CHAPTER TWO

AUDITING IN ISLAM

2.1 INTRODUCTION

This chapter reviews on the definition of Shariah audit and its practice in the Islamic banks. The first section of the chapter discuss on the view of auditing in Islam, the application of *hisbah* and its role in the early days. In the next section 2.2, highlights on the needs of Shariah audit and its definition. This section also compares the practice of Shariah audit with the conventional audit. Sections 2.3 to 2.5 will discuss on Shariah review, Shariah audit and compare between the two. Section 2.7 provides a review of Shariah audit practices in other countries such as Pakistan, GCC countries, Sudan and Indonesia. The information from this chapter will be used to guide the formulation of the research instruments used to investigate the current state of audit expectations gap in Shariah audit in Malaysian Islamic Banks.

2.2 AUDITING IN ISLAM

An earlier Islamic tradition was *hisbah* "الامربالمعروفالنهيعنالمنكرو" which is the concept of enjoining the good and forbidding the evil. *Hisbah* was institutionalised in the early days of Islam and did not focus on economic and commercial activities alone. Chik (2011) views that in the past, *hisbah* was an integral part of a just economy in a just society. One of the objectives of *hisbah* is to assist human beings in worshipping Allah (*ibadat*). These include facilitating to the rights of Allah, those related to the rights of others which includes Islamic financial transactions. The role of auditing is to monitor, control and prevent fraudulent exploitations on consumers in the marketplace. During Prophet Muhammad's (PBUH) time, in the Islamic history, the role of auditing is also known as *hisbah*. The function was linked to Quranic verses that urge Muslims to promote right and prevent wrong. For instance, the Quran notes:

> *"Let there arise from you a group calling to all that is good, enjoining what is right and forbidding what is wrong. It is these who are successful" (3: 104).*

Hisbah is essentially organised around safeguarding the limits of Allah from being violated, protecting the honour of the people, and ensuring public safety. It also includes monitoring the marketplace, craftsmanship, and manufacturing concerns to make sure that the laws of Islam are upheld by these entities (Abdullah, 2010). According to Imam Ghazali, the *hisbah* practice must be seen as a *fard kifayah* for Muslims; where every Muslim is expected to play a positive role in the propagation of good (*maaruf*) and suppression of evil (*mungkar*). A person who is appointed to administer the *hisbah* is called *almuhtasib* or *muhtasib*. The *muhtasib* is the official designated by the ruler to implement *hisbah* on behalf of the state. The institution of *hisbah* moved along with Muslims into the Western provinces of Spain and remained an integral part of the state. However, with the arrival of Western colonialism and the simultaneous eclipse of Islamic political strength, most of the Muslim institutions underwent a drastic decline. The institution of *hisbah* also declined in effectiveness and virtually disappeared. The effectiveness of *hisbah* was directly related to the strength of governance (Asri and Fahmi, 2004).

2.2.1 The Role of *Hisbah* in Contemporary Economy

Khan (1992) discussed the role of *hisbah* that promotes the achievement of market harmony. He argued that the *muhtasib* should manage the equilibrium of a country to attain a reasonable degree of efficiency and justice. The task should not be left to the state to manage for an optimum level of production and a friction-free flow of distribution. Secondly, Khan (1992) also argued that the *muhtasib* should regulate production and supply of goods and services. He needs to regulate that all trade need to be done in an open market. This is to avoid fraud, and collusion to bid up prices artificially. Thirdly, *muhtasib* must interfere in the event of the existence of market rigidities that economically powerful class can manipulate the price level. Thus, the *muhtasib* has a duty to apply corrective measures and to save the general public from hardship. In that situation, prices may be fixed by the *muhtasib* to restore a demand and supply relationship. Fourthly, it is the responsibility of the *muhtasib* to inspect the credit structure of an institution. Any transactions involving usury and *riba'* need to be avoided. The *muhtasib* also has the power to compel the debtor to repay their debts when due if they had means to do so. In case the debtor was unable to meet the claim till a later date, the *muhtasib* would arrange help from the zakat fund if they are entitled. Fifthly, according to Khan (1992) the responsibility of the *muhtasib* includes zoning and environmental affairs such as collect levies to raise fund for arranging water supply, garbage removal or any other communal services. A *muhtasib* is also responsible for manpower utilisation. The *muhtasib* would compel healthy and able-bodied individuals to engage themselves in some gainful pursuit. Lastly, the *muhtasib* is also accountable to ensure the efficiency in the public sector. There must be check and balance in the public funds and avoid improper conduct in the government office.

Based on the functions of *muhtasib* as outlined by Khan (1992), a *muhtasib* plays a major role in society to ensure every aspect of life is adherence to the Shariah. Previously a *muhtasib* not only caters on the economics or financial market aspect but the whole movement in the society. These will lead to a balance and harmonised society, which is free from unlawful activity.

2.2.2 *Hisbah* Exercise as a Scope of Shariah Audit on Morality

Murtuza and Abdallah (2007) summarised the duties performed by the *muhtasib* into three categories i) those relating to (rights of) God: These covered religious activities such as punctuality of prayers, organisations of Jum'a and 'Id congregations and the maintenance of mosques, ii) Those relating to the rights of people : These related to community affairs and behaviour in the market, such as accuracy of weights and measures and honesty in dealings, iii) Those relating to both: These pertained to municipal administration, such as keeping the roads and streets clean and lit at night and preventing the building of a factory or dwelling place which damage community interests. The criteria of Shariah auditor or *muhtasib* in the IFIs falls into the second category wherein the task is related to community affairs and behaviour in the market such as accuracy of weights and measures and honesty in dealings.

In this juncture, the practice of *hisbah* that serves the rights of the people in the society as in items ii and iii could be related to the measures in the market that ensure transactions are serving the Maqasid of the society. The application of these areas could be further operationalised to develop an extended scope of Shariah audit that includes the checks on the impact of Islamic financial transactions to the stakeholder and members of the society as a whole.

2.2.3 Application of *Hisbah* in the Auditing Profession

Hisbah is arguably the modern day audit of market players. In comparison to modern day audit, the role of *hisbah* is more expansive to include price controls and other regulative measures aimed to monitor market players as previously discussed. The role of *hasib* is to monitor, control and prevent fraudulent exploitations on consumers in the marketplace. The *hisbah* functions similar to an audit since it acts as a control mechanism within a corporation. In IFIs, this task will be carried out by the internal Shariah officer, internal auditor, as well as external auditor. The *hisbah* authority shall be placed on the management team so as to portray that they are responsible for auditing management (Asri and Fahmi, 2004). This is in line with the current requirement of the SGF (BNM, 2010) that Shariah audit shall be performed by the internal audit function of an IFI and directly report to the Audit Committee of the IFI.

The objective of *hisbah* is similar to the aim of the Shariah audit. The existence is to ensure compliance with rules and regulation set up by Islam and the local authority. Its position is best placed by internal Shariah review, internal auditor and external auditor (Asri and Fahmi, 2004; Kasim, 2010; Abdullah, 2010). These auditors, when performing their duties should be God fearing as they are responsible for a broad scale of users and are ultimately accountable to Allah. The auditors must have certain qualifications to assure that they fulfil their duties in compliance with Islamic law.

The most important criteria for the *muhtasib* are sincerity and impartiality, knowledge and wisdom, and mild temper (Kasim, 2010). These values will ensure that they will preserve their reputation so as to maintain their independence. In addition, Ibn Taymiya (1997) mentioned that the desirable traits of a *muhtasib* were considered to be *'Ilm* (Knowledge), *Rifq'* (Kindness) and *Sabr'* (patience). He added that the code of conduct for a *muhtasib* is to provide a system of checks and balances.

In addition, *hisbah* provides the benchmark to the Shariah audit practice on the technical aspects to ensure that Shariah contracts are applied as expected. In the past, trade has been seen as a major contributor to the Islamic civilisation. Allah in the Quran has manifested the special place of trade in Islam. Although trade is encouraged in Islam, *riba* (usury) is unacceptable as Allah has mentioned in the Quran (2: 275-276) "trading is permitted but riba (usury) is forbidden". This has been evidenced through this following verse:

فَاجْتَنِبُوهُ الشَّيْطَانِ عَمَلِ مِّنْ رِجْسٌ وَالأَزْلاَمُ وَالأَنصَابُ وَالْمَيْسِرُ الْخَمْرُ إِنَّمَا آمَنُواْ الَّذِينَ أَيُّهَا يَا

لَعَلَّكُمْ تُفْلِحُونَ

O ye who believe! Intoxicants and gambling, (dedication of) stones, and (divination by) arrows, are an abomination, - of Satan's handwork: eschew such (abomination), that ye may prosper (5:90).

بِالْبَاطِلِ النَّاسِ أَمْوَالَ لَيَأْكُلُونَ وَالرُّهْبَانِ الأَحْبَارِ مِّنَ كَثِيرًا إِنَّ آمَنُواْ الَّذِينَ أَيُّهَا يَا

اللهِ سَبِيلِ فِي يُنفِقُونَهَا وَلاَ وَالْفِضَّةَ الذَّهَبَ يَكْنِزُونَ وَالَّذِينَ اللهِ سَبِيلِ عَن وَيَصُدُّونَ

أَلِيمٍ بِعَذَابٍ فَبَشِّرْهُم

O ye who believe! There are indeed many among the priests and anchorites, who in Falsehood devour the substance of men and hinder (them) from the way of Allah. And there are those who bury gold and silver and spend it not in the way of Allah. Announce unto them a most grievous penalty (9:34)

Referring to the Qur'anic verse, it is clear that IFIs must ensure that their transaction is free from unlawful activities that may lead to Shariah noncompliance. The activities mentioned in the verse such as *riba'* is prohibited because it concentrates on wealth and nurtures inequality via exploitation. Islam also forbids speculation, gambling and hoarding. The only problem of this modern corporation is the inability to comply with certain values in Islam as well as the Shariah requirements. Due to that, proper checks and balances shall ensure the IFI are Shariah compliance. This is where auditing plays its role in ensuring the adherence to Shariah principles.

Hisbah is essentially organised around safeguarding the limits of Allah from being violated, protecting the honour of the people, and ensuring public safety. It also includes monitoring the marketplace, craftsmanship, and manufacturing concerns to make sure that the laws of Islam are upheld by these entities (Abdullah, 2010).

According to Imam Ghazali, the *hisbah* practice must be seen as a *fard kifayah* for Muslims; where every Muslim is expected to play a positive role in the propagation of good (*maaruf*) and suppression of evil (*mungkar*). The institution of *hisbah* moved along with Muslims into the Western provinces of Spain and remained an integral part of the state. However, with the arrival of Western colonialism and the simultaneous eclipse of Islamic political strength, most of the Muslim institutions underwent a drastic decline. The institution of *hisbah* also declined in effectiveness and virtually disappeared. The effectiveness of *hisbah* was directly related to the strength of governance (Asri and Fahmi, 2004).

Hisbah functions similar to an audit since it acts as a control mechanism within a corporation. In IFIs, this task will be carried out by the internal Shariah officer, internal auditor, as well as an external auditor. The *hisbah* authority shall be placed on the management team so as to portray that they are responsible for auditing the management (Asri and Fahmi, 2004). This is in line with the current requirement of SGF (BNM, 2010) that Shariah audit shall be performed by the internal audit function of an IFI and directly report to the audit committee of the IFI.

Murtuza and Abdallah (2007) summarised the duties performed by *muhtasib* into three categories i) those relating to (rights of) God: These covered religious activities such as punctuality of prayers, organisations of Jum'a and 'Id congregations and the maintenance of mosques, ii) Those relating to the rights of people : These related to community affairs and behaviour in the market, such as accuracy of weights and measures and honesty in dealings, iii) Those relating to both: These pertained to municipal administration, such as keeping the roads and streets clean and lit at night and preventing the building of a factory or dwelling place which damage community interests. The criteria of Shariah auditor or *muhtasib* in the IFIs falls into the second category on which the task is related to community affairs and behaviour in the market such as accuracy of weights and measures and honesty in dealings. However, in the scenario of the current practice in the IFIs, the scope of Shariah auditor or *muhtasib* has expanded to satisfy the stakeholders' desire for Shariah compliance. Although in the existing practises in IFIs in Malaysia the duties of the Shariah auditor or *muhtasib* only covers the second category, the first and third categories should be included as the main duties of aShariah auditor or *muhtasib* since they are accountable to Allah in the hereafter.

Khan (1992) discussed the functions of *muhtasib* using concepts from contemporary economics. He argued that the *muhtasib* should manage the equilibrium of a country to attain a reasonable degree of efficiency and justice. The task should not be left to the state to manage for an optimum level of production and a friction-free flow of distribution. Khan (1992) also argued that the *muhtasib* should regulate production and supply of goods and services. He needs to regulate all trade to be done in an open market. This is to avoid fraud, and collusion to bid up prices artificially. Thirdly, the *muhtasib* must interfere in the event of market rigidities that allow an economically powerful class to manipulate the price level. The *muhtasib* has a duty to apply corrective measures and to save the general public from hardship. In that situation, prices may be fixed by the *muhtasib* to restore a demand and supply relationship. Fourthly, it is the responsibility of the *muhtasib* to inspect the credit structure of an institution. Any transactions involving usury and *riba'* need to be avoided. The *muhtasib* has the power to compel the debtor to repay their debts when due if they had means to do so. In case the debtor was unable to meet the claim until a later date, the *muhtasib* would arrange help from the zakat fund if they are entitled. Fifthly, the responsibility of *muhtasib* includes zoning and environmental affairs such as collect levies to raise fund for arranging water supply, garbage removal or any other communal services. A *muhtasib* is also responsible for manpower utilisation. He is also responsible to ensure the efficiency in the public sector. There must be checks and balances in the public funds to avoid improper public administration.

Based on the functions of the *muhtasib* as outlined by Khan (1992), a *muhtasib* plays a major role in society to ensure every aspect of life adheres to the Shariah. A *muhtasib* not only caters for the wellbeing of the economy and financial markets but the entire society. This will lead to a balanced society free from unlawful activity. From the current perspectives, the role of the Shariah auditor in the IFIs needs to cover all aspect of the institutions not only its financial operations. Samad (2011) mentioned that Shariah auditors are expected to reflect their responsibility and accountability not only to the management and stakeholders but more importantly to God. Thus, a Shariah auditor must be a person qualified with a Shariah and accounting background to ensure proper checks and balances in the overall operations of the IFIs.

2.2 THE NEEDS OF SHARIAH AUDIT

For many years, the study and practice of auditing were structured according to the conventional framework. Auditing is the accumulation and evaluation of evidence to determine and report on the degree of correspondence between the information and established criteria (Arens, 2011). A competent and independent person should perform the auditing task.

With the development of IFIs and the introduction of an alternative approach to banking and finance, Shariah auditing emerged as an essential tool to help ensure Shariah compliance. Shariah audit is currently performed by the IFIs to make sure that the activities and operations of an IFI adhere to the Shariah. Due to the unique features of IFIs such as the prohibition of *riba*, *gharar*, *maysir*, the current statutory audit may not be sufficient to satisfy the Shariah requirement. The accumulation and evaluation of evidence through the current statutory audit may not achieve the degree of Shariah compliance in the IFIs since it should also cover the spiritual aspect of the activities and operations of the IFIs.

Shariah audit can be defined as a process of accumulating and evaluating evidence (Abdul Rahman, 2008) related to the overall activities and operations [process, personnel, financial and non-financial performance, financial position, systems, marketing, and etc.] of the IFIs in which the information gathered must adhere to Shariah principles (Ibrahim, 2009). Shariah audit in the IFIs shall be performed by independent auditors competent in addressing Shariah matters. The objectives of the Shariah audit are to provide an independent assessment and assurance to add value and improve the degree of compliance in relation to the IFI's business operations. It ensures a sound and effective internal control system for Shariah compliance.

Statutory or conventional audit is performed to ascertain the validity and reliability of the information provided by organisations. It also provides an assessment of a system's internal control of organisations (Arens, 2009). The goal of an audit is to express an opinion on the financial statement that it is being prepared in accordance with the approved accounting standards of a country. Due to the limited resources and time constraints, an audit seeks to provide a reasonable assurance that the statements are free from material misstatement. Hence, statistical sampling is often adopted in audits. In the case of financial audits, a set of financial statements are said to be true and fair when they are free of material misstatements - a concept influenced by both quantitative (numerical) and qualitative factors.

Shariah audit differs from a statutory audit in many aspects. One of the main differences is that a statutory audit focuses more on the financial aspect of an institution that the report of the financial statements shall reflect a true and fair view whereas Shariah audit highlights how the overall activities and operations of the IFIs are in line with the Shariah requirements. For example, Shariah requirements prohibit, among other things, the payment and receipt of *riba* or usury, gambling, hoarding and speculation (Qureshi, 1976). Islam also forbids any investing or dealing in alcohol, pork and other activities considered unlawful from an Islamic perspective. In Shariah audit, the auditors must also attest that management has complied not only with the Shariah aspects but also with the wider objective of Shariah (Maqasid al-Shariah), which is to protect and improve the condition of human life (Mustafa and Taib, 2011). In addition, statutory audit requires an independent and qualified chartered accountant as an auditor whereas in Shariah audit the person must not only be a qualified auditor but also a qualified Shariah person (Kasim, 2010). If the auditor performing the Shariah audit is not qualified in Shariah, it will jeopardise the competency level as a Shariah auditor.

This is significant due to the salient features of the IFIs in which it operates. Ibrahim (2011) highlights the difference between Islamic auditing and conventional auditing in the table below:

Table 1: Comparison between conventional and Shariah auditing

Element	Conventional auditing	Shariah auditing
Three party relationship	Entity, auditor, user	Entity, auditor and broader range of users
Appropriate subject matter	Financial statement assertions	Processes, contracts, personnel, systems, performance, financial statements
Suitable criteria	IFRS	Shariah principles and rules, AAOIFI standards and appropriate parts of IFRS
Sufficient appropriate evidence	Observation, inquiry, physical examination, vouching of documents and minutes of directors meetings	SSB rulings, fatwas of international and national fiqh boards, plus all other conventional evidence
Written assurance report	Standard audit report prepared by the auditor	A more detailed report prepared by a Shariah auditor

*Source: Ibrahim (2011)

According to the table above, conventional auditing and Islamic auditing differ regarding the parties involved in auditing. In the conventional audit, the parties involved in auditing are the entity, the auditors and the users of the related financial statements whereas in Islamic auditing, besides the entity and the auditors it involves a broader range of users such as the depositors and stakeholders. Islamic auditing involves a broader range of users due to the wide scope of subjects that need to be covered during auditing such as processes, contracts, personnel, systems, performance, and financial statements. Usmani (2002, p.116) mentioned that:

> *"...for being 'Islamic' it is not sufficient to design the transactions on Islamic principles. It is also necessary that the outlook of the institution and its staff reflect the Islamic identity quite distinguished from the conventional institution. This requires a major change in the general attitude of the institution and its management. Islamic obligations of worship as well as the ethical norms must be prominent in the whole atmosphere of an institution which claims to be Islamic".*

The above highlights the importance of Islamic auditing in IFIs. Shariah audit will ensure that IFIs are measured by their compliance with Islamic principles which involves the entire institution, its staff and atmosphere. The conventional audit is very different since it only deals with the veracity of financial statements. The conventional audit is based on International Financial Reporting Standards (IFRS) regarding reporting whereas Islamic auditing follows Shariah principles and rules, AAOIFI standards and appropriate parts of IFRS. In terms of collection of evidence, conventional audit satisfies the sufficiency of appropriate evidence through observation, inquiry, physical examination, vouching of documents and minutes of directors meetings while in Islamic auditing the sufficiency of evidence are based on Shariah Supervisory Board (SSB) rulings, fatwas of international and national fiqh boards, plus all other conventional evidence. Written assurance in conventional audit has a more standardised audit report prepared by the auditor on the findings of the audit. Islamic audits still lack written assurance since there is no detailed report prepared by a Shariah auditor to reflect the findings.

Currently, statutory or conventional audit is governed by proper standards and framework highlighted in the Companies Act 1965. Unlike statutory audits, the Shariah audit is one of the functions that complement Shariah governance in IFIs. The SGF (BNM, 2010) highlighted that the Shariah audit should be done at the internal level and shall be conducted by the internal auditors of the IFIs. The IFIs may engage Shariah officers of the institutions in conducting the Shariah audit when necessary.

According to Bank Negara on the enforcement of the SGF by the end of June 2011 each IFI authorised and operating in Malaysia is required to confirm the status of compliance with the framework, which was adopted pursuant to section 59 of the Central Bank of Malaysia Act 2009, section 53A of the Islamic Banking Act (IBA), section 69 of the Takaful Act (TA), section 126 of the Banking & Financial Institutions Act (BAFIA) and Section 126 of the Development Finance Institutions Act (DFIA). This shows that all IFIs need to consider the seriousness in implementing Shariah audit. The Shariah audit is important to complement the Shariah compliance mechanisms already in place and practised internally in the IFIs (Abdul Rahim, 2008). This is due to the increasing demands of stakeholders who require assurance of Shariah compliance and accountability.

IFIs are supposed to operate in a Shariah environment. Failure to adhere with the Shariah principles can subject the IFI to litigation and Shariah noncompliance. Such situations may reflect the weaknesses of the IFI from operating in the global market. IFI's are a fiduciary entrusted to act in the best interest of the depositors. The IFI shall operate the business in accordance with Shariah rules and regulations and apply these rules through the Shariah Committee report. These requirements subject them to Shariah auditing. The Shariah Committee uses the outcome from the Shariah audit findings as a basis of opinion when deciding whether IFIs comply with Shariah. This will enhance the public confidence in the Shariah committee report issued by the IFIs since the decision made by the Shariah Committee is supported and verified by the work of the auditors of the IFI.

Also, Shariah auditing is expected to give an objective opinion on the financial statement and compliance with Shariah requirements. Performing Shariah audit will help IFIs maintain credibility and reputation that makes them unique and niche. Without these two critical issues, IFIs will uncompromisingly lose their reputation in the eyes of their consumers (Atikah, 2009). Reputational damage could eventually cause a withdrawal of funds, which would result in a liquidity crisis. It could also make customers stop requesting finance from Islamic banks, triggering a downturn in profitability. Thus, to keep a good reputation, Islamic banks need to ensure that their financial products are Shariah-compliant and effectively maintain their fiduciary roles (Izhar, 2010).

2.3 SHARIAH AUDIT

Shariah audit has been introduced as one of the Shariah compliance functions in the SGF for Islamic Financial Institutions issued by BNM on November 2010[1]. The other three are Shariah review, Shariah risk management and Shariah research. The regular Shariah audit is required to be performed in IFIs at least on an annual basis for the internal auditors to verify the IFI's key functions and business operations comply with Shariah.

According to Bank Negara, by the end of June 2011 each IFI authorised and operating in Malaysia is required to confirm the status of compliance with the

[1] The Guideline superseding the 'Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions'.

framework, which was adopted pursuant to section 59 of the Central Bank of Malaysia Act 2009, section 53A of the Islamic Banking Act (IBA), section 69 of the Takaful Act (TA), section 126 of the Banking & Financial Institutions Act (BAFIA) and section 126 of the Development Finance Institutions Act (DFIA).

The SGF (BNM, 2010) sets out the Shariah governance process for the Malaysian Islamic finance industry. It supersedes the guidelines on the governance of Shariah committees of IFIs introduced by Bank Negara in 2004 and which outlined the role, duties and responsibilities of the Shariah Committee and its members and the relationship and working arrangement between the Shariah committee at individual institutions and the BNM's Shariah Advisory Council (SAC) at the national level.

The primary objective of the SGF (BNM, 2010) is to enhance the role of the board, the Shariah Committee and the management in relation to Shariah matters, including enhancing the relevant key organs that have the responsibility to execute Shariah compliance and research functions aimed at the attainment of a Shariah-based operating environment. The SGF (BNM, 2010) is effectively the next component of Malaysia's Islamic Finance Master Plan and part of BNM's ongoing review of policy relating to the Shariah governance processes at IFIs in Malaysia. BNM is confident that the effective implementation of the new Shariah Governance Framework will further promote stakeholders' confidence and the integrity of the Islamic financial industry thereby reducing Shariah noncompliance risks and, over the medium term, contribute to maintaining financial stability.

The relationship of the Shariah governance organs, namely the Board of Directors, Shariah Committee and the management with other functions can be observed in Figure 3.1[2]:

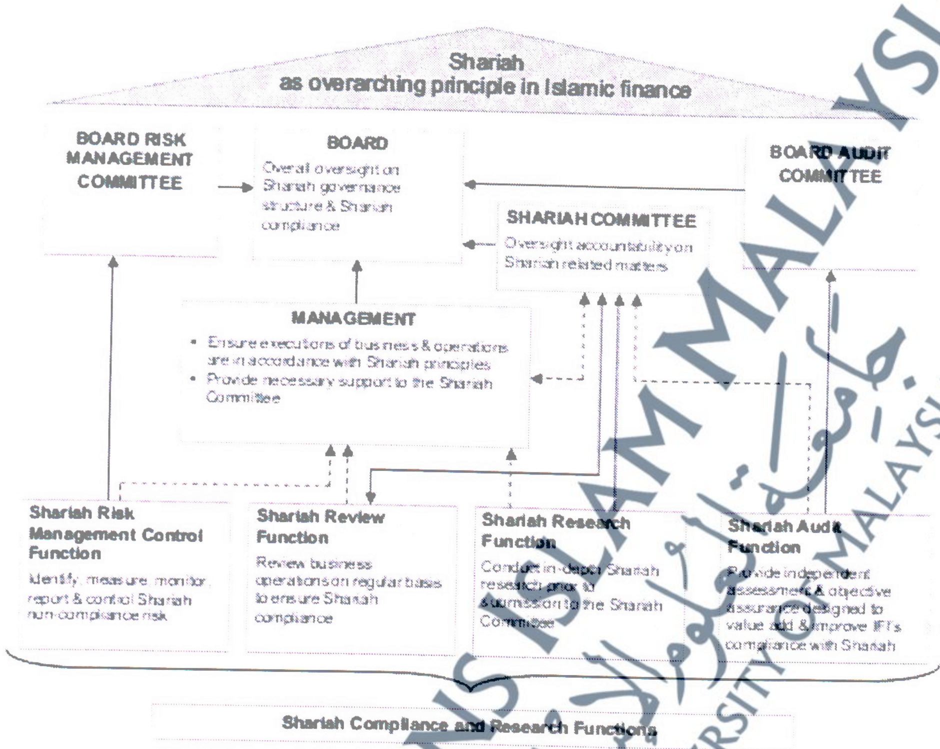

Figure 1: Shariah Governance Framework

*Source from BNM websites (2010)

The model highlights the position of the Shariah audit function as a governance mechanism ensuring sound internal controls in the IFIs. Shariah audit function acts as a control mechanism in the IFIs. This study attempts to extend the role of the Shariah audit function in the existing model and its implementation in the IFIs. It is crucial to get feedback from the Shariah audit experts on what would be the best practices in the

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[2] Shariah Governance Framework for Islamic Financial Institutions (BNM/RH/GL-012_3). Available online: http://www.bnm.gov.my/guidelines/05_shariah/02_Shariah_Governance_Framework_20101026.pdf. Retrieved on 9th December 2014.

Shariah audit function and analyse their expectations with the regulators, practitioners and the stakeholders views on the implementation of Shariah audit function especially after the issuance of the SGF Framework Model (BNM, 2010) effective 1 January 2011.

According to the figure above, the Shariah audit function shall be performed by internal auditors who have acquired adequate Shariah-related knowledge and training. Also, the internal auditors may engage the expertise of the IFI's Shariah officers in performing the audit, as long as the objectivity of the audit is not compromised.

The Shariah audit function in the IFIs reports directly to the Board Audit Committee. The Board Audit Committee, upon consultation with the Shariah Committee, will determine the deliverables of the Shariah audit function. The deliverables are consistent with accepted auditing standards. The dotted line from Shariah audit function to the Shariah Committee shows that the Shariah Committee is expected to perform an oversight role on Shariah matters related to the institution's business operations and activities. This is achieved through the Shariah review and the Shariah audit functions. Regular Shariah review reports, and the Shariah audit observations should enable the Shariah Committee to identify issues that require its attention and where appropriate, to propose corrective measures. The scope of Shariah audit in Shariah Governance Framework Model (BNM 2010) covers all aspects of the IFI's business operations and activities, including:

1) Audit of financial statements of the IFI;
2) Compliance audit on organisational structure, people, process and information technology application systems; and
3) Review of adequacy of the Shariah governance process.

The scope of Shariah audit in terms of an audit of financial statements of the IFIs, need to be emphasised. According to SGF (BNM 2010), on the scope of Shariah auditing financial statements of the IFIs that 'in the event where the audit is undertaken by external auditors, IFI has to be satisfied that the scope of audit by the external auditor with regard to Shariah audit is comprehensive'. Given the clause in the SGF (BNM 2010), the scope still needs to be highlighted further since the shareholders and the depositors of the IFIs need to clarify and seek knowledge on the Shariah issues related to the financial statements. Shariah matters relating to the financial statements of the IFIs include income purifications, Profit Equalisation Reserve (PER), zakat calculation, and profit distributions.

The process of Shariah audit is designed to enable the IFI to assess whether a sound and effective internal control system for Shariah compliance has been implemented, which should cover, but is not limited to, the following:

1) Understanding the business activities of the IFI to allow for better scoping of an audit exercise, i.e. auditability and relevance of activities;
2) Developing a comprehensive internal audit programme or plan. The programme includes objectives, scope, personnel assignment, sampling, control and duration as well as establish proper audit processes, policies and procedures of IFI's operations;
3) Obtaining and making reference to relevant sources, including the SAC's published rulings, the Shariah Committee's decisions, fatwas, guidelines, the Shariah audit results and the internal Shariah checklist;
4) Conducting Shariah audit on a periodical basis; communicating results of any assessment or findings arising from the Shariah audit to the Board Audit Committee and the Shariah Committee;
5) Providing recommendations on rectification measures taken as well as following-up on the implementation by the IFI.

According to the SGF (2010) issued by Bank Negara paragraph 7.7, Shariah audit refers to the periodical assessment conducted to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IFI's business operations, with the main objective of ensuring a sound and effective internal control system for Shariah compliance. According to Abdul Rahman (2008), Shariah auditing of Islamic financial services can be defined as the accumulation and evaluation of evidence to determine and report on the degree of correspondence between information and established criteria for Shariah compliance purposes. He argues that Shariah audit shall be performed by a qualified and competent Shariah auditor. Shariah auditors perform audits on both objective (financial information e.g. profit distribution) and subjective information (Shariah information) to ensure Shariah compliance of Islamic banks. Ibrahim (2009) defines Shariah audit as a systematic process of obtaining sufficient and appropriate evidence to form an opinion as to whether the subject matter (process, personnel, financial and non-financial performance, financial position, systems, marketing, etc.) corresponds to the criteria (the Shariah rules and principles) are broadly accepted by the Islamic community and to report to stakeholders (Ibrahim, 2009). In addition, Sultan (2007) proposed a definition of Shariah audit as a review of financial statements and other operational components of the IFI that are subjected to the risk of compliance including but not limited to products, the technology supporting the operations, operational processes, the people involved in the main areas of risk, documentations and contracts, policies and procedures and other activities that require adherence to Shariah principles.

Shariah audit in the IFIs shall be performed by independent auditors who are also competent in addressing Shariah matters. This means that Shariah audit should cover the overall operations of the IFIs to be in compliance with Shariah without any bias or interference from other parties that may jeopardise the authenticity of the Shariah opinion drawn during the auditing processes.

The term Shariah audit (التدقيق الشرعي) is a relatively new term in Shariah (Chik, 2011). Islamic religious auditing or Shariah audit provides an institution to solicit advice and to monitor performance so that the IFI operates as a strictly Islamic concern. The Islamic concepts highlighted the differences between Islamic and Western business practices. For example, Shariah prohibits, among other things, the payment and receipt of *riba'* or usury (Quran 2: 275-276), gambling (Quran 5:90), hoarding (Quran 9:34) and speculation (Qureshi, 1976). Islam also forbids any investing or dealing in alcohol, pork and other activities which are considered unlawful from an Islamic perspective. The need for Shariah audit stems from the requirement that the IFI should comply with the Shariah. If religious auditors find any violation of the Islamic principles in the operation of the organisation, then this should be reported in the organisation's financial statement as in the case of an external auditor reporting their opinion on the true and fair view of the organisation's financial position.

In February 2006, a non-profit organisation was established to maintain and promote Shariah standards for IFIs, participants and the overall industry. The Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) was created to ensure that participants in the IFIs conform to the regulations set out in Islamic finance. The founding and associate members, as well as the regulatory and supervisory authorities of the AAOIFI, define the acceptable standards for various functions. This includes areas such as accounting, governance, ethics, transactions and investment.

AAOIFI does not clearly define Shariah audit. However, AAOIFI's Governance Standards for Islamic Financial Institutions (GSIFI) No.2 defines Shariah review as an examination of the extent of an IFIs compliance, in all activities, with the Shariah. This review includes contracts, agreements, policies, products, transactions, memorandum and article association, financial statements, reports (especially internal audit and central bank inspection), circulars, etc.

On the other hand, according to AAOIFI Auditing Standard for Islamic Financial Institutions No.1 (ASIFI 1), the main objective of an audit is to enable the auditor to express an opinion that the financial statement are prepared in all material respects, in accordance with the fatwas, rulings and guidelines issued by the Shariah Supervisory Board of the IFIs, the accounting standards of the AAOIFI, national accounting standards and practices, and relevant legislation and regulations applied in the country in which the IFIs operate. Referring to the definition in the AAOIFI, the standard refers to an audit as an expression of opinion on the 'financial statement' whereas the scope should be expanded to cover the overall activities and operations of the IFIs to check whether they are in accordance with the Shariah rulings of a country. The subject matter of the Shariah audit should be wider than a financial statement audit. In line with the broader scope of the Shariah including which includes *akhlaq* (ethics), it should not only review the financial statements but the IFIs internal processes, personnel, financial and non-financial performance, financial position, information and information technology (IT) systems, marketing of the IFI's product and other relevant issues pertaining to Shariah. According to Sultan (2007), AAOIFI standards on governance (GSIFI) and auditing (ASIFI) must be read together in determining what constitutes a Shariah audit. This is because the objective of Shariah review is to ensure that the activities carried out by an IFI do not contravene the Shariah.

This means that not only should the financial statements be audited but the entire institution including objectives, processes, marketing, personnel, financial and non-financial performance should be subject to audit from Shariah perspectives. Ibrahim (2009) argues that the necessity to comply with two sets of criteria (AAOIFI and national) might lead to conflict because when national jurisdiction require banks to follow IFRS, it does not allow mutual existence and tolerance of other standards. At present, among countries that adopt AAOIFI standards as part of their regulatory framework for IFIs are GCC countries, Sudan and Jordan.

It is argued by Najeeb and Ibrahim (2014) that conventional audit fails to understand the Shariah aspects of the Islamic financial system nor does it appreciate the social objectives (that go beyond economic measures) which IFIs intend to achieve. Accountancy bodies have always sought to portray accounting as an independent, objective and neutral constructor of the state of corporate affairs (Mitchell and Sikka, 2002). This portrayal does not hold ground with the Islamic system which does not bifurcate between religion and business and Shariah takes precedence above all (Karim, 1990).

Shariah audit is currently performed by the IFIs in Malaysia to ensure that the activities and operations of an IFI adhere to Shariah. This is in line with the SGF (BNM, 2010) requirements on the implementation of Shariah audit in the IFIs. The accumulation and evaluation of evidence through the current statutory audit may not achieve the degree of Shariah compliance in the IFIs since it should also cover the spiritual aspect of the activities and operations of the IFIs. The differences between the conventional statutory audit and Shariah audit are illustrated in Table 2:

Table 2: Differences between Statutory Audit and Shariah Audit

	STATUTORY AUDIT	SHARIAH AUDIT
DEFINITION	Statutory audit provides assurance on the reality and fairness of an IFI's financial information; advice on controls and processing system weaknesses and confirmation of accounting treatments on complex transactions.	Shariah audit refers to the periodical assessment conducted from time to time, to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IFI's business operations, with the main objective of ensuring a sound and effective internal control system for Shariah compliance.
SCOPE	Financial Statements and related control pertaining to the financial operations.	Audit of financial statements of the IFI; Compliance audit on organisational structure, people, process and information technology application systems; and Review of adequacy of the Shariah governance process.
RESPONSIBILITY	External Auditor	Internal Auditor
FRAMEWORK	Conventional Audit	No proper framework
DUTIES OF THE AUDITOR	Outline in Malaysian Companies Act 1965	Generally mention in Shariah Governance Framework issued by BNM
REPORTING STRUCTURE	Shareholders and Stakeholders (external parties)	Audit Committee and Shariah Committee (internal parties)
AUDIT REPORT	Standard Audit report	Shariah Committee report

Source: Hanefah, Shafii, Salleh, and Zakaria (2011)

Based on the table above the scope of Shariah audit is much wider as compared to the scope in conducting a statutory audit. Shariah audit shall encompass the overall operations of the IFI. Given the scenario, Shariah audit should be given serious attention in its implementation in the IFI.

A survey conducted at the end of 2010 by one of the four biggest audit firms in Malaysia (PricewaterhouseCoopers, 2011) found that more than half of the total population of Islamic banks in Malaysia has implemented the Shariah audit function in its organisation. Thus, it is believed that the issuance of the SGF by BNM has had a significant impact on the establishment of the Shariah audit function within the IFIs. However, the practice of Shariah audit is still varied according to the IFIs. According to Samad (2011), most Islamic banks use the conventional framework of auditing because of the non-availability of Shariah auditing framework even though all of them believe that the Shariah auditing framework differs from the conventional framework. Sulaiman (2011) supports this argument by stressing that Shariah audit is separate from and in addition to the financial and operational auditing processes undertaken by IFIs as part of their adherence to the standard requirements of their jurisdictions. Due to that, it is crucial to have a separate Shariah auditing process in the IFIs. He mentioned that Deloitte explains in its Islamic Accounting Guidelines that: "Standards for Islamic financial institutions have to be developed because in some cases Islamic financial institutions encounter problems because the existing standards were developed based on conventional institutions, product structures or practices, and may be perceived to be insufficient" (pp 56). Thus, it is necessary for the Shariah audit function to have its Shariah audit framework since it will differentiate between conventional and Shariah transactions especially for banks that only have a window in Islamic banking operations. Having a proper Shariah audit framework will promote harmonisation among the IFIs.

Moreover, Sulaiman (2011) highlights that conventional auditing procedures do not account for the specific Shariah compliance risk to which all IFIs are exposed. The role of a Shariah auditor is different to that of a conventional auditor because its remit is derived from the basic values of the Islamic society. The auditor is accountable not only for the manner in which the bank undertakes its activities but also for the effectiveness of which these activities contribute to the principles of Shariah, to propagate the virtues of Islam in all areas of the bank.

Another key issue that been highlighted in the research conducted by PWC (2011) is a lack of communication between the Shariah Committee and management. 70% of respondents claimed that Shariah scholars had no involvement in the Shariah audit process, while 50% said that a dispute resolution process was not in place in their bank's existing Shariah governance framework. This implies that there is no avenue existed to resolve any potential conflict between the management and the Shariah committee. According to Sulaiman (2011), this is considered one of the most serious issues currently facing Shariah auditing. Shariah scholars in the IFIs are responsible for signing the Shariah Committee report; therefore, their lack of involvement in the actual auditing process is a real concern. He added that to be able to sign the statement, it is critical for Shariah scholars to be involved in the Shariah audit, which is to ensure that all the assertions are met. He opines that there should be more engagement between the work that has been performed in the Shariah audit, and the opinion which the Shariah scholars provide since the findings from Shariah audit are communicated through Shariah Committee report. Proper reporting should be addressed in the Shariah audit since according to the SGF (BNM, 2010) the findings of the Shariah audit are reported to the Audit Committee of the IFI. Since there is no specific report produced in Shariah audit to the stakeholders, unlike the standard audit report, in the event of Shariah noncompliance, the stakeholders will hardly be informed of the degree of Shariah compliance. Thus, even though SGF (BNM, 2010) has addressed the implementation of Shariah audit function in the IFIs, there remains a lack of standardised practices among the IFIs.

2.4 SHARIAH REVIEW

Shariah review is a term that creates confusion in its practice. This is because AAOIFI Governance Standards for Islamic Financial Institutions (GSIFI) No.2 (AAOIFI, 2008) defines Shariah review as an examination of the extent of an IFIs compliance, in all activities, with the Shariah. This examination includes contracts, agreements, policies, products, transactions, memorandum and article association, financial statements, reports (especially internal audit and central bank inspection), circulars, etc. Referring to the AAOIFI standard above, the practice of Shariah review reflects the Shariah audit function as per SGF (BNM, 2010). However, SGF (BNM, 2010) manages to address the difference between Shariah review and Shariah audit function.

As introduced in the SGF (BNM, 2010), Shariah review function refers to regular assessment of Shariah compliance in the activities and operations of the IFI by qualified Shariah officers. The function involves the examination and evaluation of the IFI's level of compliance to the Shariah, remedial rectification measures to resolve non-compliances and control mechanism to avoid recurrences.

The scope covers the IFI's overall business operations, including the end-to-end product development process, which starts from product structuring to product offering. The review process shall cover, but is not limited to, the following:

1) Planning the review programme which includes the objectives, scope, reporting, rectification and follow-up actions followed by the execution of the programme;
2) Documentation of the processes involved in the review;
3) Communicating the outcome of the review and highlighting any non-compliances to the Shariah Committee and the management; and

4) Rectifying any instances of noncompliance with the Shariah to prevent such events from recurring.

However, AAOIFI GSIFI No.2 defines Shariah review as the main purpose of the requirement of Shariah review for IFI is to make certain that all the activities carried out by the IFIs are truly in compliance with the Shariah rules and regulations as reflected in the fatwas, rulings and guidelines issued by the SSB. AAOIFI has recommended several procedures to be followed by the Shariah reviewers in performing the Shariah review on IFIs. The procedures are illustrated in Figure 2:

Figure 2: Shariah Review Process

The process involved in Shariah review are planning the review procedures, executing review procedures, preparation and review of working paper as well as procedures for documenting conclusions and preparation of the Shariah review report. In planning and designing the Shariah review, the Shariah reviewer is required to draw up a detailed plan whereby information such as the operations of the IFI including its products, size, locations, branches and subsidiaries should be stated in the plan to ensure that the Shariah review can be conducted and completed systematically and in a timely manner. In addition to the above, the list of all fatwas, rulings and guidelines to be obtained should also be disclosed in the plan. Therefore, it is crucial for the Shariah reviewer to be familiar with the structure, operations, transactions and other related activities of the IFI and its group of subsidiaries to enable the Shariah reviewer to provide accurate Shariah opinions on the overall functioning of the IFI. The planning procedure will also assist the Shariah reviewer to ascertain whether the transactions and products of the IFIs, which should be approved by the SSB, are carried out according to the relevant requirements.

The next stage of the Shariah review involves execution of the planned procedures as mentioned above. In this stage, the Shariah reviewer would be required to obtain the understanding of the IFI's management on their awareness, commitment and control compliance procedures for adherence to Shariah rulings. After that, the Shariah review can be considered to some extent similar to the work of an auditor whereby the Shariah reviewer shall go through, among others, the contracts, agreements and transactions entered into by the IFI to see whether they are in compliance with Shariah rules and principles. Apart from reviewing the above, the Shariah review also covers the review of other information or reports of the IFI such as circulars, minutes of the meeting, operating and financial reports, policies and procedures. All the review procedures undertaken by the Shariah reviewer are required to be documented in proper working papers. Upon completion of the Shariah review, any findings would be discussed with the management of the IFI for further action, if necessary.

The final procedure in the Shariah review as suggested by AAOIFI would be the documentation on the conclusions of the review and preparation of the Shariah review report to the shareholders that will be read at the IFI's annual general meeting and published in the annual report.

2.5 COMPARISON OF SHARIAH REVIEW AND SHARIAH AUDIT

This section explains the difference between Shariah review and Shariah audit since the implementation creates confusion among practitioners in the IFIs. This is because as discussed in the previous section, AAOIFI standards (2008) did not mention on the exact definition of Shariah audit but the implementation is equivalent to Shariah review as per GSIFI No. 2 of the AAOIFI. By highlighting the difference between both functions, it will provide a clearer picture of its implementation in the IFIs. The difference between Shariah review and Shariah audit as per SGF (BNM, 2010) is illustrated in Table 3 as follows:

Table 3: Difference between Shariah Review and Shariah Audit

	Shariah Review	Shariah Audit
Definition	Regular assessment of Shariah compliance in activities and operations of IFI by qualified Shariah officers (i.e. having knowledge in Shariah – Usul Fiqh and Fiqh Muamalat)	Periodical assessment to provide independent assessment and objective assurance to add value and improve IFI compliance in ensuring sound and effective internal control system for Shariah compliance
Roles and responsibility	Examine and evaluate IFI level of compliance to Shariah, remedial rectification to resolve noncompliance and control mechanism to avoid recurrence	Performed by internal auditors – trained and have adequate knowledge of Shariah. The internal auditors may engage expertise of Shariah officers in performing the audit
Scope	Covers the IFI's overall business operations including end-to-end product development process – from pre-product approval (i.e. product restructuring before introduce to market) to post-product approval process (i.e., product offering process)	Audit of financial statement of IFI Compliance audit on organisational structure, people and information technology application system Review of adequacy of Shariah governance process

Process	Planning the review program objectives, scope, reporting rectification and follow-up actons Documentation of processes involved in review Communicate the outcome of review and highlight any noncompliance to senior management & SC Rectify any noncompliance in Shariah & prevent recurrence Communicate results of review to the SC	Understand business activities (i.e auditability and relevance of activities) Develop comprehensive internal audit program or plan Objective, scope, personnel assignment, sampling, control & duration Establish proper audit processes Obtain and make reference to relevant references – SAC rulings, SC decision, fatwas, guidelines, Shariah audit results & internal Shariah checklist Communicate results of any assessment of findings to SC and Audit committee Provide recommendations & follow-up on rectification measures taken by IFIs

*Source: Hanefah et al. (2011)

In terms of definition, according to SGF (BNM, 2010) Shariah review refers to regular assessment whereby Shariah audit is referred as a periodic assessment of Shariah compliance activities of the IFIs. Comparing the definition of Shariah audit as per SGF (BNM, 2010) with Shariah review in the AAOIFI standard (2008), Shariah audit is to provide independent assessment and to provide assurance and to add value in improving the Shariah compliance of FIs. The objective of Shariah review in the AAOIFI standard (2008) with Shariah audit in the SGF (BNM, 2010) seems to be the same. The usage of the terms Shariah audit and Shariah review leads to confusion among the countries practising Shariah review and Shariah audit (Sultan, 2007). However, with the issuance of SGF (BNM, 2010) the definition of Shariah audit and Shariah review gives a clear idea of each of their respective functions.

Regarding responsibilities of Shariah review and Shariah audit, SGF (BNM, 2010) clearly spells out that the Shariah officers perform the Shariah review in the Shariah department, and the internal auditors perform the Shariah audit. The scope of Shariah review covers the overall business operations including end-to-end product development process. While Shariah audit scope covers the audit of financial statements of the IFIs, compliance audit and review of the adequacy of Shariah governance process.

2.6 A REVIEW OF SHARIAH AUDIT PRACTICES AMONG OTHER COUNTRIES

2.6.1 Shariah Audit Practices in Malaysia

The Islamic financial system in Malaysia was first introduced in 1963. It started from a modest beginning with the establishment of the Malaysian Pilgrims Fund Board (Tabung Haji) to the setting up of the country's first Islamic bank, Bank Islam Malaysia Berhad (BIMB), which commenced business on 1 July 1983. BNM adopted a step-by-step approach to introducing Islamic banking. The first step to spread the virtues of Islamic banking was to disseminate Islamic banking on a nationwide basis, with as many players as possible and to be able to reach all Malaysians. After a careful consideration of various factors, BNM decided to allow the existing banking institutions to offer Islamic banking services using their existing infrastructure and branches. The option was seen as the most effective and efficient mode of increasing the number of institutions offering Islamic banking services at the lowest cost and within the shortest time frame. Presently, Malaysia has 17 full-fledged IFIs operating parallel to the conventional financial system.

In Malaysia, the Shariah audit function is implemented in the IFIs through the newly introduced Shariah Governance Framework issued by BNM in November 2010. The issuance of SGF (BNM, 2010) has enlightened the practice of Shariah audit in the IFI. The function of Shariah audit should be performed by internal auditors, who have acquired adequate Shariah-related knowledge and training. In addition, the internal auditors may engage the expertise of the IFI's Shariah officers in performing the audit, as long as the objectivity of the audit is not compromised. Shariah audit in the IFI shall be conducted at least on an annual basis to verify that the IFI's key functions and business operations comply with Shariah.

Previously, the practice of Shariah audit in IFIs in Malaysia is on a voluntary basis. It was limited to Shariah compliance of the products only. This is because according to Rahman (2011) the Shariah Committee of the IFIs normally expressed their opinions on the Shariah compliance of the products and services offered (ex-ante compliance). He also argued that a comprehensive and well-guided audit of the Shariah legal contracts, documentations and operations has not been adequately conducted. The ex-post compliance stage is absent in practice. However, since Bank Negara Malaysia has launched its new SGF (BNM, 2010) by the end of June 2011 each IFI authorised and operated in Malaysia is required to confirm the status of compliance with the framework, which was adopted pursuant to section 59 of the Central Bank of Malaysia Act 2009, section 53A of the Islamic Banking Act (IBA), section 69 of the Takaful Act (TA), section 126 of the Banking & Financial Institutions Act (BAFIA) and Section 126 of the Development Finance Institutions Act (DFIA). This shows that all IFIs in Malaysia need to be serious in implementing Shariah audits.

2.6.1.1 *Internal Shariah Audit*

The practice in Islamic banks in Malaysia is to attach Shariah audit function to the internal audit department. Shariah audit function is one of the internal audit functions to perform checks and balances in the IFIs. It is led by the Shariah audit manager who assists the Chief Internal Auditors (CIA) in the establishment of the scope of Shariah audit work, and organises and manages the audit to achieve the audit plans and activities. The Shariah audit function in IFIs also reviews the risk assessment of Shariah compliance audit and ensures the audit programme covers the area of audit work. The Shariah audit manager of an IFI is also responsible for providing guidance and consultation on Shariah compliance to internal auditors in the department. At the end of the auditing process, the Shariah audit manager of an IFI shall draft the audit report on Shariah audit findings and submit it to the chief internal auditor. He/she is also responsible for updates on Shariah matters in respect to BNM guidelines and regulatory requirements.

Among the important areas that need to be audited is the internal control system of an IFI to ensure it is Shariah-compliant.An internal control for Shariah compliance should be designed and operated to provide reasonable assurance that an IFI's objectives are being achieved in the following categories: effectiveness and efficiency of operations, the reliability of financial reporting, and compliance with applicable laws, regulations, accounting and auditing standards.To develop an understanding of internal controls for Shariah compliance, the auditor should consider information from previous audits, the assessment of inherent risk, judgements about materiality, and the complexity of the IFI's operations and systems. Once the auditor develops their understanding of an IFI's internal controls, they will be able to assess the level of their control risk (the risk a material weakness will not be prevented or detected by internal controls). Further discussions on internal control for Shariah compliance will be thoroughly discussed in the following section.

At present, the industry focuses on the current conventional internal control system. With the emergence of IFIs, there should be guidelines in measuring the internal control system for Shariah compliance. The definition of internal control for Shariah compliance should also be clearly defined. IFIs should include Shariah elements in designing their internal control system. This is because the nature of the institutions that requires the Islamic elements to be inculcated in the organisations. An internal control for Shariah Compliance is needed to satisfy the scope of Shariah audit as addressed in the SGF (BNM, 2010) on the financial statements of the IFIs. Good internal control is paramount in the audit of financial statements as it one of the grounds for the reliance of users on the financial reporting in IFIs. Auditors, for that matter, will assess whether they can rely on the internal control of the IFIs.

The Shariah auditors, during the planning phase, will need to consider the internal control mechanism for Shariah compliance to decide the level of reliance on the internal work already prepared in the IFIs. Finally, the auditor will need to verify the existence of systematic control in the IFIs. According to Al-Masyal (2011), internal control for Shariah compliance consists of the following elements as depicted in Figure 3:

Figure 3: Elements of Internal Control for Shariah Compliance
*Source from conference proceedings of the Shariah Audit International Workshop (2011)

Based on the diagram above, the first elements of internal control from Shariah compliance that need to be audited concerns human resources. Personnel involved in the Islamic banking operations and activities must have the knowledge required to carry out their duties. This includes knowledge of business operations from research and development of Shariah-compliant products, Shariah committee members, Shariah secretariat and personnel marketing that related to the Islamic banking products. Personnel indirectly involved in product design and offering are also required to have Shariah knowledge related to their areas. For example, IFI employees in the accounts department must have Islamic accounting knowledge and ways to record Islamic financing transactions. Similarly, employees in the IT department must have basic knowledge of the products so that they may help system users to develop a Shariah-compliant system for IFIs. The qualified human resource is one of the most important mechanisms to ensure internal control for Shariah compliance. It serves as the first line of defence for Shariah noncompliance risk management in IFIs.

Secondly, based on Figure 3 there must an adequate Shariah policies and procedures for internal control on Shariah compliance. Adequate Shariah policies and procedures mean that Shariah policies and procedures must: i) cover all products offered by the IFIs and processes involved, ii) cover all steps of the product offering, for example, from the acquisition of the asset to the sale and finally the payments, and iii) cover required elements of control of the processes involved. This means the clear responsibility of personnel, correct sequence of transactions, separation of conflicting functions (personnel dealing with the purchase of sale of assets in Murabahah transactions should be the same person) and systematic control in the IT system.

Thirdly, Al-Masyal (2011) mentioned that in order the internal control system for Shariah compliance to be effective, an IFI must avoid elements that lead to conflict of interest in the institutions. Conflict of interest is one of the threats for effective internal control. In relation to Shariah compliance, conflict of interest can occur when some functions that should be separated are grouped together. For example, these functions should be separated to avoid conflict of interest; i) fatwa vs. executive, ii) fatwa vs. internal audit, iii) executive vs. audit, and iv) internal audit vs. external audit.

Based on the example above in the context of IFIs in Malaysia, individuals involved in issuing the resolution (fatwa), should not involve in the management (executive) regarding operations and decision-making. In Malaysia, the Shariah Advisory Council (SAC) of Bank Negara and Securities Commissions (SC) are the highest authority in issuing the Shariah resolutions. Thus, the SAC of Bank Negara and SACof SC are expected to be free from internal audit activities in any of the IFIs to avoid conflict of interest. Individuals involved in a management position should not be involved in the internal audit activities. Conflict may arise regarding check and balance in the overall operations of the IFIs since the management, and internal auditors are the same individual. Last but not least, there should be a separation of tasks between internal audit and external audit. The external auditor should be appointed by the board to avoid conflict of independence in audit activities.

The fourth element mentioned in Figure 3 is the implementation of the Shariah audit. According to Al-Masyal (2011), the Shariah audit should be conducted at the internal level. The internal Shariah audit shall be made compulsory to ensure that the management of the Islamic banking is discharging its responsibilities in compliance with Shariah rules and principles as prescribed by the Shariah Board (Samad, 2011).

With regard to the four elements above, an IFI should also include the five major components of the internal control system in the internal control system for Shariah compliance. The existing internal control system practised by an institution commonly comprises five main components; i) control environment, ii) identification and evaluation of risks and control objectives, iii) information and communication, iv) control procedures, and v) monitoring & corrective action. However, it is suggested that in each of the internal control system component, there must be a holistic approach to Shariah. This is to enhance and upgrade the current component to suit the IFIs need for Shariah compliance. For example, in the first component of the internal control system, control environment sets the tone of an IFI, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility and organises and develops its people; and the attention and direction provided by the Board of Directors. The management of IFIs should expose employees to the importance of Shariah in all activities and operations. Management with a high level of integrity will reduce Shariah noncompliance risk, the risk of fraud and error in the IFIs. Employees of IFIs must be subjected to regular training on Shariah and Islamic financial products.

In the second component of identification and evaluation of risks and control objectives (risk assessment), every entity faces a variety of risks from external and internal sources that must be assessed. According to Islamic Financial Services Board (IFSB) on Operational Risk, Principle 7.1:

> *IIFS shall have in place adequate systems and controls, including Shariah Board/ Advisor, to ensure compliance with Shari'ah rules and principles.*

This is part of the identification of Shariah noncompliance risk in the IFIs. Due to the uniqueness features of the IFIs such as the prohibition of *riba, gharar, maysir* and other requirements that its activities must be in compliance with Shariah, a precondition to risk assessment is necessary to establish the objective to be in line with the Maqasid Shariah.

The third component of the internal control system is control procedures. Control activities are the policies and procedures that help ensure that management directives are carried out. They assist in ensuring that necessary actions are taken to address risks to the achievement of the IFI's objectives. Control activities occur throughout the IFIs, at all levels and in all functions. Regarding Shariah compliance, the Shariah department or Shariah review department should undertake the responsibility to ensure that the Shariah rulings set by the Shariah Committee are carried out effectively.

The fourth component of the internal control system is information and communication. Pertinent information must be identified, captured and communicated in a form and timeframe that enables people to carry out their responsibilities.

Information systems produce reports, contain operational, financial and compliance-related information that make it possible to run and control the business. They deal not only with internally generated data but also information about external events, activities and conditions necessary to informed business decision-making and external reporting. Effective communication must also occur in a broader sense, flowing down, across and up the organisation. All personnel must receive a clear message from top management that control responsibilities must be taken seriously. They must understand their role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream. Effective communication with external parties is needed, such as with customers, suppliers, regulators and shareholders.

The last component of the internal control systems is the monitoring process. The system must be monitored as a process that assesses the quality of the system's performance over time. This is accomplished through ongoing monitoring activities, separate evaluations or a combination of the two. Ongoing monitoring occurs in the course of operations includes regular management and supervisory activities, and other actions personnel take in performing their duties. The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upstream, with serious matters reported to top management and the Board.In AAOIFI (2008) standard; ASIFI No. 5 on 'The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements'mentioned that:

"The primary responsibility for the prevention and detection fraud and error rests with those charged with Corporate Governance and management of IFIs. Management shall set controls and procedure

over the requirements of applying Islamic Shariah rules and principles to all activities of an IFI. Management shall monitor the ongoing activities of IFI adhere to Shariah principles. It is the responsibility of the management to ensure the integrity of the accounting and financial reporting systems and that appropriate controls are in place, including those for monitoring risk, financial control and compliance with the Islamic Shariah rules and principles".

AAOIFI (2008) clearly elucidates the responsibilities of monitoring rest with the management of the IFIs. This implies that management should oversee the overall operations to be in compliance with Shariah principles. In addition, according to IFSB 5, supervisory authorities need to place significant emphasis on the adequacy of an IIFS's management of risks, including its systems of controls, when reviewing the condition of the IFIs. Given the significant influence of Shariah rules and principles throughout its operations, an IFI's failure to adequately identify, monitor and control Shariah noncompliance that potentially applies to the entire spectrum of operations would be considered as making it vulnerable to eventual loss of income, as well as to reputational risk and possible insolvency. When evaluating the quality of internal controls of an IFI, the supervisory authority should give due consideration to reviewing the key elements set out in the IFSB guiding principles on risk management and corporate governance.

Given the four elements highlighted by Al-Masyal (2011) on internal control for Shariah compliance and the five top components of the current internal control system, both elements should be inculcated together during the Shariah auditing process. A systematic approach in the internal control system for Shariah compliance in the IFIs will minimise the risk and losses held by IFIs. This leads to a strong Shariah mechanism in the overall operations of the IFIs.

2.6.1.2 *External Shariah Audit*

The fiduciary relationship between the shareholders, investors and other stakeholders is paramount in good governance and an adequate financial and management reporting mechanism. This can be achieved through Shariah audit practised. Shariah audit is a valuable tool to deliver the expectation of the shareholders, investors and other stakeholders on the achievement of the IFIs. Goud (2012) mentioned that Deloitte describes the Shariah risk management function as one split between the Shariah board and the external auditors, who are intended to coordinate with the internal audit department, with external auditors acting as the "Shariah compliance Inspectors", in addition to their primary responsibility for reviewing practices, transparency and information disclosure. This description conflicts with the findings of a survey conducted by PWC (2011) of Malaysian IFIs, which found that most IFIs were overseen by internal Shariah auditors who did not interact significantly with either the independent Shariah board or the risk management department. In Malaysia, the responsibility of Shariah audit function is the responsibility of the internal auditors of the IFIs whereas in other countries such as Pakistan and GCC countries the external parties perform the Shariah audit.

Abdul Rahman (2011) discussed who should take the responsibility to perform external Shariah audit function. He started the discussion by highlighting whether the external audit firms should undertake the Shariah audit functions in the IFIs. For the audit firm to embark in Shariah audit, the firm must be ready in terms of Shariah knowledge and competency. Chapra and Habib (2002) suggested that chartered audit firms should perform the Shariah audit function. Thus, the audit firms must acquire the necessary knowledge and skills pertaining to audit and Shariah. Abdul Rahman (2010) mentioned that the process is already underway as evidenced by the increasing number of independent consulting companies and law firms offering Shariah advisory services. In addition to reducing internal audit costs in the IFIs, the use of such services would possibly give the institution access to broader range of expertise.

However, if the audit firm has been given the responsibility to perform Shariah audit, there should be a regulation and oversight body to oversee the performance of overall audit firm that embark in Shariah audit. This is to ensure that Shariah audit function will not become a commodity just like financial audit since it is related to Shariah principles and Shariah compliance. Secondly, Abdul Rahman (2011) added in his paper whether the Shariah firm should undertake Shariah audit practices in the IFIs. If the Shariah firm performs the Shariah audit function, it will encourage the Shariah scholars to initiate their Shariah firm. However, regarding competency, the Shariah scholars may not have enough skills and knowledge in accounting and auditing. Besides that, it is important for the Shariah audit function to be performed certified by professional bodies. Certification will increase public confidence in the Shariah audit function. At the annual AAOIFI Shariah conference held in 2011, one of the presenters, Mufti Aziz Ur Rahman, recommended that the industry needs "proper official training of Shariah auditors" and the "strengthening of the certification process". Thirdly, Abdul Rahman (2011) argues that BNM should perform the external Shariah audit. Since BNM is responsible for regulating and supervising other requirements related to the IFIs, thus, it is easier and more practical to enforce Shariah rulings of the Shariah Advisory Council. However, the capacity for BNM to perform the Shariah audit remains an issue. The Shariah governance system in Malaysia is classified as supervisory requirements compared to self-regulation, as in the cases of Saudi Arabia and the UK. Malaysia is identified as a strong proponent of a 'regulatory-based approach', Bahrain, Kuwait, the UAE and Qatar as a 'minimalist approach', Saudi Arabia as a 'passive approach' and the UK as a 'reactive approach' (Hasan, 2010). Regarding Shariah audit practices, the regulators need to set up a specific framework pertaining to internal and external Shariah audits. This will promote harmonisation in the practice of Shariah audit by the industry players and increase the transparency of the operations of the Islamic banks to the stakeholders.

The differences between internal Shariah audit and external Shariah audit are illustrated in Table 4:

Table 4: Differences between Internal Shariah Audit and External Shariah Audit

Key Area	Internal Shariah audit	External Shariah audit
a.Objectives	To add value and improve IFIs operations to be Shariah compliance.	To express an opinion on whether the overall operations of the IFIs are Shariah compliance.
b. Legal Basis	As per Shariah Governance Framework.	Voluntarily basis.
c. Reporting	Currently no standard Internal Shariah audit report has been made public.	Should be reported together with the Standard audit report.
d. Scope	a) Audit of financial statements of the IFI; b) Compliance audit on organisational structure, people, process and information technology application systems; and c) Review of adequacy of the Shariah governance process. (BNM, 2010)	a) Audit of financial statements of the IFI; b) Operational aspect of the IFI; c) Organisational structure and the people involved in executing key activities of each business area of the IFI; d) IT application systems that are in place to support the key business activities of the IFI. (Sultan 2007 pg.12)

Source: Teck Heang (2007)

The table is adapted from Teck Heang (2007) on the differences between internal auditing and external auditing. It has been modified to fit the purpose in comparing internal Shariah audit and external Shariah audit. The comparisons are based on Shariah Governance Framework (2010) guidelines and previous literature on Shariah audit. Based on the table above, the main differences between internal Shariah audit and external Shariah audit can be derived from four objectives, legal basis, reporting and scope. The main objective of internal Shariah audit is to add value and improve IFIs' operations to be in compliance with Shariah whereas the main objective of the external Shariah audit is to express an opinion that the overall operations of the IFI are Shariah compliance. As for the legal basis, Muneeza and Hassan (2011) argued that the implementation of the Shariah audit function in IFIs involves issues of legal conflict. According to the authors, the SGF (BNM, 2010) shall emphasise on enforcement and regulation of Shariah audit, qualification of the Shariah auditors, definition and scope and reporting resulting from the Shariah audit findings. The framework only addresses a general view of Shariah audit functions. Without proper regulations and guidelines on the implementation of the Shariah audit function in IFIs, it will result in different practices among the IFIs and involve legal conflict. In comparison to the external Shariah audit, there is still no legal basis for its implementation since it is still a voluntary practice. Regarding reporting, previous literature (Abdul Rahman, 2010; Ibrahim & Ratna, 2007; Sultan, 2007) highlights the needs of having Shariah audit reporting separately from the Shariah Committee report. This is to ensure the independence of reporting is not jeopardised. As for the scope of the audit, through external Shariah audit, the coverage will be much wider to cover the overall operations of the IFIs and increase the level of confidence among the stakeholders.

2.6.2 Shariah Audit Practices in Pakistan

The Islamic banking movement in Pakistan was nationwide and comprehensive. As it was a mammoth task that was implemented in phases. The process started by transforming the operations of specialised financial institutions like the National Investment Trust (NIT), Investment Corporation of Pakistan (ICP), and House Building Finance Corporation (HBFC) to conform to the Islamic principles with effect from July 1, 1979. Separate interest-free counters started operating in all the nationalised commercial banks, and one foreign bank from January 1, 1981, to mobilise deposits on a profit and loss sharing basis. As from July 1, 1985, all commercial banking operations were made 'interest-free'. From that date, no bank in Pakistan, including foreign banks, was allowed to accept any interest-bearing deposits. All existing deposits in banks were treated on the basis of profit and loss sharing. However, foreign currency deposits/loans continued to govern on an interest basis. The government also passed Mudarabah Companies Act 1984, which enabled financial institutions or business groups to set up special mudaraba companies.

The State Bank of Pakistan (SPB) governs the regulatory authority in Pakistan. It has established a dedicated Islamic Banking Department (IBD) that operates in close coordination with the Policy and Regulatory Department and Inspection and Supervision Departments to facilitate IFIs development. The IBD coordinates with the SBP and banking industry to provide valuable regulatory guidance related to overall Shariah compliance and specific issues/ challenges being faced by the Islamic banks in Pakistan[3].

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[3] Sources from Keynote address delivered at Annual Corporate Governance Conference Dubai on November 27, 2006 by Dr. Shamsad Akhtar Gabenor of State Bank of Pakistan on *'Shariah-Compliant Corporate Governance'*.

According to Akhtar (2007), SBP has put into place a comprehensive and robust multi-tiered Shariah compliance mechanism to lend customers and investors confidence in the Islamic banking industry. The Shariah compliance mechanism has three main pillars: (i) a Shariah board at SBP which approves policies and guidelines as well as the fit and proper criteria for advisors; (ii) Shariah advisors in all banks to provide guidance to banks and comfort to customers on Islamic financial services; and (iii) a Shariah audit system. The Shariah audit system is developed based on the inspection manual, which is very comprehensive, was compiled by Ernst & Young out of Bahrain in collaboration with their affiliate in Pakistan.

The Shariah Audit System is needed to ensure that specific terms of Islamic contracts, a fatwa on the transaction, as well as the sequence of execution of the agreement are conducted according to Shariah principles. The preparations of the financial statements are based on AAOIFI standards and the inspection is geared towards auditing the transactions according to these standards. In addition to the regular SBP inspection, all banks conducting Islamic banking will also have to undergo the Shariah Compliance Inspection. Shariah compliance inspection of Islamic banks covers a review of the Islamic banks' arrangements and operations, their services and products, financial statements and accounting records to ensure that all transactions are being carried out in accordance with the injunctions of Shariah.

To strengthen the Shariah compliance mechanism in Islamic banking, the SBP ensures that all relevant Islamic banking regulations are complied with in letter and spirit and shall be adherence to the Shariah compliance framework. The Shariah compliance framework in Pakistan emphasises Shariah aspects with relevant provisions of existing laws, rules, regulations, policies and procedures related to Islamic banking need to be embedded in the IFI's processes in such a manner that monitoring and reviewing of issues related to Shariah compliance forms part of the internal control structure. Monitoring and reviewing for Shariah compliance should cover all activities, products and locations of the IFI. The basic purpose of this responsibility is to ascertain whether the transactions, processes and products undertaken by the IFI are Shariah-compliant and all related conditions are being met, as approved by the Shariah advisor.

Regarding auditing, the internal audit of the IFIs in Pakistan introduces a system of internal Shariah audit, so as to ensure that the goals and objectives of Shariah compliance are achieved. Internal Shariah audit of IFIs is part of the regular internal audit or as a separate unit depending upon size the of operations of the IFI. The primary objective of the internal Shariah audit is to ensure that the management of the IFI is discharging its responsibilities in compliance with Shariah rules and principles as prescribed by the State Bank of Pakistan and the Shariah advisor of the IFI. The purpose of the internal Shariah audit is to ensure that the system of internal control for Shariah compliance is conceptually sound and effective in implementation, so as to ensure that the goals and objectives for Shariah compliance are achieved. The internal Shariah audit is carried out in conformity with Shariah rules and principles, guidelines and instructions issued by the State Bank of Pakistan. The internal Shariah auditors have direct and regular communications with all levels of management and Shariah Advisor. There is no scope limitation and restriction of access to information, documents, reports and etc.

Regarding reporting, the report of internal Shariah audit contains observations and assessment of systems and controls in place for Shariah compliance. The internal Shariah audit report will also include recommendations for potential improvements and corrective actions to be taken. Any disputes/difference of opinion between management and Internal Shariah auditors on matters relating to Shariah interpretation is referred to the Shariah advisor of the IFI for decision. The report of the internal Shariah audit is tabled before the Shariah advisors for advising the appropriate corrective action and then before the Audit Committee of the IFI for consideration and appropriate remedial measures as advised by the Shariah advisors.

The report from Shariah audit findings is extensively highlighted in the IFIs of Pakistan through the Shariah Supervisory Report. For example, in the annual report of Meezan Bank, in the Shariah Supervisory Report, there is specific paragraph emphasising Shariah audit matters. Areas covered during Shariah audit were disclosed extensively. This reflects transparency in reporting on Shariah compliance. Shariah audit practices conducted in Meezan Bank covers all the main branches to ensure and evaluate the overall Shariah compliance of the bank's operation and their alignment with the guidelines given by the Shariah Advisor and the Shariah Supervisory Board. The audit areas covered in Shariah auditing are as follows:

1) Agreements for *Murabaha*, *Ijarah*, Diminishing *Musharakah*, *Istisna*, *Tijarah* and *Bai Salam*.
2) Declaration, description of assets, relevant purchases invoices, sequence and order of the documents and time differences between purchases and declaration in *Murabaha*.
3) Murabaha monitoring sheets and delayed declaration reports.
4) Ownership ratio in Diminishing *Musharakah* for housing and issuance of timely unit sale receipts.
5) The investment made in stock concerning the stock screening criteria.
6) Import finance transactions and related documentations.
7) Extensive reviews of client payment, purchase cycle and periodic assessment of client's processes.

8) Other related documents and procedures followed by different functional areas.
9) Profit-sharing ratio, profit weightages, pool working, asset & deposit allocation for deposit products.

According to Ashfaque (2011), SBP instructed all IFIs to dedicate few members of IFIs' Internal Audit Department for Shariah audit or create a separate Shariah Internal Audit Department, depending on the size of the bank. The main responsibility lies with this department for Shariah audit. There are some areas like PLS profit distribution, where SBP instructed banks to audit the whole process jointly from Shariah Advisor (SA) and external auditors. Thus, one can say that in Pakistan, Shariah audit is done by both internal and external auditors.

In addition, the external auditor report in Islamic banking in Pakistan did not mention Shariah audit findings. The rationale behind this is that Islamic banking is in its nurturing stage, and any such type of Shariah observations will not only hurt the bank but also hurt the perception of the Islamic banking industry (Ashfaque, 2011). Thus, it is not enforced by the law to mention Shariah findings in the report. Further, if internal or external auditors find Shariah observations, then they highlight these to SA to take action with what he deems fit. The SBP Banking Inspection team also inspects Shariah compliance of the bank and any observations are highlighted to the SA to decide to impose penal action.

2.6.3 Shariah Audit Practices in Indonesia

The development of modern Islamic banking in Indonesia was formally initiated in 1992, in line with the enactment of Banking Act No. 7 of 1992 which includes provisions to develop interest-free banking. Indonesia's first Islamic bank was Bank

Muamalat, which was established in 1991. It operates according to the tenets of Shariah law, which prohibits charging interest on loans and paying interest on deposits. Based on the Banking Act No. 7 of 1992, Indonesia recognised the existence of a dual banking system, that is, a system where conventional banking grows side-by-side Islamic banking to serve the economy.

On 25 June 2003, an agreement was signed between Bank Indonesia and The Indonesian Institute of Accountants (IAI) to structure the accounting standard for Islamic banks (including the implementation of research and training cooperation for the field that relates to the competency of IAI). Since 2001, Audit Guideline for Islamic Banks, Review on Guideline of Financial Accounting Standard (PSAK) 59 and Financial Accounting Standard for Islamic Banks in Indonesia (PAPSI) have been issued by IAI. In drafting the Shariah financial accounting standards, IAI works with Bank Indonesia, National Shariah Board and Shariah banking practitioners. Standards released by AAOIFI are used as a benchmark.

Islamic banks in Indonesia conduct Shariah reviews instead of Shariah audits. Shariah review is carried out by the Shariah Committee of the IFIs and is declared in the annual report. The findings arise from Shariah reviews and are not disclosed in the annual report[4].

2.6.4 Shariah Audit Practices in Sudan

The Central Bank of Sudan was established in 1959 to undertake the functions of the Central Bank stipulated in the Bank of Sudan Act. These functions included oversight and supervision of the banking system and its development and promotion,

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[4]Sources fromannual report of Bank Shariah Mandiri, Indonesia

issuance and management of the national currency, management of the exchange rate, maintaining stability of the economy and other functions carried out by the central banks as a primary body contributing in the economic turnover of the economic wheel in the country. There are two unique and important characteristics associated with Sudanese banking system, namely, it is the first banking system in the world based on the rules of Islamic Shariah which prohibit interest rates. Since 1983 Sudan had adopted a purely Islamic banking system until, the signing of the Comprehensive Peace Agreement (CPA) between Sudanese Government and the Sudanese People's Liberation Movement in 2005, according to the CPA the South was exempted from conducting an Islamic system and instead to operate a conventional system. The Sudan Central Bank operates within two systems: Islamic in the North and conventional in the South, which represent the second characteristic of the Sudanese banking system, namely a single monetary policy governing two banking systems.

In Sudan, the term Shariah audit is not mentioned neither in the annual reports of the Islamic banks nor the website of Central Bank of Sudan. However, they conduct Shariah reviews as a commitment to show their responsibility in determining Shariah compliance in the Islamic bank. However, the Shariah Supervisory Report in the annual report of its Islamic banks did not thoroughly disclose the findings of the Shariah review. At present, there is no disclosure on the Shariah noncompliance activities in the Islamic banks in Sudan.

2.6.5 Shariah Audit Practices in GCC Countries

GCC countries consists of five countries namely Kuwait, Bahrain, United Arab Emirates, Qatar and Saudi Arabia. According to Hassan (2010), the majority of the IFIs in GCC countries have developed their Shariah guidelines and standard processes on Shariah compliance. The study conducted by Hassan (2010) also found that although some GCC countries clearly stated in their regulations the adoption of the AAOIFI standards, only 22.8% had indicated its implementation. Most of the GCC countries conduct Shariah reviews rather than Shariah audits. Shariah reviews in the GCC countries are carried out by the Shariah Supervisory Board (SSB) of the IFIs. However, regarding auditing according to Hassan (2010), 22.8% of IFIs' Shariah Supervisory Board in GCC countries indicated that the functions had been delegated to internal Shariah compliance unit.

In terms of reporting of Shariah review findings some of the annual reports in the GCC countries such as in Bahrain disclosed significant findings in its Shariah Supervisory Report. This effort shows that the IFIs in the GCC countries promote transparency in Shariah compliance. In recent years, Bahrain has rapidly become a global leader in Islamic finance, playing host to the largest concentration of IFIs in the Middle East. In addition, Bahrain is at the forefront in the market for Islamic Securities (Sukuk), including short-term government sukuk. The Central Bank of Bahrain (CBB) is responsible for regulating and supervising Bahrain's financial sector[5]. For example, the SSB in Bahrain Islamic Bank (BISB) performs a monitoring function including the checking of documents and procedures to scrutinise each operation carried out by the Bank, whether directly or through the Shariah Internal Audit department. The SSB of BISB planned with the Shariah Internal Audit Department to implement monitoring functions by obtaining all the information and clarifications deemed necessary to confirm that the Bank did not violate the principles and provisions of Islamic Shariah.

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[5]http://www.cbb.gov.bh/cmsrule/index.jsp?action=article&ID=19

The Shariah Internal Audit Department in BISB audited the Bank's transactions and submitted a report to the SSB. The report confirmed the Bank's commitment and conformity to the SSB's opinions.

Al-Rajhi Bank in Saudi Arabia established an independent Shariah Board, formed and ratified by the Constituent General Assembly with the objective of ensuring that all bank activities are subject to the approval of the Shariah Board. The Juristic Control Department is responsible for exercising the necessary controls and reports directly to the Shariah Board. The Juristic Control Department is responsible for supervising the activities of the Bank in terms of verifying the implementation of the Shariah Board's decisions. In 2011, over 300 visits were made to branches, transfer centres, and trading rooms and training sessions were conducted for 340 new employees with 15 courses held. However, in Al-Rajhi's 2011 annual report, the Shariah Supervisory Board report was not disclosed to the public.

In Kuwait Finance House, through the Shariah Supervisory, reviews are conducted on a random basis on samples of operations which provided returns to all transactions of KFH with shareholders, investors and others. This is based on the annual Shariah audit plan on all departments, periodic reports submitted by Shariah Supervisory Department regarding the auditing operations, field visits and on the operation and the correct implementation of Fatawa and resolutions issued by the Shariah Board.

The practice in the Qatar Islamic Bank through its Executive Committee and Shariah Audit Department is that the SSB directly supervises the Bank's activities and are satisfied that its resolutions have been righteously executed. The SSB confirms that the responsibility for applying the Shariah norms and controls lies mainly on the Bank's management, as the SSB's liability is confined to giving relevant jurisdictions (Fatwas) and reviewing the transactions referred to it, whether they were addressed to it directly or through the Shariah Audit Department as implied by the authorities vested in the Shariah Audit Department. Also, the Qatar Islamic Bank played an equally important role in developing AAOIFI standards working closely with the Accounting and Auditing Standards Council for Islamic Financial Institutions.

According to Mufti Aziz Ur Rehman[6] in Dubai, internal Shariah review is an integral part of the bodies of governance in IFIs and operates under the policies established by the Islamic financial institution according to the memorandum and article of association. It consists of a statement of purpose, authority and responsibility. The example given by Mufti Aziz Ur Rehman (2012) on the statement of purpose, authority and responsibility is the charter. The charter shall be consistent with Islamic Shariah rules and principles in both conventional banks opening Islamic windows as well fully fledged IFIs. The charter should be approved by the Fatwa and Shariah Supervisory Board (F&SSB) and issued by the Board of Directors. The charter shall be regularly reviewed. The charter mentioned by Mufti Aziz Ur Rehman that been practised in Dubai, are similar to the Shariah Compliance Manual d evelop in most of the Islamic banks in Malaysia.

According to Mufti Aziz Ur Rehman (2012), an external Shariah review has also been conducted in the IFIs in Dubai. The external Shariah review and audit is conducted to review the internal procedures and to act in support of the internal audit. This practice promotes greater transparency regarding the independent approach in examining the work of Shariah review. By doing this, he added that it gives the external auditors a

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[6]Shariah manager at Dubai based Mawarid Finance as well as a member of several Shari'ah boards. He is also a lecturer, trainer and author. He is qualified in both contemporary finance and Islamic jurisprudence, with a specialism in Fiqh Ul Mu'amalaat. He has a degree in Islamic finance; is a Chartered Shariah Auditor and Advisor formally certified by AAOIFI and a Certified Islamic Finance Arbitrator.

pool of knowledge, experience and insight which can be used when assisting IFIs to improve their performance in these areas. Another significant opportunity is keeping up-to-date with latest industry developments.

In terms of Shariah audit practice in Dubai, three major reports heavily depend on the work of Shariah audit; i) the annual management report ii) shareholders report and iii) Fatwa and Shariah Supervisory Board (F&SSB). The Shariah Supervisory Board, however, does not perform the audit, but they trust the Shariah auditors and Shariah department within the Islamic financial institution to perform it. Shariah auditors and/or the heads of Shariah departments in the IFIs in Dubai therefore, have two sets of responsibilities – to the management of the IFI and the F&SSB. They have to provide facts to the F&SSBs because without evidence no one can submit an audit report to the Shariah Board and subsequently the F&SSB report prepared for the shareholders. In the AGM the F&SSB representative reads this report, taking the responsibility that the IFI fulfilled the Shariah requirements and the total profit earned is pure.

However, existing practices of Shariah audits in the IFIs in Dubai do not satisfy the public and the clients of the IFI (Mufti Aziz Ur Rehman, 2012). He added that it is insufficient to say 'our Shariah Board approved' but it is the responsibility of the Shariah auditor to convince the client and prove the superiority of Islamic financial products in contrast to the conventional. This is due to the level of public awareness on the Islamic financial products is poor. Due to that, he recommended that the practice of Shariah audit shall be improved and strengthened in the following ways:

i. Proper, official Shariah audit training
ii. A review of the AAOIFI certification process
iii. The establishment of some criteria, some prequalification to be accepted on an AAOIFI CSAA study course to enhance the value and standing of the certificate
iv. More detailed standards for Shariah audit and governance
v. Limiting certification to professional auditors
vi. Proper control and support by the Shariah Supervisory Board in appointment procedures with the F&SSB reviewing and interviewing applicants
vii. The F&SSB should select a person with the ability to function as a Shariah auditor
viii. Standardisation of Shariah audit procedures
ix. The industry, in cooperation with global audit firms, needs to establish a professional, dedicated audit body with close links to AAOIFI and other standard bodies
x. The industry needs to find ways to improve its standards in the preparation of audits, governance and human resources

Based on the suggestions above, the Shariah audit practices can be harmonised not only in GCC countries but also to related countries. This will boost the Islamic banking practices and increase the networking among the countries that promote Islamic finance. He mentioned that:

> *"The Islamic finance industry is like a tree planted by our respected Shariah scholars. It is our religious and ethical responsibility to tend that tree, to water it and take care of it, so that it grows strongly and healthily"*(Mufti Aziz Ur Rehman, 2012 pp 5).

Thus, regulators and IFIs need to take its responsibility to developing the Shariah audit practices seriously to ensure the Islamic finance industry will grow stronger and stable in the long-run.

2.6.6 Summary of Shariah Audit Practices among Countries

Shariah audit implementations vary according to the regulation of each country. Regulators in each country are responsible for ensuring that Islamic banks in GCC follow AAOIFI requirements pertaining to Shariah audit. Regulators in GCC could adapt BNM's SGF to improve the practice of Shariah audit, in term of the establishment of distinct functions that uphold the Shariah governance mechanisms in IFIs. Table 5 summarises the Shariah compliance framework for IFIs among countries:

Table 5: Summary of Shariah Audit Practices among Countries

Country	Regulatory Authority	Islamic Banking Law	Shariah Committee		Shariah Standards	Acctg Standard	Shariah Audit Practices
			At Central Bank	At Bank Level			
Malaysia	Bank Negara Malaysia	Islamic Banking Act 1983	National Shariah Advisory Council (NSAC)	Shariah Committee	All products approved by NSAC of BNM	Acctg Stds developed by MASB	Internal audit level of the IFIs
Pakistan	State Bank of Pakistan	Islamic banking act	Shariah Board	Shariah Board	AAOIFI	Acctg Standards developed	Internal and external Shariah audit
Bahrain	Central Bank of Bahrain	NIL	Shariah Supervisory Committee	Shariah Supervisory Board	AAOIFI	AAOIFI	Shariah compliance dept.
Indonesia	Bank Indonesia	Introduced in 1992 & Amended in 1999	National Shariah Board (NSB)	Shariah Supervisory Board	Fatwa on products issued by NSB	AAOIFI	National Shariah Board-Shariah review
Sudan	The Bank of Sudan	Islamic banking law exists	Higher Shariah Supervisory Board	Shariah Board	AAOIFI	AAOIFI	nil
GCC	Central Bank of each country	NIL	Shariah Board	Fatwa & Shariah Supervisory Board	AAOIFI	AAOIFI	Internal Shariah Compliance unit

Based on the table above, Malaysia and Pakistan are at the forefront regarding regulation of Islamic banking due to the existence of Islamic banking acts in each country. Pakistan has a proper Shariah Compliance Manual, which has been adopted by all Islamic banks in its country. Furthermore, the State Bank of Pakistan plays a major role in implementing Shariah audit externally. The Shariah Audit Department at the State Bank of Pakistan performs the Shariah audit function. This increases the level of transparency from the stakeholders' point of view in the Islamic banking operations. As for the GCC countries, Shariah audit is done by the internal Shariah compliance unit, while the Shariah Supervisory Board performs the Shariah review. In the GCC countries, the practice of Shariah review seems to be more on Shariah compliance aspects, while Shariah audit focuses on the financial aspects. This can be referred in the AAOIFI standard on the definition and process of Shariah review and audit.

2.7 CHAPTER SUMMARY

This chapter highlights on the definition and general term on auditing in Islam. The role and application of Hisbah were discussed thoroughly in the section. In the following section this chapter also highlights on the needs of Shariah audit and its comparison with Shariah review. Among other discussions in this chapter were on review of Shariah audit practices among other countries such as Malaysia, Indonesia, Pakistan and GCC countries.