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Kyoto University
Management of Shariah Non-Compliance Audit Risk in the Islamic Financial Institutions via the Development of Shariah Compliance Audit Framework and Shariah Audit Programme

Zurina Shafii*, Supiah Salleh**, Syahidawati Hj Shahwan***

I. Introduction

Shariah compliance audit is conducted to enable the Shariah committee to express an opinion that the operations of IFIs are conducted in accordance with the fatwas, rulings and guidelines issued by the Shariah Supervisory Board of the Islamic financial Institutions, the accounting standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), national accounting standards and practices, and relevant legislation and regulations applied in the country in which the Islamic Financial institution operates. Shariah review is an examination of the extent of an IFI’s compliance in all its activities, with the Shariah. This examination includes contracts, agreements, policies, products, transactions, M&A, financial statements, reports and circular.

The objective of the review is to ensure that the activities carried out by an IFI do not contravene the Shariah. Practically in Malaysia, it is the responsibilities of Shariah Advisor (SA) to ensure that all products and services and related policies and agreements of Islamic Instruments are in compliance with Shariah rules and principles. In terms of reporting, Shariah Advisors shall prepare a written Shariah opinion report in the Bank’s annual financial statement in respect of its Shariah compliance. Duties and responsibilities of Islamic Financial Institutions (IFI) are to refer all Shariah issues to the Shariah Advisors. The IFI also must adopt SA’s advice pertaining to policies and agreements, ensure that all product documents be validated, provide access to relevant documents, provide sufficient resources to SA in terms of budget allocations, reference materials and training and remunerate the SA accordingly.

Nevertheless, there is no external Shariah audit being imposed in Islamic Financial Institutions in Malaysia. External Shariah Compliance Audit has not yet been made mandatory by the regulators in Malaysia. It is only Imposed internally or only a few from Islamic Financial Institutions might voluntary appoint Shariah Advisory firms to review on the Shariah matters whether it comply with the Shariah rules and principles or not. The reason behind this is because currently, in Malaysia there is no standard Shariah Compliance Audit framework that can be used as guidelines in implementing external Shariah compliance.

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Audit in Islamic Financial Institutions. A proper standard framework for Shariah Compliance Audit is essential to ensure the harmonization of Shariah practice in Islamic Financial Institutions. The development of Shariah audit programme is also important as to ensure the procedures (Magasid Shariah) of each product in IFI are being followed. Thus, this study is aimed to develop Shariah Compliance Audit Framework and Audit Programme development for Islamic Financial Institutions specifically in Islamic Banking and Takaful institutions.

Shariah Compliance Audit Framework and Audit Programs for the products of IFIs will be able to mitigate the Shariah non-compliance risk as it recognises the operational issues in the IFIs that complies to the Shariah and other sources of attestation or otherwise. Shariah compliance is critical to IFIs operations and such compliance requirements must permeate throughout the Organization and their products and activities. As a majority of the fund providers use Shariah-Compliant operation as a matter of principle, their perception regarding IFIs compliance with Shariah rules and principles is of great importance to sustainability of IFIs. In this regard, Shariah compliance is considered as falling within a higher priority category in relation to other identified risks.

Shariah Compliance Audit is performed to manage the operational risk in IFIs. The principles are grouped into six categories of risks, and shall be used as the basis for Islamic Financial Institution’s risk management process. A review on the principles of Islamic risk management as indicated by the Islamic Financial Services Board (IFSB) its “Guiding Principles of Risk Management for Institutions (other than Insurance institutions) offering only Islamic Financial Services”1 document, to be discussed in Section II.

II. Risk Management in Islamic Financial Institutions

“Guiding Principles of Risk Management for Institutions (other than Insurance institutions)” published by the Islamic Financial Services Board (IFSB) categorises risks in IFIs into six categories of risks, namely; Credit risk, Investment risk, market risk, liquidity risk, rate of return risk and finally, operational risk. This paper will focus on the management of operational risk in IFIs by the way of carrying out proper Shariah Compliance Audit to the IFIs.

“Guiding Principles of Risk Management for Institutions (other than Insurance institutions)” presents 15 principles covering the general principles and specific risks mentioned above as follows:

2.1 General Principle
Principle 1- Islamic Financial Institution (IFI) should have a comprehensive risk management

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and reporting process in place. The process should consider appropriate steps to comply with Shariah rules and principles and to ensure the adequacy of relevant risk reporting to the supervisory authority.

2.2 Credit Risk

**Principle 2-** IFI should have a strategy for financing. The instruments used must be in compliance with Shariah, whereby it recognises the potential credit exposures that may arise at different stages of the various financing agreements.

**Principle 3-** IFI shall carry out a due diligence review in respect of counterparties prior to deciding on the choice of an appropriate Islamic financing instrument.

**Principle 4-** IFI should have appropriate methodologies for measuring and reporting the credit risk exposures arising under each Islamic financing instrument.

**Principle 5-** IFI shall have in place Shariah-compliant credit risk mitigating techniques appropriate for each Islamic financing instrument.

2.3 Investment Risk

**Principle 6-** IFI should have appropriate strategies in place for risk management and reporting processes in respect of the risk characteristics of equity investments, including Mudarabah and Musharakah investments.

**Principle 7-** IFI must ensure their valuation methodologies are appropriate and consistent, and they should conduct the assessment on the potential impacts of their methods on profit calculations and allocations. The methods shall be mutually agreed between the IFI and the Mudarib and/or Musharakah partners.

**Principle 8-** IFI shall, in respect of their equity investment activities, including extension and redemption conditions for Mudarabah and Musharakah investments, exit strategies should be defined and established and must subject to the approval of the institution’s Shariah Board.

2.4 Market Risk

**Principle 9-** In respect of all assets held, IFI shall have in place an appropriate framework for market risk management (including reporting) and also for those that do not have a ready market and/or are exposed to high price volatility.
2.5 Liquidity Risk
Principle 10- IFI shall have in place a liquidity management framework (including reporting) taking into account separately and on an overall basis their liquidity exposures in respect of each category of current accounts, unrestricted and restricted investment accounts.

Principle 11- IFI shall assume liquidity risk commensurate with their ability to have sufficient recourse to Shariah-compliant funds to mitigate such risk.

2.6 Rate of Return Risk
Principle 12- A comprehensive risk management and reporting process should be established by IFI in order to assess the potential impacts of market factors affecting rates of return on assets in comparison with the expected rates of return for investment account holders (IAH).

Principle 13- IFI must ensure that an appropriate framework for managing displaced commercial risk is in place, where applicable.

2.7 Operational Risk
Principle 14- IFI should have in place adequate systems and controls, including Shariah Board or Advisor, to ensure compliance with Shariah rules and principles.

Principle 15- IFI shall have in place appropriate mechanisms to safeguard the interests of all fund providers.

III. Literature Review on Shariah Compliance Audit

In developed economies, auditing is deemed significant because the process of wealth creation and political stability depends heavily upon confidence in processes of accountability, and how well the expected roles are being fulfilled (Sikka et al., 1998). As such, the courts, regulatory agencies and various stakeholder groups have played their parts in demanding that the profession move in an expeditious fashion to meet its responsibilities as perceived by the public (see Humphrey et al., 1992; Jacob, 1992; Ali et al., 2006). In contrast, for countries undergoing economic transition from communism to capitalism (Sucher & Zelenka 1998; Sucher et al., 1999; Hao, 1999; Sucher and Bychkova, 2001; Sucher and Kosmala-MacLullich, 2004; Lin and Chen, 2004) and in societies that have different cultural values (Hines 1992) or philosophies, the role of external auditing should be considered on its own merit since it is interwoven with historical, political, social and cultural processes.
The studies conducted on Shariah audit are very limited. Thus, this study attempts to venture findings related to Shariah audit, that later can contribute to the development of Shariah audit literature. To date, we have writing which attempts to explore the perceptions of Accounting Academicians, Audit Practitioners and Shariah Scholars on the practice of Shariah Audit for Islamic Financial Institutions that highlights the importance of developing a proper governance of the Shariah compliance issues (Shahul Hameed, 2007).

In addition to that, there is also a study that identifies the issues and challenges of Shariah compliance process in the IFIs on corporate governance and Shariah compliance in institutions offering Islamic financial services (Grais & Pellegrini, 2006). Their study focused on the limitations in relying on the Shariah compliance assurance to the internal party (i.e. Shariah Committee). They also proposed in their study that an effective framework to monitor and assess Shariah compliance. This finding is similar with study conducted by Abdul Manan (2006) that finds out even though the auditors are responsible in auditing the financial statement and give reasonable assurance that the financial statement is free from material misstatement, but somehow the external auditors did not assess or audit whether the transaction made by Shariah listed company is free from unlawful transaction which outline by the Qur’an and Sunnah. Abdul Manan (2006) also proposed in his study that there should be a proper framework for the external auditor to audit the IFIs.

The increase in complexity of transaction and an unpredictable economy also increases the requirement in producing Shariah Compliance Audit in the financial reporting. Even though there is discussion on the importance of corporate governance but the impact is still little in ensuring quality of Shariah auditing in financial reporting (Adawiah, 2007).

According to Engku Rabiah Adawiah (2007) there are 7 parts of Shariah Compliance that need to be fulfilled. The 7 parts of Shariah Compliance Governance can be illustrated through Figure 1 below.

![Figure 1: Shariah Compliance Governance](image-url)
However currently the on going process of Shariah compliance in Malaysia are currently looking at only 3 aspects, which is inception and conceptualization of an Islamic product, structuring the rules and principles as according to Shariah, and legal documentation procedures. The other four parts is still an on going process in Malaysia. The audit review stage, the process is still not yet formulized at the regulatory level. Even though some banks might impose it at the internal department level such as Internal Audit department, but there is no independent party being appoint to audit the financial report of the Islamic Financial Institutions. The latest study which is more comprehensive in identifying the issues and challenges of Shariah audit is done by Abdul Rahim (2008). He argued that Shariah audit is needed to complement the current governance mechanism of Islamic financial services industry. Abdul Rahim (2008) also discussed in his paper on some challenges which considered as pre-requisites to effectively undertake Shariah audit.

In addition to the above, Shariah Advisors shall also conduct and arrange Shariah training programs for the Islamic Banking staff especially the internal audit department to ensure the accuracy of financial reporting for Islamic instruments. Significantly, a strong Shariah infrastructure is essential to ensure that Islamic financial instruments and strategies are Shariah-compliant. (Adawiah, 2007)

The success of any kind of audit depends on the strength of human resources. The critical success factor is having expertise to do the Shariah audit and having credible people setting the work plan and reviewing the results. Although Shariah audits have not been made mandatory, hopefully such legislation will be passed since there is a gap between issued fatwas and the respective implementations. Even though there is no legislation requiring an External Shariah audit, we expect the demand to grow and get more attention from the Central Bank, Securities Commissions and other Islamic Financial Institutions.

IV. Proposed Shariah Compliance Audit Framework and Audit Programme for Islamic Financial Institutions

Islamic financial institutions are required to operate in the Shariah compliant manner. This is discharged through a report signed by the Shariah Advisor of the financial institutions that the company is operating under the Shariah requirements. Shariah audit framework is the frame of reference to be used by the Shariah auditors to audit the financial statements of Islamic financial institutions before they can decide that the operation of the business is performed in the manner not contradicts the Shariah. At current, the practice in the banking and takaful industry is that the Shariah Advisor depends on the work of internal auditors or via the voluntary appointment of external Shariah auditors to audit the financial statement and determine that the financial statements reflect the compliancy of their operations with the
Management of Shariah Non-Compliance Audit Risk in the Islamic Financial Institutions

Shariah. This creates the need for audit framework for Shariah auditors, internal or external to work with. Shariah auditors will be better off in term of being able to conduct audit in a standardized and efficient manner with a detailed audit programme for all Shariah compliant products. With the help from audit programmes for every product, comparability can be enhanced.

In developing the Islamic capital market, several aspects have been laid down mainly, the prohibition of Ribā, Gharar, Maysir, dealing in sinful activities. In addition, every contract has to be performed lawfully, following the acceptable contract objectives. These requirements can be used as the guiding principles that have to be observed by the Shariah Committee.

As Shariah audit is the process to attest that all the Shariah concern is being taken care of, the framework for Shariah audit can begin with the examination on the GPS-1 of BNM- Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions. The guideline states the roles of Shariah Committee towards the Islamic financial they are attached to. The guidelines took effect on the 1st April 2005. The guidelines has the broad objectives as to become “an effective Shariah framework would serve to ensure uniformity and harmonization of Shariah interpretations that will strengthen the regulatory framework and governance practices for the Islamic financial industry”.

Shariah compliance audit framework should enlighten the Shariah Committee on how they can discharge their professional duties to the board of directors, which in turn owe to the investors that the company operates under the Shariah guidelines.

The guidelines by the BNM aim at achieving:

a) To set out the rules, regulations and procedures in the establishment of a Shariah Committee,
b) To define the role, scope of duties and responsibilities of a Shariah Committee, and
c) To define relationship and working arrangement between a Shariah Committee and the SAC of BNM

Part E of the Guideline states the duties and responsibilities of the Shariah Committee and the Islamic financial institutions. The main duties and responsibilities of the Shariah Committee are as follows:

a) To advise the Board on Shariah matters in its business operation
b) To endorse Shariah Compliance Manual. A document contains the request for advice is made to the Shariah Committee, the conduct of Shariah Committee’s meeting and the manner of compliance with any Shariah decision.
c) To endorse and validate relevant documentations; including the proposal form,
contract, agreement or other legal documentation used in executing the transactions. Other documentations are product manual, marketing advertisements, sales illustrations and brochures.

d) To assist related parties on Shariah matters for advice upon request
e) To advise on matters to be referred to the SAC
f) To provide written Shariah opinion
g) To assist the SAC on reference for advice

The GPS-1 guideline can be a starting point for us to establish a Shariah Compliance Framework where it can enlighten the Shariah Committee on how to discharge their duties and responsibilities stated above. In a), the Shariah Committee’s duties to advise the Board on Shariah matters in its business operation encompasses a large area of responsibilities. This proposal proposes that Shariah Compliance Audit to be undertaken to all the products offered by the Islamic financial institutions following the audit programs established by the IFIs and endorsed by the Shariah Committee. And this shall form part of the Shariah Committee’s disposal of duties under the item a).

This guideline can act as a theoretical framework of Shariah Compliance Audit as the Guideline stated the scope of documentation audit falls under the responsibility of SC. Shariah Compliance Audit Framework may start from establishing the Audit Program to audit these documents (proposal form, contract, agreement or other legal documentation used in executing the transactions, product manual, marketing advertisements, sales illustrations and brochures) for each of the products stated as Shariah Compliant. The Shariah Compliance of the operations based on these documentations, in turn can be attested against the various sources ranging from regulations, Shariah guidelines, accounting and auditing standards (AAOIFI), etc.

Sources of Attestation for Shariah Compliance Audit for Islamic Banks consist of the following; among others:

i. Islamic Banking Act 1983 (ACT 276)
ii. Companies Act 1965
iii. All guidelines and Circulars Issued by BNM regards to Islamic Banking i.e. Financial Reporting - Guidelines on Financial Reporting for Licensed Islamic Banks
iv. Resolutions of Shariah Advisory Council of Bank Negara Malaysia
v. Guidelines and Circular by the Shariah Advisory Council of Securities Commission
vi. Shariah Standards issued by AAOIFI
vii. Guiding principles issued by the Islamic Financial Services Board (IFSB)
viii. Internally Developed Standards (Subject to Shariah Committee approval) i.e.
Company’s Shariah Manual
ix. Resolution and Minute meeting of Company’s Shariah Committee
x. Additional reference i.e.
   - The OIC Fiqh Academy
   - The Islamic Research Institute of the al-Azhar University
   - Practise of internal auditing standard.

4.1 Proposed Shariah Compliance Audit Framework

Referring to Figure 2, the basic general rulings in Muamalat are all transactions for Islamic Financial Institutions should be free from Riba, Maysir, Gharar and other prohibited activities. These rules are essential and considered the most important guidelines that need to be followed and inline with Al-Qur’an and As-Sunnah.

Secondly, Figure 2 shows that the needs for Shariah compliance audit are because of the requirements from regulators by Bank Negara Malaysia of GPS-1 on the duties and responsibilities of Shariah Committee in IFIs. The first and second level of the pyramid is the preliminary stage of Shariah compliance audit framework.

The third level is where the auditing process of attestation and assurance on the documentations and procedures (proposal form, contract, agreement or other legal documentation used in executing the transactions, product manual, marketing advertisements, sales illustrations and brochures).
Lastly, the issuance of Shariah compliance audit report will take place whereby the Shariah auditors need to state their opinion whether the institutions comply with the Shariah regulations and principles or not. The issuance of Shariah Compliance Audit report is important to the stakeholders that require assurance on Shariah compliance and accountability in the Islamic Financial Institutions.

4.2 Shariah Audit Programme

In order to provide a guideline to the external and internal Shariah auditors, a comprehensive step by step audit program is vital to ensure the operation of IFIs is conducted in accordance to the Shariah principles. A Shariah Audit Program can be designed to attest the business operation of IFIs as well as the values practiced in the IFIs through observations and interviews.

\[\text{SHARIAH AUDIT PROGRAMME}\]

\begin{tabular}{|l|}
\hline
Business Operations \\
\hline
- Maqasid Shariah (Objectives of Shariah) \\
- Aqad \\
- Screening for the prohibition or Riba, Gharar, Maysir and non-permitted activities \\
- Documentation and procedures audit \\
- Financial considerations \\
- (e.g. where investment is parked, the threshold of non-permitted activities in the core operation) \\
\hline
Values \\
\hline
- Observations \\
- Interviews \\
\hline
\end{tabular}

Figure 3: Shariah Audit Programme

V. Scope of Shariah Compliance Audit

The scope of work encompasses the examination of the adequacy and effectiveness of the system of Shariah control and the quality of performance in carrying out assigned responsibilities. Shariah rules and principles shall provide direction to the scope of work and activities to be reviewed.
The purpose of the examination of adequacy of the Shariah control system is to ascertain whether the system provides reasonable assurance whether Islamic Financial Institutions (IFI) is effective and efficient in meeting the objectives of Shariah compliance. The examination of the effectiveness of the system is to ensure that the system was functioning as intended. Hence effective planning, organizing and directing of the processes by the reviewers is necessary to determine whether reasonable assurance for the accomplishment of Shariah compliance objectives as well as other goals exist.

5.1 The Performance of the Shariah Compliance Audit Work
The performance of Shariah Compliance Audit work comprises of the following:

5.1.1 Planning and Documentation
The planning and documentation involved the following tasks:

- Establishing Shariah compliance audit objectives and scope of Work
- Obtaining Shariah Supervisory Board (SSB) fatwas, guidelines, instructions, prior year internal and external Shariah review results and other relevant correspondence with supervisory and regulatory agencies
- Determining the capacity as well as resources to perform the review
- Communicating with relevant parties involved with the review
- Performing feasibility survey and interview on activities, risks and controls to identify areas of emphasis
- Developing Shariah Audit Programs
- Determining mode and timing review results to be communicated
- Obtaining approval of the Shariah audit work plan from concerned authorities including SSB of IFI

5.1.2 Examining and Evaluating Internal Shariah Review Information
Shariah Auditors shall collect, analyze, interpret and document information related to Shariah audit objectives to support their Shariah audits results. Types of information are as follows:

- Examination of documents
- Observations
- Analytical reviews
- Inquiries
- Discussion with management
Quality of information should be sufficient, relevant, reliable and useful to provide sound basis for Shariah audit findings and recommendations.

Prepared working papers by the auditor should be complete, organized, reviewed by the head of department and retained.

5.1.3 Reporting
Quarterly reporting to the board of directors and copies to SSB and management shall be made. Prior to issuing the report the head shall discuss conclusions and recommendations with the various levels of management. Quality of report should be objective, clear, constructive and timely. The report shall include the following:

- Purpose
- Scope
- Findings
- Opinion
- Recommendations
- Corrective actions
- Feedback from those reviewed

Any dispute relating to Shariah interpretation to be resolved with SSB.

5.1.4 Follow Up
The internal Shariah auditor has a duty to follow up with corrective action and recommendations so as to ensure that the action is rectified and to prevent recurrence of non-compliance.

5.2 Management and Quality Assurance
The Head of the Shariah Audit is to establish plans for the review; to establish written policies and procedures to guide the Shariah review staff; and to establish a program to select and develop staff. It is also important to ensure that the Shariah review and the Shariah audit are properly coordinated. Furthermore there is a need to establish an effective and efficient quality assurance program to evaluate the operations of the Shariah audit.

5.3 Elements of Shariah Audit Control System
Three elements are identified by the standards as follows:

5.3.1 Employees
Only qualified, experienced and committed staff are recruited and retained as well as
continuously trained and developed. SSB involvement in the recruitment will encourage staff with the right aptitude and attitude.

5.3.2 Segregation of Duties
Non executive or operational involvement of Shariah auditors in the activities of IFI is observed.

5.3.3 Control Procedures
IFI management to establish controls, policies and procedures to achieve IFI objective of compliance with Shariah rules and principles.

VI. Conclusion

Non-Compliance risk faced by the IFIs can be mitigated through Shariah Compliance Audit. Shariah Committee who has the responsibility to express their opinion that the operation of the IFIs is fully Shariah compliant may rely the information from the audit work performed on various aspects of the operations including documentation, reporting and to the extend of the segregation of duties and control procures that involves documentation, system and employees involvement in the operations. Shariah audit will serve as a governance mechanism in Islamic finance so as it provides the verification that the IFIs operate according to the Shariah.

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