

ENHANCING THE INTEGRITY OF ISLAMIC FINANCIAL INSTITUTIONS IN MALAYSIA: THE CASE FOR THE SHARĪ'AH AUDIT FRAMEWORK

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I. INTRODUCTION

Enhancing integrity is of prime importance for any business and it is especially more pressing in the case of Islamic Financial Institutions (IFIs). IFIs claim to practice ethical finance and thus must be in compliance with the Sharī'ah in all their business activities and operations. Their stability, financial performance and ability to provide intermediate resources will depend on stakeholders' confidence in the integrity of the IFIs. A particular feature of confidence and integrity 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 (Graiss and Pallegriani, 2006).

Since the Sharī'ah is the cornerstone of Islamic financial products and services, if the stakeholders are aware that the products that they have in their portfolio are not Sharī'ah-compliant, this would seriously undermine the integrity of and confidence in the Islamic financial services industry as a whole (Bhambra, 2007). Some regulators have sought to find a solution through the implementation of adequate systems and controls that ensure compliance with the Sharī'ah. Such Sharī'ah systems and controls should ensure that the rulings of the Sharī'ah Committee are disseminated and implemented throughout

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the financial institutions. The Sharī'ah systems and controls need to be supplemented with Sharī'ah audit requirements. These audit requirements will provide mechanisms for a regulator to monitor, control and take action against the financial institutions if they do not meet the Sharī'ah requirements.

In broad terms, Sharī'ah audit is a process of accumulating and evaluating evidence to determine and report on the degree of correspondence between information and established criteria for Sharī'ah compliance purposes (Abdul Rahman, 2008). Auditing is an assurance process conducted by a competent and independent person. To conduct an audit, there should 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. Sharī'ah auditors may perform audits on both objective (financial information, e.g. profit distribution) and subjective information (Sharī'ah information) to ensure Sharī'ah compliance of IFIs.

The objective of the paper is to provide an overview of a research and development initiative initiated by the International Sharī'ah Research Academy in Islamic Finance (ISRA) and Bank Negara Malaysia (BNM) to produce the Sharī'ah Audit Framework. The Framework aims to provide a guide for IFIs in Malaysia to conduct Sharī'ah audit. The paper firstly explains the Sharī'ah Governance Framework recently issued by BNM, which the Sharī'ah Audit Framework will aim to complement. Secondly, the paper provides a discussion on the need for the Sharī'ah Audit Framework. Thirdly, the paper presents some of the institutional arrangements and requirements that need to be considered to ensure that the IFIs will be able to effectively undertake a Sharī'ah audit function.

II. THE SHARĪ'AH GOVERNANCE FRAMEWORK: AN OVERVIEW

Bank Negara Malaysia (BNM) recently issued the Sharī'ah Governance Framework that is effective from January 2011. The Sharī'ah Governance Framework (hereinafter to be referred to as the Framework) is a set of organisational arrangements through

which Islamic financial institutions (IFIs) ensure effective oversight, responsibility and accountability of the board of directors, management and Shari'ah Committee. The Framework serves as a guide towards ensuring an operating environment that is compliant with Shari'ah principles at all times. Shari'ah principles provide the foundation for the practice of Islamic finance through the observance of the tenets, conditions and principles propagated by Islam. Comprehensive compliance with Shari'ah principles would bring confidence to the general public and the financial markets in the credibility of Islamic finance operations.

The Framework aims essentially to strengthen the Shari'ah governance process, decision making, accountability and independence. The Framework reinforces the Shari'ah compliance functions, internal Shari'ah review and audit requirements, and is supported by an appropriate risk management process and research capability. It is envisaged that the implementation of the Framework will contribute towards more robust and sound Shari'ah governance within Islamic financial institutions which, in turn, will promote Shari'ah compliance throughout the organisation.

The Framework is divided into six sections as follows:

- i. General requirements of the Shari'ah governance framework
- ii. Oversight, accountability and responsibility
- iii. Independence
- iv. Competency
- v. Confidentiality and consistency
- vi. Shari'ah compliance and research functions.

The general requirements describe the essential key functional areas or key organs of the Framework. The guidelines on oversight, accountability and responsibility outline the levels of accountability and responsibility of the directors, Shari'ah Committee and management of IFIs. The guidelines on independence are aimed at safeguarding the independence of the Shari'ah Committee in ensuring sound Shari'ah decisions, and emphasise the role of the board of directors in recognising the independence of the Shari'ah Committee.

The competency guidelines highlight the requirements and expected competencies to ensure key functions are capable of

implementing Sharī'ah governance. The confidentiality and consistency guidelines provide a minimum set of rules that emphasise the importance of observing and preserving confidentiality and improving consistency by the Sharī'ah Committee. Finally, the guidelines on Sharī'ah compliance prescribe the functions of the internal Sharī'ah review, Sharī'ah audit, Sharī'ah risk management process and the Sharī'ah research functions.

Islamic financial institutions are also expected to establish three functions that provide a system of checks and balances within the organisation, which include the following:

- i. The Sharī'ah *risk management control function* that is able to identify all possible risks of Sharī'ah non-compliance and, where appropriate, remedial measures to manage this risk;
- ii. The Sharī'ah *review function* that continuously assesses Sharī'ah compliance of all activities and operations. Where instances of non-compliances are identified, the institution is expected to take prompt rectification measures and put in place the necessary mechanisms to avoid such recurrences; and,
- iii. The Sharī'ah *audit function* that performs annual audits to provide an independent assessment of the adequacy and compliance of the Islamic financial institution with established policies and procedures, and the adequacy of the Sharī'ah governance process.

The Framework clearly delineates the Sharī'ah review function and the Sharī'ah audit function. While the Sharī'ah review function is the responsibility of the organs of the IFIs, namely the board, the management and the Sharī'ah Committee, the Sharī'ah audit function should be undertaken by an independent internal audit unit, or externally by a qualified and competent third party. The word "audit" entails an independent assurance process, while the review function is performed by the management themselves. Hence, there is a clear need for the Sharī'ah audit function, and more importantly, the Islamic finance industry needs proper and comprehensive guidelines to enable IFIs to undertake Sharī'ah audit.

III. DEVELOPING THE SHARĪ'AH AUDIT FRAMEWORK

In essence, there is a need for Sharī'ah audit to ensure that all activities and operations carried out by the IFIs do not contravene the Sharī'ah. The first scope of Sharī'ah audit is the audit of the financial operations of the IFIs. The audit of the financial transactions is needed to ensure that the transactions are recognised, measured and reported accurately and reflect the rights and obligations arising from the various Sharī'ah contracts. The adherence to best practices should consider both the existing accounting standards, the existing BNM rules and regulations, the Sharī'ah parameters, the resolutions of the Sharī'ah Advisory Council (SAC), and the relevant international standards, such as those provided by AAOIFI.

Secondly, Sharī'ah audit should undertake a systematic examination of policies and procedures of the IFIs, such as product manuals, operational processes, contracts, etc. Thirdly, Sharī'ah audit needs to examine the organisational structure of the IFIs to ensure their feasibility to undertake Sharī'ah-compliant activities. This will include the availability of qualified staff with a sufficient knowledge of Sharī'ah to support the operations of the IFIs.

For Sharī'ah audit to be effectively undertaken there is a need for Sharī'ah auditors that understand the business of the IFIs, including the nature of contracts used for different types of Islamic financial services. An audit program will then need to be identified and developed for the key auditing processes to be undertaken, the objective of each activity and the techniques to be used (including sampling techniques) in order to achieve each audit objective.

The Islamic financial industry does not currently fully and systematically undertake Sharī'ah audit. Even though the products and services are approved by BNM and the Sharī'ah Committee, no systematic auditing has been comprehensively undertaken to ensure proper Sharī'ah compliance. In the absence of proper guidelines to undertake Sharī'ah audit, many IFIs have difficulties in properly planning, executing and reporting Sharī'ah audit.

ISRA has recently initiated a study that aims to come up with a policy guidance paper – the Sharī'ah Audit Framework – to be considered by the Islamic finance industry and BNM. This policy guidance paper will serve as the guidelines for the proper undertaking

of Sharī'ah audit. These guidelines are expected to assist the IFIs by facilitating the proper undertaking of Sharī'ah audit in their respective institutions.

This study aims to achieve the following three objectives:

- i. To review the current Sharī'ah supervisory and auditing practices among the IFIs in Malaysia.
- ii. To evaluate the present Sharī'ah Governance Framework of the IFIs in Malaysia.
- iii. To propose the Sharī'ah Audit Framework that will lay out policy recommendations and guidelines in order for the IFIs to properly conduct Sharī'ah audit.

The study adopts a number of approaches and techniques to achieve the above objectives. In the first stage, the research will draft the Sharī'ah Audit Framework based on inputs gathered in the focus group (research cluster) meetings. The members of the focus group comprise selected Sharī'ah scholars, academic experts, and industry experts. Literature review is also conducted in parallel with the focus group meetings to provide theoretical support for the research.

In the second stage, the draft of the Sharī'ah Audit Framework is presented and discussed with the IFIs and the stakeholders. The industry feedback is crucial to ensure the relevance of the draft and effective implementation later. In the final stage, the final Sharī'ah Audit Framework will be re-drafted and further consolidated before submission to and consideration by the BNM.

IV. SHARĪ'AH AUDIT FRAMEWORK: INSTITUTIONAL ARRANGEMENTS AND REQUIREMENTS

In the course of developing the Sharī'ah Audit Framework, the study focuses its work on the internal Sharī'ah audit function. While the external Sharī'ah audit is crucial, based on the initial feedback of the industry players and BNM, the study found that the more immediate need is to have an effective internal Sharī'ah audit function in place. The internal Sharī'ah audit is concerned with sound and effective

internal control systems for Sharī'ah compliance through continuous periodical assessment. The Sharī'ah audit function is designed to add value and improve IFI compliance by providing an independent assessment and objective assurance. The paper will present necessary institutional arrangements and requirements that will facilitate the internal Sharī'ah audit function.

A. Objectives and Scope of Sharī'ah Audit

The primary objective of the internal Sharī'ah audit should be to ensure that the management is discharging its responsibilities of Sharī'ah compliance in all activities and operations of the IFI. In addition, the purpose of internal Sharī'ah audit should also be to ensure that the system of internal control for Sharī'ah compliance is conceptually sound and effective in its implementation.

For the implementation of internal Sharī'ah audit, the IFI shall need an internal Sharī'ah audit unit that is independent from the management. The unit is accountable directly to the Board through the Board Audit Committee. The head of the internal Sharī'ah audit unit shall be appointed by the Board.

Prior to the implementation of a separate unit of the internal Sharī'ah audit unit, the IFIs should consider their scale of operations, capacity in terms of manpower or human resources and also the costs associated in its implementation. Members of the internal Sharī'ah audit unit should build and develop trust with other units in the IFI in order to effectively and efficiently execute their tasks. They should appear as business partners rather than auditors or corporate watchdogs.

The Board should ensure that the internal Sharī'ah audit unit is adequately resourced in terms of qualified and competent staff and adequate funds to ensure the effective performance of its functions. The internal Sharī'ah audit unit should have a Sharī'ah audit charter that establishes the audit's position within the organisation and addresses the following issues:

- i. The nature of internal Sharī'ah auditing;
- ii. The Sharī'ah audit objectives;
- iii. The scope of Sharī'ah audit work;
- iv. Sharī'ah audit's responsibilities;

- v. Sharī'ah audit's authority;
- vi. Sharī'ah audit's independence.

The Sharī'ah audit charter should clearly specify the planning, implementation and reporting of internal Sharī'ah audit. The internal Sharī'ah audit unit should plan the Sharī'ah audit activities for the year, which must be communicated to the Sharī'ah Committee and their feedback should be considered. Once the Sharī'ah audit function is performed by the auditors, it should then be reported directly to the Board Audit Committee and the Sharī'ah Committee for deliberation. The final report should then be tabled before the Board for their attention and remedial action.

The internal Sharī'ah audit function should specify that the internal Sharī'ah auditors must have direct and regular communications with all levels of management and the Sharī'ah Committee. There should not be any scope of limitation and restriction of access to documents, reports, personnel, etc. placed on the internal Sharī'ah auditors. This is to ensure the efficiency and effectiveness of the internal Sharī'ah audit function.

The scope of the Sharī'ah audit function shall cover all aspects of the IFI's business activities and operations, including:

- i. Sharī'ah matters affecting the financial statements of the IFI (e.g. profit distribution policy; penalty charge; basis of income recognition; zakat computation, etc.)
- ii. Compliance audit on organisational structure, human resource and information technology application systems;
- iii. Sharī'ah compliance of the products, services and marketing;
- iv. Effectiveness of Sharī'ah internal control system;
- v. Sharī'ah non-compliance risks management function;
- vi. Special or ad-hoc Sharī'ah audit assignments as directed by the Board or the Sharī'ah Committee; and
- vii. Adequacy of Sharī'ah governance processes.

The function of the internal Sharī'ah audit unit shall include, but is not limited to:

- i. understanding the business activities to allow better audit implementation, i.e. auditability and relevance of activities;

- ii. developing a comprehensive internal Sharī'ah audit program that shall include objectives, scope, procedures, personnel assignment, sampling, control and duration;
- iii. obtaining and making reference to relevant established Sharī'ah criteria, including published Sharī'ah Committee rulings, BNM guidelines and BNM Sharī'ah parameters and possibly the OIC *Fiqh* Academy Rulings and AAOIFI Sharī'ah standards;
- iv. conducting Sharī'ah audit on a periodical basis;
- v. communicating results and findings to the Board Audit Committee.
- vi. providing regular formal internal Sharī'ah audit reports to the Board Audit Committee as well as the Sharī'ah Committee; and
- vii. providing recommendations as well as following up on rectification measures taken by IFIs.

The report of internal Sharī'ah audit shall also contain the observations and the assessment of systems, Sharī'ah non-compliance risks and controls. The internal Sharī'ah audit report shall provide recommendations for potential improvements and corrective actions to be taken. If there are any disputes/differences of opinion between the management and the internal Sharī'ah auditors on matters relating to Sharī'ah, the interpretation and final decision shall be referred to the Sharī'ah Committee of the IFI.

B. Independence and Reporting

To ensure independence, the internal Sharī'ah audit reports should be presented, reviewed and endorsed by the Board Audit Committee. In addition, the reports should also be escalated to the Sharī'ah Committee of the IFI. The internal Sharī'ah auditors should have an independent mental attitude. The competency 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, internal Sharī'ah auditors must strive to maintain a high level of independence to retain the confidence of users relying on their reports. Internal Sharī'ah auditors are required to report directly to the Board Audit Committee.

Internal Sharī'ah audit should be part of the regular internal audit function. The internal Sharī'ah audit unit is a dedicated unit to conduct Sharī'ah audit in the IFI. Proper implementation of the internal Sharī'ah audit unit requires its members to always ask themselves whether or not they will be able to provide assurance on what has been audited.

The Board Audit Committee, upon consultation with the Sharī'ah Committee, shall determine the deliverables of the internal Sharī'ah audit. The Board Audit Committee is expected to review and endorse the Sharī'ah audit plan. The reports of the Sharī'ah audit findings should be submitted for the consideration and deliberation of the Board Audit Committee.

Since the members of the Board Audit Committee may have inadequate Sharī'ah knowledge to effectively execute their supervisory function, it may be necessary that the representative of the Sharī'ah Committee be invited to attend selected meetings according to needs. In addition to the reports provided to the Board Audit Committee, the internal Sharī'ah audit function should also provide reports of their audit to the Sharī'ah Committee of the IFI for their attention, deliberation and further action.

It is imperative that the internal Sharī'ah audit activity should be free from interference in determining the scope of auditing, performing work, accessing evidence and communicating results. Internal Sharī'ah auditors should have an impartial, unbiased attitude and avoid conflict of interest. If independence or objectivity is impaired in fact or appearance, the details of the impairment should be disclosed to the Board Audit Committee. The nature of disclosure will depend upon the nature of the impairment.

C. Audit Criteria and Standards

The internal Sharī'ah auditing process should be undertaken with reference to the established Sharī'ah criteria, which include but are not limited to:

- i. the written opinions of the SAC BNM;
- ii. the Sharī'ah parameters established by the BNM;
- iii. other relevant and applicable pronouncements issued by the BNM;

- iv. the written opinions of the SC of the IFIs;
- v. the Sharī'ah standards and/or Fatwas issued by the OIC Fiqh Academy, AAOIFI, IFSB and other established authorities; and
- vi. the product manuals and the standard operating procedures of the IFIs.

Audit evidence is the necessary information used by the auditor to determine whether the information being audited is in accordance with the established criteria. For the Sharī'ah auditing process, evidence may take many forms, including:

- i. product manuals, contracts, minutes and agreements;
- ii. accounting transactions, books and documents;
- iii. oral testimony of the auditee;
- iv. written communication with outsiders;
- v. observations by the auditor; and
- vi. electronic data about transactions.

To satisfy the purpose of the audit, the auditors require reliable and sufficient quality and quantity of evidence. Auditors must determine the types and amount of evidence necessary and evaluate whether the information corresponds to the established criteria. Sharī'ah auditors need to determine the appropriate types and amount of evidence to accumulate and to evaluate their sufficiency and reliability to be satisfied with the existence of effective internal controls over Sharī'ah matters. Sharī'ah audit also needs to review the organisational structure to ensure it is conducive to undertake Sharī'ah compliance activities and operations.

Sharī'ah audit needs to develop a systematic and thorough Sharī'ah audit program. The list of audit procedures for an entire Sharī'ah audit is termed as a Sharī'ah audit program. An audit program is designed to audit a particular area of the overall scope of the audit exercise. It is common to have several different audit programs for the various departments and business activities. Sharī'ah auditors should develop audit programs to cover a variety of Islamic financial products and services.

In the case of Sharī'ah audit of the financial statements of the IFIs, there is a need to review and to ensure that the financial transactions are recognised, measured and reported accurately and

reflect the rights and obligations of affected parties arising from the various Sharī'ah contracts. The adherence to best practices should also consider the existing enforced accounting standards, BNM rules and regulations, and the relevant international standards, such as those provided by AAOIFI.

D. Competency

The internal Sharī'ah auditors should possess adequate auditing knowledge, skills and competencies regarding the following:

- i. proficiency in applying internal auditing standards and procedures;
- ii. proficiency in accounting principles and techniques;
- iii. understanding of management principles;
- iv. appreciation of accounting, economics, commercial law, taxation, finance, quantitative methods and IT;
- v. skills in dealing with people and communicating; and
- vi. skills in oral and written communication.

The internal Sharī'ah auditors should have the ability to construct relevant and appropriate audit tests in line with the audit objectives of any particular area of the audit. The internal Sharī'ah auditors should also have adequate knowledge of the Sharī'ah. The specialised nature of their work requires knowledge of Sharī'ah, especially *fiqh mu'āmalāt*, essential for them to carry out their work effectively.

The IFIs should encourage members of the internal Sharī'ah audit unit to continuously participate in training on *fiqh mu'āmalāt*. This is to keep them abreast with issues, development and practices concerning *fiqh mu'āmalāt*. Consequently, the IFIs should create a special position of internal Sharī'ah auditors that will function within the internal Sharī'ah audit unit of the IFIs.

V. CONCLUSION

Internationally, Shari'ah audit regulation is yet to be fully enforced by the respective central banks and monetary authorities (Abdul Rahman, 2009). Shari'ah audit is essentially an assurance process and it should be conducted by third party and independent auditors. The Shari'ah Committee of the IFIs only advises the institutions, and it is not in the position to audit the processes and activities of the institutions concerned. Hence, Shari'ah audit is needed to fill the gap of Shari'ah-compliant activities and services (Abdul Rahman, 2009). The stakeholders need to be assured that the institutions that offer Islamic services have sufficient levels of Shari'ah-compliant processes and controls in place. The imperative next step for the development of the Islamic financial industry is to meet the need for comprehensive guidelines on the Shari'ah audit function to complement the current Shari'ah governance mechanism. The initiative by BNM and ISRA to develop the Shari'ah Audit Framework is a timely and commendable effort to further enhance the integrity of IFIs.

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