

Shariah Auditing and Shariah Compliance Assurance in Malaysian Islamic Banks

Ahmad Fahmi Sheikh Hassan

Department of Accounting and Finance, Faculty of Economics and Management,
43400 UPM serdang, Malaysia
Office No. : +60397697270
Mobile Phone No. : +60132462035
Email: ahmadfahmi@upm.edu.my

Nurfarahin Mohd Haridan

PhD Candidate at Faculty of Economics and Management,
43400 UPM serdang, Malaysia
Mobile Phone No. : +60186672130
Email: farahinharidan@yahoo.com

Abstract

Shariah committees (*SCs*) of Islamic banks have the crucial governance role of providing Shariah compliance assurance. In order to maintain the integrity of the bank in conforming with religious faith *SBs* should have the talent and skills for an effective monitoring which among others include contributing to Shariah audit task. To gain an in-depth understanding on the Shariah compliance audit role of *SB*, our present study has performed semi-structured interviews with 14 key players at two fully-fledge Islamic banks. Our study shows that the diverse Shariah and non-Shariah backgrounds of *SB* members could result in a more holistic view of Shariah issues, being more vocal in giving opinion and criticism on the Shariah audit practices undertaken by Islamic banks. However, our findings reveal the existence of imbalance competency among *SB* members and the absence of proper Shariah audit framework in the two banks governance framework. As a result, most of the *SB* members delegate their Shariah audit role to be mainly performed by their Shariah audit division whose outcome will be submitted to them for approval. We argue that this passive role of *SB* members triggers concern on their independence and, consequently, compromised the Shariah compliance assurance provided to stakeholders.

Keywords: Shariah, Shariah Audit, Shariah Committee, Islamic Bank and Shariah Compliance Assurance

INTRODUCTION

Recent market analysis shows Islamic finance assets are continually growing from USD 1.493trillion in year 2016 to USD 1.557trillion in 2017 with the global Sukuk issuance increased by 25.6% amounting at USD 399.9billion as at end 2017 (IFSB, 2018). In respect to the Islamic bank (IB) market industry, Malaysia is acknowledged to be the most developed globally with a comprehensive governance framework (IMF, 2017) and well progress of sukuk issuances amounting at USD612 billion, followed by Gulf Cooperation Council (GCC countries) (i.e. Saudi Arabia (USD95 billion) and United Arab Emirates with (USD68 billion) and Indonesia (USD63 billion) (MIFC, 2018; IIFM, 2018). It has been established by the recent empirical studies that the most appealing feature of IBs to customers is their compliance to the religious provisions (see Abedifar et al., 2013; Amin et al., 2013; Berg & Kim, 2014; Bizri, 2014). In essence, Shariah Committees (*SCs*) play a crucial role for the issuance of a quality Shariah compliance assurance in the annual Shariah report of IBs. This Shariah assurance provides an independent affirmation of *SC*

that Islamic banks have done their businesses according to the Shariah law and *SC* resolutions. It can be well argued that the integrity of an IB would be undermined and stakeholders would lose confidence if its operation is found to be non-Shariah compliant. As a matter of interest, the effective role of *SC* may contribute a great spur to the prudence of IBs by escalating the confidence level of stakeholders and providing the IBs with a good image (Ghayad, 2008; Safiullah & Shamsuddin, 2018).

Apart from Shariah compliance, Shariah audit provides the manifestation of an additional governance mechanism of IBs in conforming to their Islamic financial accountability and stakeholders' interest (Rahman, 2008; Yaacob & Donglah, 2012; Ghani & Rahman, 2015). However, it appears that there are no specific frameworks for the Shariah audit (Yahya & Mahzan, 2012; Kasim & Sanusi, 2013; Othman & Ameer, 2015; Khalid, Haron & Masron, 2018; Laldin & Furqani, 2018) and IBs still remain in the struggle to establish an effective auditing framework (Ginena, 2014; Shafii et al., 2014). In this light, the establishment of Shariah audit framework and an effective Shariah audit program in IBs may be able to reduce the Shariah non-compliance risk and assist the harmonization of Shariah practices across IBs (Rahman, 2008; Uddin et al., 2013). Hence, our present study attempts to examine the Shariah compliance audit role of *SC* in providing Shariah compliance assurance on Islamic banking operations.

The rest of the paper is organized as follow: the next section briefly reviews the relevant literature on Shariah compliance audit, *SC* roles and attributes, impediments on the role of *SC* and Shariah audit issues. This is followed by a section that describes the methodology of the present study and subsequently a section on its findings. Finally, the last section concludes the study.

LITERATURE REVIEW

The Shariah promotes IBs to uphold social justice and religious values while conducting their business (Dusuki, 2008; Abu-Tapanjeh, 2009; Saif Alnasser & Muhammed, 2012). In this sense, the accountability in every aspect of the Islamic banking management will be questioned since they are not only performing their role to the stakeholder's objectives but are also accountable to God in overall activities of IBs. In regards to assuring greater Shariah compliance, the Malaysian Islamic banking industry has experienced several stages of improvement. Since year 2005, Bank Negara Malaysia (BNM) provided a requirement for all IBs to comply to the Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions (GPS-1) but was later changed to the new Shariah Governance Framework (SGF) from 2011 until now. To strengthen the Shariah governance of IBs, the BNM subsequently introduced Islamic Financial Services Act (IFSA 2013). In the requirement of the new SGF and IFSA 2013, the *SC* has been emphasized as an important Shariah governance mechanism that provides Shariah compliance assurance in all IB's operations and businesses. In addition, the SGF sets the minimum requirement for *SC* membership to be at least five with a majority of them being from a Shariah educational background (BNM, 2010, Section II). Besides the *SC*, IBs also have to establish other key mechanism that support the function of the *SC* such as the internal Shariah department as well as Shariah auditor in ensuring the provision of a quality Shariah compliance assurance to stakeholders (see BNM, 2010, Principle 7; AAOIFI, 2010; Ginena, 2014; Bougatef, 2015; Najeeb and Ibrahim, 2015). Among others, the roles of Shariah auditors are to perform audit on Shariah compliance in all IB businesses, affairs and documentations (BNM, 2010 and 2013; IFSB, 2009).

Indeed, Shariah compliance audit has been argued by many as an instrumental role of the *SB* in providing Shariah compliance assurance to the stakeholders (Rahman, 2008; Yaacob and Donglah, 2012; Ghani and Rahman, 2015). Generally, the term Shariah audit has been defined by Haniffa (2010, pp. 45) as “an examination of, all of IB activities, particularly the financial statements and other operational components of the IFIs that are subjected to the risk of compliance including but not limited to products, technology supporting the operations, operational processes, the people involved in the key areas of risk, documentations and contracts, policies and procedures and other activities that require adherence to Shariah principles”. Thus, it is important to note that the competency and independence of each *SC* member will ascertain the effectiveness of the Shariah compliance audit role undertaken by the *SC* in assuring the legitimacy of Islamic banking operations (Garas and Pierce, 2010; Grassa, 2013) and enhancing the bank’s portfolio (Safiullah & Shamsuddin, 2018; Hassan et al., 2018). For this reason, the *SC* should comprise of members who are experienced and qualified in various disciplines such as Shariah, accounting, auditing, finance, and law (see for example Gambling et al., 1993; AAOIFI, 1997, para. 7; Grais & Pellegrini, 2006; Ghayad, 2008; BNM, 2010, Section IV; Ginena, 2014).

However, various empirical studies have highlighted several impediments on the role of *SC* when undertaking its Shariah compliance role. For example, Ullah et al. (2016) indicated that the absence of strong governance in place either from internal, external or regulatory pressure has made IBs to not truly uphold the Islamic law and principles thereby appointing lenient Shariah scholars for the sake of business profit achievement rather than assuring Shariah compliance. Ullah et al. (2016) also asserted that the management of IB tends to limit the *SC* role in providing Shariah assurance to the extent of seeking product approval only and the managers attempt to avoid the supervision and audit by the *SC*. Additionally, Mollah & Zaman

(2015) undertook a survey of *SC* members from six different countries i.e. Bangladesh, Bahrain, Malaysia, Indonesia, Pakistan and UK to examine the relationship between *SC* supervision and performance. The researchers revealed that the governance of *SC* contributes to a positive impact on the performance of IB but then the impact is limited to Shariah advisory role only. As a result, Mollah & Zaman (2015) called for IBs to appoint a well-functioning, independent and diligent *SCs* to better realize the ethical legitimacy of IB. Meanwhile, in relation to Shariah audit practise in Malaysian IBs, studies have reported that IBs have not properly undertaken their Shariah audit due to the absence of regulation on the Shariah auditing framework and experts to perform this task (Rahman, 2008; Ghani & Rahman, 2015, Ali et al., 2018). It is therefore not surprising that Yahya & Mahzan (2012) made a revelation that Malaysian IBs used conventional auditing frameworks when undertaking the Shariah audit, although such use of International Standards on Auditing (IAS) and adoption of International Financial Reporting Standards (IFRS) are argued to be inappropriate as the provisions in IAS and IFRS do not take into account the Shariah contractual and principles in their standards (Gambling and Karim, 1991; Karim, 2001; Archer & Karim, 2007; Vinnicombe & Park, 2007; Haniffa, 2010). Prior studies also indicates that IBs have added the audit procedures and audit tool of conventional bank to include element of Shariah compliance (Ghani and Rahman, 2015). In conventional auditing, the Institute of Internal Auditors (IIA) has clearly defined the audit process of internal auditor as developing the risk based audit plan and assessment, reviewing the contracts, policies and procedure, and examine the adequacy of internal control (IIA, 2017) whereas Islamic bank extends the process of auditing to include independent assessment on the degree of Shariah compliance in Islamic banking operations (SGF, 2010, Principle 7; IFSB, 2009, pp. 3).

RESEARCH METHODOLOGY

Most intensive studies on social sciences are called “case study” for a single phenomenon or “multiple case studies” if involving more than one instance of the phenomenon. Additionally, Yin (2009) asserted that the case study method allows the researcher to find the characteristics of real life events such as individual life cycles, small group behaviour, organizational and managerial processes. Several social studies also documented the beneficial inputs of undertaking interview approach, such in the area of accounting (see example, Jones & Solomon, 2010; Hung & Luo, 2016), auditing (Dobija, 2013), and corporate governance (Haridan et al., 2018; Ullah et al, 2016). In light of these arguments, our study employed a qualitative approach of case study using semi-structured interview to gain an in-depth understanding on the Shariah audit structure and governance of IB under the implementation of Malaysian SGF. At the time of the study, there were 16 fully-fledged IBs and 7 conventional banks offering Islamic windows in Malaysia. For the purpose of this study, only two full-fledged IBs were selected to meet the case study research design meant for this study. The selection of the two IBs as our sample of case study are based on relatively similar net profits for the financial year end 2015 indicating similar commitment of both IBs in preserving the quality of their Shariah portfolio. In order to maintain the anonymity of the selected IBs, the two IBs are disclosed as Bank A and Bank B. We eventually had conducted 14 interviews which are 7 respondents coming from each of the two banks. All of our interviewees are senior officers comprising of CEO of both banks, SC members, Shariah Officers and Internal Auditor who are highly knowledgeable and have more than 5 years experience of working in IB.

We performed each of the interview sessions for approximately 90 minutes on average with a standardised checklist being used to guide our interviews and assurance of confidentiality and anonymity given to all our interviewees.

We took about 3 months to complete our interview data collections beginning June and until August 2015 which account for almost four years after the implementation of the new SGF, hence enabled us to obtain perceptions of its impact. We have received various responses and views from the interviews conducted and we believe that our respondent provide truthful information and responses. Immediately after each interview session, we transcribed the recorded interview data to obtain general ideas of what the interviewees were responding to and then we further reflect on its meaning before the data was encoded. Richards & Morse (2007, p. 137) highlighted that data coding is not just an analysis of data and data interpretation but allows researchers to link between the data to the idea and from the idea to all the data pertaining to that research. Subsequently, we categorized the data and generated the themes based on the data coding. There are two ways of generating themes: inductively from raw information and deductively from theory and previous research (Boyatzis, 1998). The present study used the deductive approach to generate the themes from the stakeholders theory and from previous literatures. We used Atlas.ti software to assist us in the process developing codes and generating themes as the data analysis software documented to have been widely used in accounting and management qualitative studies (see for example, Kend and Katselas, 2013; Schäffer et al., 2015; Teixeira et al., 2016).

FINDINGS AND DISCUSSIONS

SC Limited Knowledge, Skills and Talent

The prominent role of SCs in monitoring and overseeing business operations would require its members to comprise of diverse backgrounds including Shariah and other related qualifications to the operations of an IB (see example AAOIFI, 1997, para. 7; BNM, 2010, Section IV; Gambling et al., 1993; Grais & Pellegrini, 2006; Ghayad, 2008). Ideally, the SC members should be able to apply their relevant knowledge to understand the theoretical and

practical aspects of Islamic banking operations. The interview with the CEO of Bank A posits a similar claim that the inclusion of religious and non-religious scholars in SC membership could enhance the competency and capabilities of the SC in providing religious assurance as well as critical deliberation on Shariah matters and other issues pertinent to Islamic banking operations. The CEO of Bank A remarked:

“Our SC members comprised of people from Shariah and legal experts only and now, we (the bank) are looking for SC members who have expertise in banking operations..”

Similar sentiments were also expressed by the CEO of Bank B that the combination and consolidation of various backgrounds in the governance structure of the SC will enhance the governance compliance role of the SC on their commitment to provide a quality religious assurance on the Islamic banking operations. The CEO highlighted this point and remarked:

“In the appointment of the SC, we try to balance and make a combination of the experience and qualifications of SC in the field of law, Fiqh, finance and accounting. In fact, the Bank Negara has stated in the new SGF that IB should include non-Shariah and Shariah individuals in the appointment of SC.”

However, the discussion held with interview participants of these two banks provided a grave concern on the deficiency of SC members in performing their Shariah governance functions, i.e: Shariah compliance review and audit. Currently, the SC members of these two IBs reportedly lack of knowledge in banking operations and this would result in difficulties for the SC members in fulfilling their governance responsibilities. The Chairman of SC of Bank B remarked:

“It is difficult for me to attest to the financial report because we (SC members) have lack of understanding on the discussion of subject matters. We ask for the assistance of bank

officers to explain the issues pertaining to the operations of IB.”

Meanwhile, both IBs under this study are reported to have taken another initiative to equip the governance role of the SC with various backgrounds by providing specialist training to their respective SC members. A SC member of Bank A highlighted this point and remarked:

“Our bank has allocated part of the financial budget for sending our SC members to several relevant workshop and training.”

The above interview discussion made apparent that the participation of mixed background in the SC membership will enable greater engagement when performing Shariah compliance audit and present a good image on the governance system of the individual IB. It is worth noting that previous studies have also highlighted the significance of strengthening human capital as this would yield better business performance and sustain industry growth trends (see Wang et al., 2009; Morris et al., 2017 and Nawaz, 2017).

Ineffectiveness of SC in performing Shariah Compliance Audit

The interview discussions held with the SC members and Chief Internal Auditor of Bank B highlighted that the involvement of SCs in the development of Shariah audit program would be considered as biased. The Chief Internal Auditor of Bank B remarked:

“The SCs cannot be involved in developing the Shariah audit program as their participation may be considered biased. It cannot be the same person who develops the program, performs the task and provides approval for the results. The segregation of duties in undertaking the Shariah audit role is crucial to be independent.”

The discussion corroborated the idea that the Shariah audit procedure was mainly taken on by the Shariah Audit Officer. The participation

of the SC in the Shariah auditing is limited to giving opinion and feedback on how the Shariah Audit Officer should be performing their role using the Shariah audit program. At the final stage, the Shariah Audit Officer will concurrently submit the regular Shariah audit report to the Board Audit Committee (BAC) and the SC for their approval and decision. The Shariah Auditor of Bank A also remarked:

“The SCs were not given access to the daily operations of our bank. In issuing the Shariah decision and opinion, the SC will rely on the result and findings made by the Shariah Auditor.”

Similar interview discussions with one SC member highlighted that the SCs play a crucial role in providing opinions and views related to the development of the Shariah audit program. In this regard, the Shariah Audit Officer will assist the SCs in performing the internal Shariah audit roles and the Shariah report will be given to the SCs for verification. The SC member of Bank A remarked:

“In a monthly meeting, the SC will advise the Shariah Auditor on how to conduct the audit process. The Shariah Auditor will then check and review all the bank branches and table the result to SC for their further rectification and recommendation.”

Eventhough the Shariah Audit Officers will provide rectification on Shariah issues, the SCs have a right to obtain further explanation and deliberation from the particular department upon the SC meeting. The SC member of Bank A highlighted this point and remarked:

“SC members only receive the report (from Shariah Audit Department). They only verify and approved the report. In instances where there are Shariah non-compliance events the Shariah Audit Officers will bring the matter to our attention who will then ask things to be rectified.”

The discussion with Shariah Audit Officer highlighted that the involvement of the SC in the Shariah audit functions serve to provide recommendation and correction on the Shariah audit plan. The Shariah audit plan is one part of the Shariah audit framework which will guide the Shariah Audit Officers in performing the internal Shariah auditing task. In doing so, the Shariah Audit Officers will usually table their Shariah audit plan to the SC and BAC at the beginning of the year before the audit functions are taken up. The Shariah Auditor of Bank A highlighted this point and remarked:

“The Shariah audit plan will assist us as an audit tool in performing the audit assessment. The SC will contribute by giving additional input to the development of audit plan in term of identifying the level of Shariah risk occurrence.”

It is apparent from the above discussion that the SCs play a crucial role in providing additional input to the Shariah auditing practices as their opinions and views will enhance the development of the Shariah audit program which affect Shariah compliance in these banks. Consistent with earlier studies, our findings demonstrate that the ability of SC members in applying their skills and knowledge would allow an effective Shariah audit compliance to be undertaken, hence contributing to higher bank performance (see for example Mollah & Zaman, 2015; Almutairi & Quttainah, 2017).

Shariah Audit Framework

The discussion with the interview participants of both IBs indicated that the Shariah audit program is an essential tool to assist the Shariah Audit personnel in detecting and rectifying the Shariah issues. For example, the CEO of Bank B asserted that the implementation of the Shariah audit is instrumental in ensuring Shariah compliance of the banking operations. The CEO expanded on this point by remarking:

“The SGF sets a requirement for the IB to establish the Shariah audit functions. It outlined

general recommendations on how the IB should conduct the Shariah audit and who are responsible for performing the Shariah audit.”

In addition, SC members of Bank A expressed a similar argument that the SGF improved the governance mechanism of IBs by including the recommendation to establish the Shariah auditing function. The new IFSA 2013 imposed banks offering Islamic banking products to develop the Shariah audit program based on the recommendations laid down in the SGF. Additionally, the IB may appoint any person who is eligible to perform duties and function on Shariah compliance auditing (BNM, 2013, Section 37 and 38). Similar emphasis has been given by IFSB as the international regulatory body stressed that the Shariah officers may require the management to rectify any matters related to Shariah compliance (IFSB, 2009, pp. 3). In fact, the failure of IBs to comply with the provisions mentioned shall make the responsible parties liable to imprisonment for a term not exceeding eight years or to a fine not exceeding twenty-five million ringgit or to both (BNM, 2013, para. 29). The SC of Bank A stressed these points when he remarked:

“In the case where IBs were not complying with the requirements of SGF, they are also not complying with the IFSA act. For me, SGF would be the framework that enforces the IB to seriously develop a Shariah audit in ensuring the Shariah compliance assurance.”

In addition, the interviews held with the two IBs revealed that the lack of SC participation in the Shariah audit program is due to the SGF being silent on the Shariah audit procedures to be implemented by industry players. This, expectedly, has resulted in IBs having the discretion to delineate their own Shariah audit program. The Chief Internal Auditor of Bank B highlighted this point and remarked:

“Even though Bank Negara requires IB to establish the Shariah audit function, there is no clear guideline on how it works and how

it is to be implemented in IBs. As a result, you can see that every bank has a different audit program depending on their nature of risk and business.”

In addition, the SC members of Bank reported that the application of the Shariah audit program and framework will be different amongst IBs depending on the size of bank and the nature of its risk. The SC member of Bank A highlighted this point and remarked:

“Our Shariah audit practice might be different with other IBs. Our audit department closely worked with the Shariah department in developing the Shariah audit framework. The Shariah audit program will be part of the Shariah audit framework and will be conducted by a Shariah qualified officer.”

Discussions held with representatives from the two Islamic banks revealed that both banks will first outline the number of audit assignments to be undertaken and identify the areas with potential Shariah risk. Later, the Shariah Audit Officer will perform the audit procedures following the Shariah audit program. At the final stage, the Shariah Audit Officer will rectify any issues related to the Shariah and report the results to the SC and BAC. In the case of any Shariah non-compliance, the IBs have to rectify their plan and action on the Shariah issues to the Shariah Compliance Unit of Bank Negara within 30 days (BNM 2013, Section 28; BNM, 2010, Section 2). Additionally, our results shows that most of the time SC will delegate their Shariah compliance task to the internal Shariah department. Moreover, the SCs were invited to go through all the Islamic banking process during the reviewing and audit assessment but the limitation on the Islamic banking background amongst the SC members make them difficult to make a right and proper decision. In fact, conventional auditing practices require auditors to perform their audit assessment with professional skepticism and due care so that in any doubtful case the auditors may ask the right question to the right person.

Similar to the role of SC, inadequate Islamic banking knowledge will lead them to ask the wrong question, check the wrong documents and unable to appropriately assess the Shariah non-compliance risk issues. Additionally, the discussions gathered from representatives of both IBs revealed that the lack of SC participation in the Shariah audit program is due to the inexistence of Shariah audit procedures in SGF. This gives opportunity for the IBs to define their own Shariah audit program.

CONCLUSION

Our study has identified numerous issues and challenges faced by the SC in undertaking their Shariah compliance audit task. Most of our interview participants strongly believe that SC involvement in providing constructive criticism and opinions on the development of Shariah audit plan could contribute to the robust nature of the Shariah audit framework in IBs. It is argued that a diverse backgrounds in the composition of SC members would enhance their credibility and the quality of Shariah compliance assurance provided to stakeholders. However, our study reported the deficiency of the SC members in performing the Shariah audit compliance task due to the lack of accounting related knowledge amongst the SC members and the inexistence of Shariah audit framework. More disturbingly, our findings presented the evidence that the SCs are delegating their Shariah audit function to the Shariah Audit Officer whose result would then be presented to the SCs for their decision. Our present study also highlighted a significant impact of the Malaysian SGF on the Shariah audit function in the Islamic banking industry. However, the existing guideline only provides general recommendations, allowing IBs the flexibility to operate ceremonially rather than fulfilling their task diligently. For the time being, the present study provides the view that the Malaysian regulatory bodies should take a comprehensive initiative to standardize the Shariah audit process and to develop more effective Shariah audit tools. As with other empirical studies, our study also has several

limitations. First, this study has a limitation in generalizing the views from the key players of all IB as our case study only provide insightful knowledge on the current practice of the two IBs. Therefore, more views and opinions are required to gain an holistic discussion on the Shariah compliance audit practices in IBs. Secondly, this study has focused on the quality of Shariah compliance assurance from the Shariah compliance audit and implementation of the Shariah audit program undertaken by the Islamic banking industry. However, there are other governance mechanisms in IBs as well such as Shariah research and Shariah risk management that may influence the SC's decision. Hence, additional study on the roles of the Shariah research and Shariah risk management to examine the quality of Shariah compliance assurance would be worth considering for future studies.

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