor’s work
- Reference to the Shari’ah supervisory board (SSB)
- Making the Auditor’s draft report available to the SSB

**Auditing Standard No. 5:**
**Auditor’s responsibility to consider fraud and error in an audit of financial statements**

The purpose of this Auditing Standard for Islamic Financial Institutions (ASIFI) is to establish guidance on the auditor’s responsibility when considering the risk of fraud and error in an audit of financial statements of an Islamic financial institution.

The standard shall provide the following:
- Guidance on the characteristics of fraud and error the limitation of the auditor’s responsibility in relation thereto
- Define the minimum procedures that shall be applied by and auditor in case of indication, inquiries and discussions relating to any fraud and error in the financial statement of and Islamic finance institution (IFI).
- Guidance to the auditors relating to management representatives considering fraud and error in and IFI.

**AAOIFI Governance Standards**

There are 7 governance standards developed by AAOIFI. These standards are described below:

**Governance Standard No. 1:**
**Shari’ah Supervisory Board: Appointment, Composition and Report**

The purpose of this governance standard for IFI is to establish standards and provide guidance on the definition, appointment, composition, and report of the shari’ah supervisory board for ensuring compliance of the IFI in all its dealings and transactions with Shari’ah rules and principles.

This standard covers the following points:
- Appointment of shari’ah supervisory board and fixing of its remuneration
- Composition, selection and dismissal of shari’ah supervisory board
- Basic elements of the shari’ah supervisory board’s report

**Governance Standard No. 2:**
**Shari’ah Review**

The purpose of this governance standard for IFI is to establish standards and provide guidance to assist shari’ah supervisory board of IFIs in performing Shari’ah reviews to ensure compliance with Shari’ah rules and principles as reflected in the fatwas, rulings and guidelines issued by them.

This standard covers the following points:
- Responsibility for compliance with the Shari’ah
- Shari’ah review procedures
- Quality assurance
- Report
- Responsibility for implementation of the standard
Governance Standard No. 3: Internal Shari’ah Review
The purpose of this governance standard for IFI is to establish standards and provide guidance on the internal shari’ah review in institutions which conduct business in conformity with shari’ah rules and principles.
The standard covers the following:
- Internal shari’ah review
- Independence and objectivity
- Professional proficiency
- Scope of work
- Performance of the internal shari’ah review work
- Management of the internal shari’ah review
- Quality assurance
- Elements of an effective internal shari’ah review control system

Governance Standard No. 4: Audit and Governance Committee for Islamic Financial Institutions
The purpose of this governance standard for IFI is to define the role and responsibilities of an Audit and Governance Committee (AGC) for an IFI.
The standard covers the following:
- Importance of AGC
- Functions of AGC
- Responsibilities of AGC
- Reporting of AGC

Governance Standard No. 5: Independence of Shari’ah Supervisory Board
The purpose of this governance standard is to provide guidance for members of Shari’ah Supervisory Boards (SSBs) of IFIs pertaining to its independence, monitoring of such independence and ways to resolve issues of independence.
The standard covers the following:
- Importance of Independence of SSBs
- Basis of SSB Independence
- Resolution of issues of independence impairment
- Responsibility for implementation of this standard

Governance Standard No. 6: Statement of Governance Principles for Islamic Financial Institutions
The purpose of this standard is to serve as the minimum standard in the establishment of governance structures in an IFI. The principles set forth will also provide the foundation for AAOIFI in its effort to set governance standards in relation to some or all of the individual principles or aspects of the principles framework set out herein in future.
The principles of Governance are:
Governance Standard No. 7: Corporate Social Responsibility, Conduct and Disclosure for Islamic Financial Institutions

The purpose of this governance standard for Islamic Financial Institutions (IFI) is to establish standards on the definition of Corporate Social Responsibility (CSR) for Islamic financial institutions, provide both mandatory and recommended standards to implement CSR in all aspects of the IFI activities and provide guidance on disclosure of CSR information to the IFI’s stakeholders.

This standard covers the following points:
- Definition of CSR for Islamic Financial Institutions
- Objectives of the Standard
- Responsibilities under this standard
- Disclosure requirements and presentation treatment options
- Responsibility under this standard