

**SHARI'AH AUDIT FOR ISLAMIC FINANCIAL SERVICES:
THE NEEDS AND CHALLENGES¹**

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Introduction

Institutions that offer Islamic financial services are expected to operate by the code of Islamic ethics and must function within the limits of *shari'ah*. In order to ensure that the operations of Islamic financial institutions do not contradict with *shari'ah*, *Shari'ah* Advisory Council (SAC), *Shari'ah* Supervisory Board (SSB) or *Shari'ah* Supervisory Committee (SSC) normally functioned as advisors or supervisors of Islamic banking activities. Internationally, Accounting and Auditing Organizations of Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB) have issued a number of governance standards and guidelines. In Malaysia, Bank Negara Malaysia (BNM) has also issued relevant guidelines to ensure prudence regulation of *shari'ah* matters of Islamic financial institutions.

The main objective of the present paper is to argue for the needs of *shari'ah* audit in order to complement the *shari'ah* compliance mechanisms that are already in place. *Shari'ah* audit is argued need to be systematically undertaken as part of the corporate governance mechanism of the Islamic Financial Institutions (IFIs). This is due to the increasing demands of stakeholders that require assurance of *shari'ah* compliance and accountability. The paper also discusses some challenges as pre-requisites to effectively undertake *shari'ah* audit.

The Status Quo

The present *shari'ah* governance structure in Malaysia is centered on the National *Shari'ah* Advisory Council (NSAC) that act as the sole authoritative body to advise Bank Negara Malaysia (BNM) to oversee the Islamic banking and Takaful operations. NSAC has the power to issue fatwa and these fatwa resolutions are binding on all financial institutions in the country. The functions of NSAC are, among others, to ensure compliance by the banks to the *shari'ah* rules and guidelines. The NSAC, in theory, is expected to study and scrutinize the *shari'ah* opinions of the SSCs of Islamic banks and financial institutions. The NSAC is also entrusted to ensure compliance with *shari'ah* rules and guidelines by supervising bank's operations. Other functions may include advising Islamic banks and financial institutions on *shari'ah* issues related to operations and financial dealings. The NSAC also has authority to examine laws, by-laws and circulars governing the financial institutions activities.

In addition, Securities Commission (SC) provides guidelines in the Offering of Private Debt Securities 2000, Section 32 (1) and spelt out criteria of a *shari'ah* advisor(s) or *shari'ah* committee. The advisor(s) must be an undischarged bankrupt, who has not been convicted for any offence arising out of a criminal proceeding. The advisor(s) also is of a good repute and must possess the relevant qualifications and expertise, particularly in *fiqh mua'malat* and Islamic jurisprudence, with a minimum of 3 years working experience or exposure in Islamic finance. The above section also stated that the issuer of Private Debt Securities must either appoint an independent *shari'ah* advisor with the above criteria or appoint the *shari'ah* committee of Islamic bank or a licensed institution approved by Bank Negara Malaysia.

In 2006, Islamic Financial Services Board (IFSB) has issued Guiding Principles on Corporate Governance for Institutions offering Islamic financial services. They recommended that Board of Directors (BOD) to set up a Governance Committee, comprising at least three members, to coordinate and integrate the implementation of the governance policy framework and one of the member should be a *shari'ah* scholar (possibly from the institution's SSB). This is to empower the role of *shari'ah* advisor as well as to place *shari'ah* compliance as part of a wider governance system. This is also an effort to assist the Governance Committee to effectively address *shari'ah*-related governance issues, and also to coordinate and link the complementary roles and functions of the Governance Committee and the SSB.

The requirements for all Islamic banks and financial institutions to carry out business in line with the *shari'ah* rules and guidelines are clearly stated in Islamic Banking Act, 1983. Section 5(b) of the Act specifies the need for the establishment of *Shari'ah* Advisory Council (SAC) – “that there is, in the articles of association of the bank concerned, provision for the establishment of a *shari'ah* advisory body to advise the bank on the operation of its banking business”. Generally, there are 2 types of *shari'ah* compliance: (i) ex-ante compliance, and (ii) ex-post compliance. The ex-ante *shari'ah* compliance is basically the SACs supervision, monitoring and control tasks that take place upon and during implementation of the bank's dealings. These activities include making sure that the banks and financial institutions comply with the *shari'ah* rules and guidelines during the designing of the contracts and agreements, during the process of transactions, during the conclusion of the contract, and the execution of the contract up to the implementation of the terms of contract until liquidation.

So far, very few institutions undertake ex-post *shari'ah* compliance process. Ex-post *shari'ah* compliance process requires thorough and comprehensive *shari'ah* audit to review and check the transactions that took place after the execution of the contracts. The ex-post *shari'ah* compliance is basically to perform the random samples of completed transactions to ensure that these transactions conform to *shari'ah* rules and guidelines. An internal audit or external audit may be required to perform this where the result of the audit needs to be reported to the management.

Cursory examination of the Islamic financial services industry especially in Malaysia will show us an apparent gap in the *shari'ah* supervisory practices. Even though, SSCs of the Islamic banks did express their opinions on the *shari'ah* compliance, thorough audit or review processes of the *shari'ah* legal contracts, documentations and operations were not conducted properly. Without such audit and review processes will result in a functional gap of *shari'ah* compliance processes. This gap is a serious loophole in the Islamic financial system that is founded on *shari'ah* precepts.

Shariah advisors are not carrying out thorough internal *shari'ah* review or audit on the operations of Islamic banks due to their restricted scope of work. On the other hand, as required by the companies act, Islamic banks are also subjected to financial audit conducted by external auditors which are normally carried out by professional accounting firms. In Malaysia, BNM as the supreme regulatory body of the local financial market also carried out supervisory roles of Islamic banks which include *shari'ah* related matters.

In Malaysia, a comprehensive *shari'ah* audit program so far has not been developed. *Shariah* audit program means a manual-based document that clearly spells out step-by-step *shari'ah* audit procedures, policies and processes when offering Islamic financial services. The audit program should also include standard operating procedures including accounting (MASB, AAOIFI etc), regulatory requirements (BNM) etc. Since, *shari'ah* audit is yet to be made a regulatory requirement by BNM, there is a need for external financial auditors, internal auditors, and *shari'ah* unit or department within the IFIs to work closely with *shari'ah* advisors to ensure *shariah* compliance of Islamic financial activities. In comparison, the State Bank of Pakistan (SBP) has undertaken an exercise to develop a manual for *shari'ah* audit which was developed in consultation with an external advisory partner. The manual was put on test in an Islamic bank in Pakistan where the Islamic financial institution develops *shari'ah* audit skills among its staff while providing hands-on training to SBP's inspection staff.

The Needs

Enhancing stakeholders' value is a central purpose for any business including Islamic financial institutions. Their stability, financial performances and ability to intermediate resources will depend on stakeholders' confidence. A particular confidence feature in respect of Islamic financial services is the requirement of conveying to stakeholders that their financial business is conducted in conformity with their religious beliefs (Grais and Pallegriani, 2006).

Since *shari'ah* is the cornerstone of Islamic financial products and services, if the customers are aware that the products that they have in their portfolio were not *shari'ah* compliant, this would seriously undermine the confidence in the Islamic financial services industry as a whole. Thus, *shari'ah* non-compliance risk is clearly a major challenge for regulators (Bhambra, 2007). Some regulators have sought to find a solution through the implementation of adequate systems and controls that ensure compliance with *shari'ah*. Such *shari'ah* systems and controls should ensure that the rulings and fatwa of the SSC are disseminated and implemented throughout the financial institution. However, the *shari'ah* systems and controls need to be supplemented with external and internal *shari'ah* audit requirements. These audit requirements will provide mechanisms for a regulator to monitor, control and take action against the financial institutions if they did not meet the *shari'ah* requirements based on a failure to maintain and comply with its internal systems and controls. In addition, every regulatory structure needs to have adequate enforcement powers to ensure necessary actions can be taken in the event of violation of *shari'ah*.

Current practice to ensure *shari'ah* compliance relies essentially on internal corporate structure in particular SSC. These certainly offer stakeholders a level of comfort. Nevertheless, they face a number of challenges relating to their independence, the confidentiality of institution-specific proprietary information, the limited availability of professionals with both *shari'ah* scholarship and financial skills, and the need for consistency in pronouncements between the various SSCs (Grais and Pallegriani, 2006).

Recent literature and practice have focused on establishing external corporate governance structures to ensure effective *shari'ah* governance and audit. Chapra and Habib (2002)

suggested that chartered audit firm should acquire the necessary knowledge to undertake *shari'ah* audit. This process is already underway as evidenced by the increasing number of independent consulting companies and law firms offering *shari'ah* advisory services. In addition to reducing internal audit costs in the Islamic financial institutions, the use of such services would possibly give the institution access to broader range of expertise. However, it is not certain that by switching to external shariah audit would bring tangible guarantees of *shari'ah* compliance. Another argument is that internal auditors are generally more familiar with the record systems, policies and procedures of the institution and can provide quick responses to managers. The result could be more detailed and exhaustive internal *shari'ah* audit.

If we examine the current practice, the final output of the SSCs pronouncement will be presented as part of the annual reports of Islamic banks. The practices of SSCs currently have a number of constraints. The following extracts are taken from an Islamic bank's annual report:

"We conducted our audit in accordance with approved Standards on Auditing in Malaysia. These standards require that we plan and perform the audit to obtain all information and explanations which we consider necessary to provide us with evidence to give reasonable assurance that the financial statements are free from material misstatements."
(Report of the Auditors)

"The duties and responsibilities of Shariah Supervisory Council (SSC) are to review, appraise and advise the Directors on the operations of the Group and of the Company's business in order to ensure that they do not involve any element which is not approved by Islam. (...) We,.....and....., being two members of the SSC, do hereby confirm on behalf of the Council, that in our opinion, the operations of the Group and of the Company for the year ended...have been conducted in conformity with Shariah principles." (Report of the Shariah Supervisory Council)

If we compare the above two extracts, a number of issues can be identified. First, the Report of the Auditors clearly provides an independent assurance on the integrity and fairness of financial information produced by the Islamic banks. Financial statement

audit is to enable the auditor to express an opinion as to whether the financial statements are prepared, in all material aspects, in accordance with an identified financial reporting framework. The financial statement audit involves obtaining and evaluating evidence about an entity's financial affairs so as to establish the degree of correspondence between the management's assertions and the established criteria, such as legal requirements and accounting standard (Leung, Coram and Cooper, 2007). This type of audit is performed by independent auditors appointed by the shareholders of the company. Auditors must be qualified and able to exercise their skills in an independent and objective manner. Since the transactions of the business are too many, evidences need to be accumulated on a sampling basis. Thus, what the auditors expressed are only based on reasonable assurance and certainly, not a complete assurance.

On the other hand, the Report of SSC is a statement of opinion that reflect a complete assurance of the operations of the Islamic bank were conducted in conformity with *shari'ah* principles. However, if we examine the roles and responsibilities of the SSC, they are not functioned to conduct an audit as performed by the financial auditors. Therefore, it may be inappropriate for them to make such a 'strong' statement to indicate a complete assurance, since their functions are much less than what have been undertaken by the financial auditors. The SSC has not conducted *shari'ah* audit to express their opinions but they only approved the products and services as well as the required legal documentations of the services provided to the customers. This is a functional gap if we compare and contrast the Report of the Auditors and the Report of the SSC.

Secondly, financial auditors are independent and they are either individual practitioners or members of public accounting firms who render professional auditing services to clients. By virtue of their education, training and experience, independent auditors are qualified to perform the audit. Like members of medical and legal professions, auditors work on fee basis. The auditor is expected to be independent of the client carrying out an audit and reporting the results. To be independent, auditors should be without bias in respect of the client under audit and should appear objective to those relying on the results of the audit. On the other hand, even though members of SSCs are qualified *shari'ah* scholars, they have not been subjected to rigorous training in conducting review and audit work, as the auditors. Currently, there is no specific training program or professional qualification for the *shari'ah* scholars for them to effectively function and express their independent opinion.

Members of SSC are assumed to be people with deep religious commitment. The SSC's failures to keep the *shari'ah* compliance should exact an unbearable moral cost, which is much greater than loss of economic revenue. In terms of public perception, SSC must be perceived as independence so that the report can be considered as credible (Abdel Karim, 1990). Unlike financial auditors, whom are governed by legal rules and professional codes of ethics, SSC is guided by religious and moral beliefs where there is an obligation to religious peers and the community. These expectations imposed greater scrutiny for the SSC to be more competent and independent. Since, there is no requirement for a *shari'ah* audit to be undertaken as yet, it is then too much to expect the SSC to effectively report their assurances.

Thirdly, for financial auditors, they are liable under the statute and the common law. In cases of irregularities, auditors are required to report if they have reasonable grounds to suspect any contravention of the law. In the case of SSC, they have statutory responsibility as per Islamic Banking Act 1983 (Section 5b) "that there is, in the articles of association of the bank concerned, provision for the establishment of a *shari'ah* advisory body to advise the bank on the operation of its banking business...". Section 124(7)(1) of BAFIA also states the need for the *shari'ah* Advisory Council to advise on the Islamic banking business or Islamic financial business.

The responsibility of SSC is mainly to advise and the main responsibility lies with the management of the Islamic banks. However, the above Report of *Shari'ah* Supervisory Council indicates the SSC has taken the responsibility not only to advise but also to provide assurances. It remains to be seen to what extent the SSC is legally liable in the case of *shari'ah* non-compliance and irregularities. However, SSC also need protection not only by the laws but also morally in the eyes of the public. The Report of SSC is certainly of great value to the management to ensure credibility of IFIs to the public at large.

The Islamic financial services industry currently are not fully and systematically undertake *shari'ah* audit. Even though, the products and services are approved by BNM and the *shari'ah* advisors, no systematic review has been comprehensively undertaken to ensure proper *shari'ah* compliance. This implementation process should be initiated by the relevant authorities such as Bank Negara Malaysia (BNM), IFIs themselves or/ and a dedicated independent institution to be established either by the industry or by the BNM.

The Challenges

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 *shari'ah* compliance purposes. Auditing should be done by a competent, independent person. To do an audit, there must be information in a verifiable form and some standards (criteria) by which the auditor can evaluate the information. Information can and does take many forms. *Shari'ah* auditors perform audits on both objective (financial information e.g. profit distribution) and subjective information (*shari'ah* information) to ensure *shari'ah* compliance of Islamic banks.

Shari'ah Audit Evidence

The first challenge to undertake *shari'ah* audit is to establish audit evidence. *Shari'ah* audit evidence can be defined as any information used by the auditor to determine whether the information being audited is stated in accordance with established criteria for *shari'ah* assurance purposes.

The criteria for evaluating information vary depending on the information being audited. In the audit of historical financial statements by auditors, the criteria are usually the financial reporting standards (FRS). For more subjective information, it is more difficult to establish a criteria. Typically, auditors and entities being audited agree on the criteria well before the audit starts. For the *shari'ah* auditing process of Islamic financial services, the criteria could be developed based on the written opinions of the SSC, the product manuals and the standard operating procedures.

Audit evidence is necessary information used by the auditor to determine whether the information being audited is in accordance with the established criteria. Similarly for *shari'ah* auditing process, evidence may take many forms including: oral testimony of the auditee; written communication with outsiders; observations by the auditor; and as well as electronic data about transactions. To satisfy the purpose of the audit, the auditors must obtain a sufficient quality and volume of evidence. Auditors must determine the types and amount of evidence necessary and evaluate whether the information corresponds to the established criteria.

Evidence includes information that is highly persuasive, such as the auditor's investigation of legal documents, and less persuasive information, such as responses to questions of client employees. The auditor gathers evidence to draw conclusions. A major decision facing every *shari'ah* auditor would be to determine the appropriate types and amount of evidence to accumulate to be satisfied that the client maintained effective internal control over *shari'ah* matters.

Shari'ah audit should involve a systematic review of the operational aspects of the IFIs. This will include an examination of the policies and procedures of the IFIs such as product manuals, operational processes, contracts etc. *Shari'ah* audit also needs to review the organizational structure to ensure it is feasible to undertake a *shari'ah* compliant activity. This will include the availability of qualified staff with a sufficient knowledge of *shari'ah* to support the operations of the IFIs.

Shari'ah Audit Programs and Procedures

The second challenge to undertake *shari'ah* audit would be to develop a systematic and thorough audit program. The list of audit procedures for an entire *shari'ah* audit is considered as a *shari'ah* audit program. There will be an audit program for legal documentations, for operational procedures, and so on. An audit program is designed to audit a particular area of the overall scope of the audit exercise. Therefore, it is common to have several different audit programs for the various departments and business activities.

Shari'ah audit programs can be developed to cover variety of Islamic financial products and services such as: (i) Islamic deposit and investment based on *wadi'ah* and *mudarabah*; (ii) Islamic home financing based on BBA and *musharakah mutanaqisah*; (iii) Islamic motor vehicle financing based on *ijarah*; (iv) Islamic trade financing based on *murabahah*, *wakalah*, etc.; (v) Islamic personal financing and credit card; and many others. The *shari'ah* audit program also need to be written in the language that can be easily understood by the potential stakeholders. Their feedbacks are required after a period of testing the *shari'ah* audit program in practice.

Shari'ah audit is a process to ensure that any activities carried out by the Islamic financial institutions do not contravene the *shari'ah*. The first scope of *shari'ah* audit could be the audit of financial statement of the IFIs. This is to review and to ensure the financial transactions are recognized, measured and reported accurately and reflect the rights and

obligations arising from the various *shari'ah* contracts. The adherence to best practices should also consider the existing accounting standards, BNM rules and regulations, and the relevant international standards such as those provided by AAOIFI.

There are at least 3 phases of the *shari'ah* audit i.e. (1) Planning; (2) Examination; and (3) Reporting (Mohamed Sultan, 2007). At the Planning stage, the auditors need to understand the business of the Islamic financial institutions including the nature of contracts used for different types of Islamic financial services. Then, the *shari'ah* auditors need to identify appropriate techniques, resources and scope to develop audit program. The audit program will then identify the key activities to be undertaken, the objectives of each activity and techniques to be used including sampling technique, in order to achieve each audit objective. Among the techniques to be adopted would be examination of papers, interviewing, benchmarking, surveys, case studies, flow charting and others.

At the Examination stage, the right audit techniques need to be identified and deployed. The right techniques are needed to gather the required evidence both in quality and quantity, to enable reasonable conclusions to be reached on the *shari'ah* compliance. There will be certain aspects of the audit fieldwork which will require sampling techniques. A more detailed examination of the documentations would be necessary whether sampling methodology is used or not. Of immense importance during the field work are the working papers and audit records. The main purpose of retaining working papers is to furnish systematic record of work carried out during the audit and they also represent a record of information and facts obtained to support the findings and conclusions.

At the final stage i.e. Reporting stage, it represents deliverable of the audit exercise. This will include preparing the *shari'ah* audit report, which is the communication of the auditor's findings to users. Reports differ in nature, but all must inform readers of the degree of correspondence between information and established criteria.

Shari'ah Audit Education

The third challenge would be to produce competent and independent *shari'ah* auditors. The *shari'ah* auditors must be qualified to understand the criteria used and competent to know the types and amount of evidence to accumulate to reach the proper conclusion after the evidence has been examined. The auditors must also have an independent

mental attitude. The competence of the individual performing the audit is of little value if he or she is biased in the accumulation and evaluation of evidence. Although absolute independence is impossible, *shari'ah* auditors must strive to maintain a high level of independence to keep the confidence of users relying on their reports. In the case of internal *shari'ah* auditors – those employed by the companies they audit – they usually report directly to top management, keeping the auditors independent of the operating unit they audit.

So far, there is no specialized academic and professional education and training program on *shari'ah* audit that can cater the needs of both the financial institutions and the regulators. The education and training program should equip the *shari'ah* auditor with two basic knowledge i.e. specialised *shari'ah* knowledge as applied in Islamic banking and finance, and Accounting and Auditing knowledge and skills. Two groups of potential entrants to *shari'ah* audit education and training would be *shari'ah* graduates and accounting graduates. The needs for a professionally dedicated qualification would be necessary in the long term in view of the expansion of Islamic banking and finance industry world wide.

Conclusion

The paper has argued for the needs of *shari'ah* audit to complement the current governance mechanism of Islamic financial services industry. There are a number of challenges as identified above that must be addressed to ensure *shari'ah* audit can be effectively implemented. In the mean time, there is a need to focus on research and development. Research and development requires critical review of the current *shari'ah* supervisory practices, and also to evaluate the sufficiency and the limitations of the present governance framework. There is a requirement for a framework that will detail out policy guidance to properly conduct both the internal and the external *shari'ah* audit. This policy guidance framework for the proper undertaking of *shari'ah* audit can be used as part of the routine supervision of the IFIs in Malaysia. In addition, a policy guidance paper is also needed for the IFIs themselves, for the proper undertaking of internal *shari'ah* audit in their respective institutions. Finally, a thorough and tested *shari'ah* audit program for Islamic financial services will become a requirement once the regulatory infrastructures are in place. This can be achieved with the cooperation of relevant interested parties such as IFIs, BNM, accounting and auditing firms, and SSCs to effectively develop *shari'ah* audit program to ensure proper conduct of *shari'ah* compliance.

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