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Shariah Assurance in ICM: Proposed External-Internal Control Framework

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I. Introduction

In Malaysia, there are two main sectors that house Shariah-compliant financial services, namely, Islamic financial institution (IFI) and Islamic capital market (ICM). In term of regulation, IFI is regulated by the central bank of Malaysia, Bank Negara Malaysia (BNM) while ICM is regulated by Securities Commission (SC).

There are two pertinent regulations introduced to govern IFIs. First is the issuance of Shariah Governance Framework (SGF) by Bank Negara Malaysia in 2010. The issuance of SGF has offered a significant impact to the IFIs. Since then, people are getting better awareness on the importance of the Shariah compliance. Among the highlights of SGF is the requirement to establish the Shariah compliance functions like Shariah research, Shariah review, Shariah risk management and Shariah audit, (Bank Negara Malaysia, 2010) by each and every IFIs. As a result, the Shariah compliance level and awareness in the IFIs has significantly improved. This shows the serious commitment of the regulator i.e the BNM, in ensuring that all the operations and business activities of IFIs are in accordance with Shariah.

The regulatory evolution in the IFIs in Malaysia continues with the issuance of Islamic Financial Services Act (IFSA) 2013, with the main objective to promote financial stability and compliance with Shariah (Bank Negara Malaysia, 2013). In light with this objective, the IFSA 2013 highlighted that any breach of Shariah requirement and the IFIs do not take corrective action when aware of any non-compliance, any person responsible will be liable for eight years of imprisonment or penalty amounting to RM25 million (Bank Negara Malaysia, 2013: Part IV, Section 28).

On the other hand, in the ICM industry, SC has also made an initiative in 1995 to introduce the Shariah screening process, in order to undertake Shariah screening for listed companies, with the first list came out in 1997. This initiative emerges as an easy guideline to the investors and fund managers who are seeking for the Shariah-compliant investment securities as opposed to the conventional securities that are not fully Shariah compliance. In addition, SC also detail out the Shariah screening process in order to screen and segregate between conventional and Shariah compliant securities. In the process, it assesses the quantitative and qualitative aspects of the securities, and the qualitative aspects are decided by the Shariah Advisory Council (SAC) of SC. In 2012, the SAC of SC introduced a revised,

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more comprehensive Shariah stock screening methodology with the introduction of a two-tier quantitative assessment.

It is evident of the different approaches taken by BNM and SC in regulating the Islamic financial industry in Malaysia. It is worth to note that as to date, SC has not introduce any guideline or framework related to the Shariah governance in ICM despite the strong demand by the investors that illustrates in Table 1.

Table 1: Statistics of Shariah Compliant Securities and Market Capitalization

	2017	2016
Number of Shariah-compliant securities	688	671
Total listed securities	905	904
% to total listed securities	76.02%	74.23%
Market Capitalization (RM billion)		
Shariah-compliant securities	1,133.83	1,030.56
Total market capitalization	1,906.84	1,667.37
% to total market capitalization	59.06%	61.81%

Source: Securities Commission Malaysia (2016, 2017)

Therefore, as the demand increases, it is expected that the regulator, i.e., SC should take a proactive approach in strengthening the Shariah compliance framework in ICM. Thus, do we need to have Shariah compliance function in order to provide assurance on the level of Shariah compliance in ICM? However, as the previous literature on the current practices in ICM or particularly Shariah-compliant securities is very limited, it is pertinent to study on the current practices used by the company in ensuring Shariah compliance.

II. Shariah Screening for Shariah-compliant Securities

Stock screening is the process of reducing the universe of all possible stocks to just a few stocks that match the criteria of an investment strategy. Whilst in Shariah-compliant stocks, screening is used to segregate between the Shariah compliant and non-Shariah compliant stock in one particular market (Hamizah Binti Najib *et al.*, 2014). This is one of the important roles play by SC, through its SAC, in ensuring Shariah compliant in the ICM. Since there is no specific establishment of Shariah governance framework in ICM, it is vital to understand the Shariah screening methodologies used by the SC of Malaysia in ensuring the Shariah compliance status of the stock.

There are several Shariah screening methodologies that available worldwide presently.

To name a few, there are Dow Jones Islamic Market Index (DJIM), FTSE Global Islamic Market Index Series, and Standard & Poor (S&P) Islamic Market Indices. Meanwhile, in Malaysia, SC through its SAC has established the Shariah screening process to determine the Shariah-compliant status of listed companies. In other words, SAC of SC is the authority body whose approve the list of the Shariah compliant securities which the release of the list of Shariah-compliant securities is done twice a year.

Statistically, it is more than sixty percent of the market was capitalized by the Shariah compliant securities (as at October 2018), as indicated in Table 2.

Table 2: Statistics of Shariah Compliant Securities

	Oct 2018	2017
Number of Shariah-compliant securities	689	688
Total listed securities	902	905
% to total listed securities	76.39%	76.02%
Market Capitalization (RM billion)		
Shariah-compliant securities	1,048.88	1,133.83
Total market capitalization	1,726.59	1,906.84
% to total market capitalization	60.75%	59.06%

Source: Securities Commission Malaysia (2018)

Meanwhile, in term of the number of Shariah-compliant securities, there are more than 75% of the securities are Shariah compliant as compared to the total list of securities with the total number of Shariah compliant securities that keep increasing. The details of the securities that classified according to sector is provided in Table 3.

Table 3: List of Shariah-compliant Securities with Breakdown According to Sectors

No	**Main Market/ ACE Market**	**Number of Shariah-compliant Securities**	**Total Securities***	**Percentage of Shariah-compliant Securities**
1	Consumer products	133	194	69
2	Industrial products	208	254	82
3	Energy	29	32	91
4	Construction	50	52	96
5	Transportation	27	35	77
6	Property	76	101	75
7	Plantation	36	44	82
8	Technology	76	88	86

9	Utility	11	14	79
10	Financial Services	2	34	6
11	Health Care	17	18	94
12	Telecommunications & Media	24	33	73
13	SPAC	0	2	Nil
14	Closed-end Fund	0	1	Nil
	Total	689	902	75

Source: Securities Commission Malaysia (2018)

The early Shariah stock-screening process that the first list was out in December 1997, was involving quantitative and qualitative aspects. In 2012, the SC has revised the Shariah stock screening methodology to reflect the current development and sophistication of Islamic finance industry also as an expansion of the market to global level. The revision is expected to bolster the competitiveness of the Malaysian Islamic equity market and Islamic fund management industry (Securities Commission Malaysia, 2012a). The revision of the screening methodology mainly affects the quantitative assessment of the stocks. The revision is performed to further facilitate the orderly development of the Islamic equity market and fund management industry at both domestic and international levels (Securities Commission Malaysia, 2012a).

Generally, the quantitative aspects involve the screening of the main business activity of the company. In evaluating the main business activity of the business, a stock will be considered ineligible for further evaluation if the main business of the company involves with prohibited activity. The company will be considered as a Shariah non-compliant company if it involves with any of these activities; (a) financial services based on interest (*riba*); (b) gambling (*maysir*) and gaming; (c) manufacture or sale of non-halal products or related products; (d) conventional insurance; (e) entertainment activities that are non-permissible according to Shariah; (f) manufacture or sale of tobacco-based products or related products; (g) stockbroking or share trading in Shariah non-compliant securities; and (h) other activities deemed non-permissible according to Shariah. Thus, if a particular company involves with any of the above criteria, it will not be screened for the next level, the qualitative aspects.

The new methodology applies a two-tier quantitative assessment on the securities. The first tier quantitative assessment is the same as the previous Shariah screening methodologies, only that the business activity benchmark has been revised from four benchmarks i.e. 5%, 10%, 20% and 25% to only two benchmarks, 5% and 20%. The five percent level of business activity benchmark mainly designs to assess the level of mixed contributions from activities that are clearly prohibited in Islam. Whilst the twenty percent level of activity benchmark is purposely to assess the level of mixed contributions from activities that are generally permissible according to Shariah and have an element of *maslahah* (public interest), but there are other elements that may affect the Shariah-compliant status of these activities.

At the second tier assessment, a financial ratio benchmark is introduced with the objective to measure *riba* (usury) and *riba*-based elements in the balance sheet of the company. In calculating the financial ratio, the cash will only include cash that placed in conventional accounts and instruments, while debt will only include interest-bearing debt. Table 4 depicted the difference between the previous and revised Shariah-screening methodologies in Malaysia.

Table 4: The Difference between Previous and Revised Shariah Screening Methodologies in Malaysia

Quantitative Assessment	Revised Methodology	Previous Methodology	Business Activity	Classification of the benchmark
Business Activity Benchmark	5%	5%	conventional banking conventional insurance gambling liquor and liquor-related activities pork and pork-related activities non-halal food and beverages Shariah non-compliant entertainment	To assess the level of mixed contributions from activities that are clearly prohibited
		10%	interest income from conventional accounts and instruments tobacco and tobacco-related activities other activities deemed non-compliant according to Shariah	
	20%	20%	rental received from Shariah non-compliant activities other activities deemed non-compliant according to Shariah	To assess the level of mixed contributions from activities that are generally permissible according to Shariah and have an element of maslahah (public interest), but there are other elements that may affect the Shariah status of these activities
		25%	hotel and resort operations share trading stockbroking business	
Financial ratio benchmarks	33%	Not applicable	Compute the financial ratios: Debt/Total Assets; Cash and Cash Equivalent/ Total Assets	To measure riba' and riba'-based elements in the company Balance Sheet

Source: Securities Commission Malaysia (2012b), Hamizah Binti Najib *et al.* (2014)

For qualitative aspects, the SAC considers two additional criteria: (a) the public perception or image of the company must be good; and (b) the core activities of the company are important and considered benefit in general (*maslahah*) to the Muslim nation (*ummah*) and the country, and the non-permissible element is very small and involves matters such as common plight and difficult to avoid (*'umum balwa*), custom (*'uruf*) and the rights of the non-Muslim community which are accepted by Islam (Securities Commission Malaysia, 2012b).

III. Needs for Shariah Audit in ICM

As established, Shariah screening methodology is meant to classify the securities between Shariah and non-Shariah compliant securities. In classifying these securities, the SAC received input and support from the SC. The SC obtained information on the companies through, among others, annual reports and enquiries made to the companies. The review of the status of the securities listed on Bursa Malaysia, is done by SAC, through the SC, on an annual basis, based on the latest available annual audited financial statements of the companies (Securities Commission Malaysia, 2017).

As discussed in the earlier section, Shariah screening process is conducted on annual basis by the SAC, through SC, with the main information is obtained from the audited financial statement of the particular company with Shariah-compliant securities. Meanwhile, according to SGF 2010, *"An IFI carrying out Islamic financial business shall ensure that the aims and operations of its business are in compliance with Shariah principles at all times."* In this regard, Bank Negara Malaysia, (2010) not just emphasizing on compliance with Shariah principle, but it must also be on compliance at all times. Also, it is believed that all the stakeholders are expecting the same objective as stipulated by BNM.

Applying the same objective, in order to meet the said objective, the Shariah-compliant securities is assessed in making sure the same objective is achieved and to explore on the needs for Shariah audit in this area. In this regard, an annual assessment or review by the SAC of SC may achieve the objective to ensure that the operations of the companies with Shariah compliant securities are complied with the Shariah principles. In this regard, it is achieved the fulfillment of the requirements on quantitative and qualitative aspects.

Since the criteria of assessment is based on quantitative aspect that mainly according to the income from non-permissible activities over the total income, the financial ratios of; debt over total assets and cash and cash equivalent over total assets. It is known that the total income and total assets are always changing; increase and decrease. And once there is a change in any of the nominator or the denominator of the said ratio, the same will affect the ratio. Thus, the securities that regarded as Shariah-compliant securities during the assessment may not be longer Shariah compliant if the ratio exceeded the stipulated benchmark. Therefore, the requirement to comply with Shariah principles at all times may not be achieved.

For instance, the securities that regarded as Shariah compliant securities during the assessment is taking a short term loan for a period of three or six months. This will affect the total debt of the securities. And happen to be that, if the financial ratio is calculated (after taking into consideration the new short term loan), the financial ratio of debt over total assets, is now become 35%, and thus exceed the SC stipulated benchmark. Moreover, this will not be taken into consideration by the SC as the short term loan is only affect the period during the year, and not reflected in the audited annual financial statement.

Furthermore, it is important that the Shariah-compliant securities companies maintain it status in order to ensure that the number of investible securities for Islamic investors and fund managers at least is not drop, if it cannot increase. Additionally, there are significant negative implications of being delisted from the Shariah-compliant securities list. An empirical study that carried out in 2014, after the announcement by SC on the revised Shariah screening methodologies, showed that there is a significant negative impact on the stock prices of the companies even before the actual delisting date (Sakti and Nizam 2014). Interestingly, there is encouraging market reactions that is favourable to Islamic finance industry showed by the delisted Shariah-compliant securities companies. For instance, companies being delisted based on the financial ratio screens, in 2014, such as Air Asia and SP Setia that have 39% total conventional debt relative to total assets. This is similar to the situation of Oriental Holdings which has cash to assets ratio greater than 33% benchmark were made the adjustments in their financial positions to make them Shariah compliant again (Wong, 2013). This shows that the Shariah-compliant securities companies are concern on its status of Shariah compliant which subsequently affect their potential Islamic investors and fund managers.

Concern with the said issue and the importance of the companies with Shariah compliant securities to maintain it status, therefore, there is a high need for Shariah audit to be implemented in ICM and particularly the Shariah-compliant securities. However, it is not fair to just jump into conclusion for the Shariah audit implementation. Instead, it is more recommended to study the internal and external control practices that is practiced by the company with Shariah compliant securities.

IV. Internal and External Control Practices

Generally, the internal audit activity is designed to provide independent, objective assurance and consulting services in order to add value and improve a company's operation with the concentration on the three factors that are internal control, risk management and governance (The Institute of Internal Auditors (IIA), 2012). As the current Shariah audit function is riding on the conventional internal audit set up, the three major factors are highly relevant to be studied. However, as proposed in the earlier section, the internal control plus the external control practices are recommended to be studied. Thus, being focuses on internal control, The Institute of Internal Auditors (IIA) (2012) defines the system of internal control as *"the actions taken by the board and management to manage risk and increase the likelihood that established goals will be achieved."*

Furthermore, in structuring the system of internal control, the system should be structured in such a way that it provides reasonable assurance that the likelihood of a significant adverse impact on objectives arising from a future event or situation is at a level acceptable to the business. It achieves this through a combination of preventive, detective and corrective measures. COSO (2013) highlighted the five components to mitigate the risks of an organization's failure to achieve the objectives, which are; control environment, risk assessment, control activities, information and communication and monitoring activities.

While, BusinessDictionary.com, defines external control as *"various measures that affect a company's operations, which are not enacted by the company but rather by the government or other organizations. External control includes any rule or regulation which has an effect on the actions of the company."* In light with the Shariah compliant securities, the external control is only taking into consideration of the regulator i.e the SC, as the external parties because SC is the only party that may affect the company's Shariah compliant status.

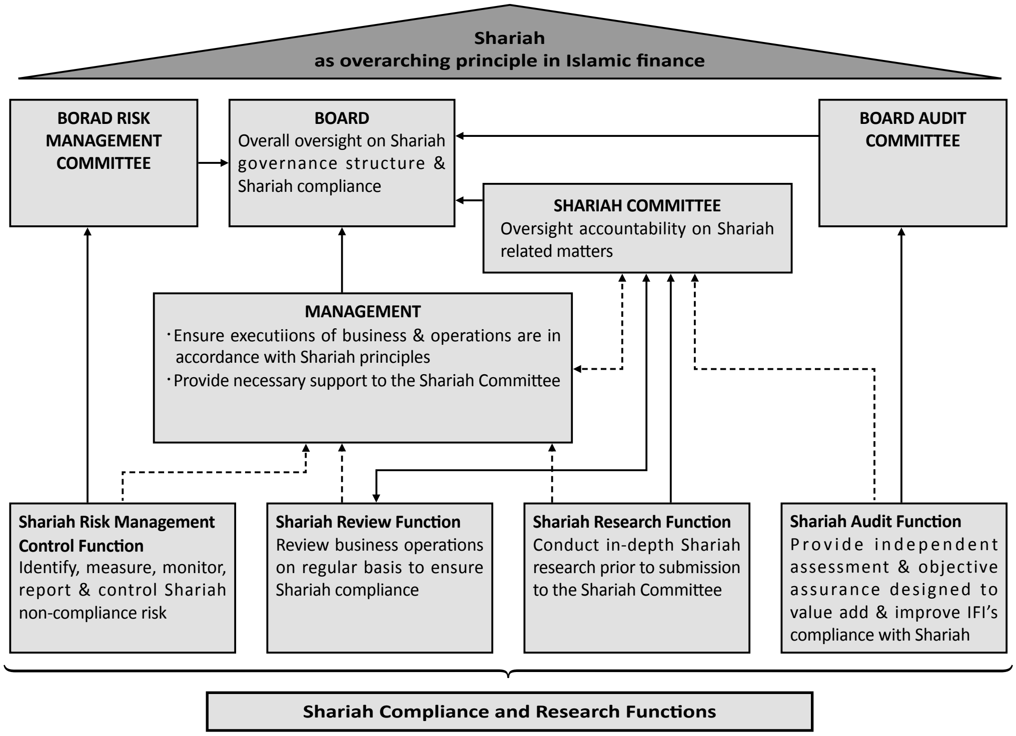
It is undeniably that the current available study on external control is very limited, especially in the setting of Islamic institutions. However, Ahmad *et al.* (2016) studied the dimension of Shariah compliance in another ICM product that is Islamic Real Estate Investment Trusts (i-REITs). This study outlines the five dimensions that is used by SC in ensuring Shariah compliance for i-REITs that are; (i) Shariah Advisory Council of SC, the highest authority body for ICM in relation to Shariah matters, (ii) Shariah advisers that are appointed by the said i-REITs, (iii) benchmark, that is used for the tenants with the operation of mixed activities (not more than 20% threshold), (iv) Shariah adviser report, interim and annual to state the level of compliance with Shariah by the said i-REITs, and (v) visit, periodical visit to the said real estate by SC.

V. Shariah Audit Implementation: Lessons Learnt from Islamic Financial Industry

Shariah audit is currently been performed by the IFIs in Malaysia in order to ensure that the activities and operations of an IFI are in adherence to Shariah. This is in line with the SGF (Bank Negara Malaysia, 2010) requirements on the implementation of Shariah audit in the IFIs. According to SGF issued by Bank Negara Malaysia (2010), paragraph 7.7, 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.

Besides Shariah audit, SGF also outlines the other Shariah compliance and research functions, namely Shariah review, Shariah risk management and Shariah research. The following Figure 1 best explains the model that currently implemented and practiced in IFIs.

Figure 1: Shariah Governance Framework Model for Islamic Financial Institutions



Source: Bank Negara Malaysia (2010)

In studying the current Shariah audit practices, Yahya, Y. and Mahzan, N. (2012) obtain an in-depth understanding on the current practice of Shariah audit in terms of scope, objective, framework and the role of internal auditors. They gain the information using a qualitative approach through interview with the chief internal audit. In addition, Nur Laili (2014) and Hassan, R. *et al*. (2012) have examined it using a survey questionnaire method. Hassan, R. *et al*. (2012) has examined the Shariah governance practices not just for Islamic banks, but also for Takaful companies. Meanwhile, Ainon Yussof, S. (2013) focuses on the current Shariah audit practices in Islamic banks using the Exposure Draft of Internal Shariah Audit Framework issued by International Shariah Research Academy (ISRA) (2011) as the benchmark. In her study, she covers the audit objectives, audit and governance, audit scope, audit charter, competency of internal Shariah auditors, audit process and reporting requirements in performing Shariah audit practices.

VI. Conclusion

It is not required by law in Malaysia that ICM should establish the Shariah governance and compliance functions, taking into just like IFIs. However, it is deem that every companies in ICM should carry out their activities in accordance with the principles of Shariah, at all times. Thus, it is imperative to have a proper Shariah audit function. Thus, it is essential to have a comprehensive, robust and well-functioning Shariah control system to ensure that Shariah is upheld at all times. It implies that there is a need to study external and internal control mechanisms practiced by the regulator and the companies with Shariah compliant securities to ensure its Shariah compliant status. The external and internal control framework proposed in this paper provides a preliminary information on the area to be explored, especially the empirical study, in evaluating the current internal control practices of the companies with Shariah compliant securities to ensure compliance with Shariah.

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