Integrated Internal-External Shariah Audit Model: A Proposal towards the Enhancement of Shariah Assurance Practices in Islamic Financial Institutions

Zurina Shafii, Ahmad Zainal Abidin, Supiah Salleh
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Author(s): Zurina Shafii, Ahmad Zainal Abidin, Supiah Salleh

Abstract
Shariah Governance and audit is one of the vital elements of corporation as it promotes principles of accountability, transparency and Shariah assurance of IFIs to the stakeholders. In addition to the clear structure of the organs of Shariah governance namely the Board of Directors, Shariah Committee and the Management, an Islamic Financial Institution (IFI) must ensure the Shariah compliance function to be carried out through the Shariah review and Shariah audit functions. The studies conducted on the practice of Shariah review and audit in the jurisdictions adopting Islamic finance revealed that both functions are conducted inconsistently. Many jurisdictions are yet to offer independent Shariah assurance as they only managed to perform Shariah review function. Shariah review serves as compliance function that provide review to the management on the state of IFIs’ Shariah compliance. Shariah audit, on the other hand, is an independent exercise that aims to examine the effectiveness of the internal control for Shariah compliance within the organization. Both of the functions serve as the Shariah assurance mechanisms that ensure robust practice of Shariah-compliant activities. This study identifies the practice of Shariah audit among GCC countries, namely Bahrain, Saudi Arabia, Kuwait, UAE and Qatar and in Islamic Development Bank’s member countries where Islamic finance is adopted as part of the mainstream finance, i.e. Sudan, Pakistan, Indonesia and Malaysia. Upon identifying the practice of Shariah assurance mechanisms, this study develops a model for Shariah audit that integrates the internal and external Shariah audit function. This study identifies the scope of Shariah audit that is to be performed by internal Shariah auditors and external Shariah auditors. In order to formulate the integrated internal-external Shariah audit model, this study qualitatively analyses the arguably the most comprehensive guideline on Shariah governance Framework issued by Bank Negara Malaysia in 2010 and other guidelines issued in jurisdictions practicing Islamic finance that forms guiding principles for Shariah audit conduct. For the external Shariah audit function, the study refers to the standards that are applicable to Islamic financial transactions issued by the International Financial Reporting Standard (IFRS). This study is useful for policymaking in the jurisdictions that offer Islamic finance, with relation to Shariah assurance mechanisms, especially on policies related to Shariah audit conduct. The integrated model of internal-external Shariah audit will promote efficiency and effectiveness of Shariah audit practice in IFIs.

Keywords: Shariah assurance, Shariah audit, Integrated Shariah audit model
JEL Classifications: M41, M42

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Integrated Internal-External Shariah Audit Model: A Proposal towards the Enhancement of Shariah Assurance Practices in Islamic Financial Institutions

Zurina Shafii,1 Ahmad Zainal Abidin2, Supiah Salleh3

1. Introduction

Shariah law encompasses aspects of belief and religious practice, including rules relating to prayer, fasting, the making of the Haj and giving Zakat. It also covers aspects of everyday life such as behavior towards other people, dress codes, manners and morals. Finally, it includes laws relating to crime and evidence, international relations, marriage, divorce and inheritance, commercial transactions and many other subjects that would be included under the Western definition of law. In other words, Shariah does not separate religion with daily life activities, but rather integrating the social with religious in a single, unified system of law. As for the Islamic financial system, the obligation to establish and strengthen the economy of a Muslim community does not concentrate on the Shariah compliance of the products only (Sultan, 2007). There are also Islamic principles on the establishment of good human resource capability, the proper treatment of investment strategies, etc.

One of the earliest observations on Shariah assurance mechanisms were proposed by Chapra and Ahmed (2002), that suggested that the standard tools for effective Board and management in corporate governance in IFIs are; internal controls, risk management, transparency, loan accounting and disclosure, Shariah clearance and audit, external audit and regulation and supervision. Their model of corporate governance in IFIs includes internal and external players. The model does not discuss in detailed about internal and external audit as the actors that play the role of Shariah assurance within the IFIs. In other words, Chapra and Ahmed’s model is a conceptual model that provides ideas on how IFIs could be managed, in order for Shariah compliance could be established and maintained.

Their work stresses on the role of moral dimension and the role of Islamic banks towards realizing the maqasid of Shariah. In their opinion, Shariah audit should cover the scope of the assurance that IFIs are realizing the maqasad al-Shariah, in addition to the compliance to laws, regulation and fiqhi requirements. They discussed extensively on the measures from the literature that promote effective corporate governance. Among the measures related to moral dimension that was discussed in their seminal work on corporate governance in Islamic financial institutions are:

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i. Market mechanism
ii. Moral integrity of Islamic finance operators
iii. Enablement of socio-political environment

Due to the importance of the role moral dimensions on the effectiveness of corporate governance, the inclusion of moral checks as part of Shariah audit scope is important. At current, Maqasid of Shariah is examined as part of Shariah audit on compliance to Shariah rules and regulations as follows:

Figure 1: Shariah Audit on Compliance to Shariah Principles

Source: Hanefah et al. (2010)

To some extent, the suggestions by Chapra and Ahmed (2002) for the conduct of compliance review and external audit to form Shariah assurance mechanisms were operationalised by the AAOIFI standard on Shariah review and currently, the SGF (2010). However, the industry is still struggling to translate the mechanisms of Islamic moral checks into Shariah audit practice. The lack of measurement to audit the performance of IFIs in relation to the realization of maqasid al-Shariah and the lack of guidelines on the subject from the regulators in the Islamic finance fraternity leaves the industry to concentrate on the compliance of IFIs to Shariah resolutions on products and operational issues.

IFIs are mandated to operate in the environment of Shariah compliance with the reference to Al-Qur’an and As-Sunnah. Failure to adhere with the Shariah principles attracts Shariah non-compliant risk which may render to litigation from depositors, shareholders and investors. It is the fiduciary duties of the IFIs to act in the best interest of the depositors and shareholders. The IFI shall operate the business in accordance to Shariah rules and regulations, which the Board of Directors and management discharge through the Shariah Committee report. In order for Shariah Committee to express the opinion that an IFI is following the Shariah, they will rely on the outcome from Shariah audit findings. This will enhance the public confidence on the Shariah committee report issued by the IFIs since the decision made by the Shariah Committee is supported and verified by the work of the auditors of the IFI.
The requirement for Shariah audit practices is mainly to strengthen the Shariah compliance and enhance the integrity of the IFIs. Shariah audit has currently emerged as an important mechanism in ensuring Shariah compliance in line with the rapid development of IFIs. Shariah audit is currently been performed by the IFIs in order to ensure that the activities and operations of an IFI are in adherence to Shariah. Due to the unique features of the IFIs such as the prohibition of riba, gharar, maysir and additional requirements that the activities must be in compliance with Shariah principles, the current statutory audit may not be sufficient to satisfy the Shariah requirements. Furthermore, the accumulation and evaluation of evidence through the current statutory audit may not achieve the degree of Shariah compliance in the IFIs. Shariah audit differs from statutory audit in many aspects. One of the main differences is statutory audit focused more on financial aspect of an institution that the report of the financial statements shall reflect true and fair view whereas Shariah audit highlights on the importance of the overall activities and operations of the IFIs must be in line with the Shariah requirements. For example, Shariah prohibits, among other things; transactions involving riba or usury, gambling, hoarding and speculation. Besides that, Islam also forbids any investing or dealing in alcohol, pork and other activities which are considered unlawful from an Islamic perspective. In Shariah audit, the auditors must also attest that management has complied not only with the Shariah aspects, but also with the wider objectives of Shariah (Maqasid al-Shariah), which is to protect and improve the condition of human life in all dimensions.

There are concerns about the scope of Shariah audit and the parties that should be conducting the audit. At current, AAOIFI requires for external auditors to express assurance on Shariah compliance. On the other hand, Malaysia and Pakistan, resort to internal Shariah audit practice, to be conducted by internal auditors. Shariah audit could be performed by internal and/or external auditors. External audit is preferred as it constitute independent assessment, while internal audit ensures the governance, monitoring and control with regards to Shariah compliance. Chapra (2014) argues that having too many auditors to audit the Shariah aspects could introduce resistance from the auditees. Thus, a clear scope for internal and external auditors with regards to Shariah audit practice is needed to introduce effectiveness and efficiency of Shariah audit conduct.

Due to the importance of Shariah assurance practices the objective of this study is to identify the practice of Shariah audit in selected Islamic banks in GCC countries, namely Bahrain, Saudi Arabia, Kuwait, UAE and Qatar, by examining financial and non-financial statements in their annual reports. In addition, this study examine the practice of Shariah assurance practices in countries where Islamic finance is adopted as part of the mainstream finance, namely Pakistan, Sudan, Indonesia and Malaysia. In addition, this study aims to develop a model for Shariah audit that integrates the internal and external Shariah audit function upon the identification of the scope of Shariah audit that is to be performed by internal auditors and external Shariah auditors.

This paper contains six sections. This section serves as the primer section that discusses the direction of this paper. Section Two defines Shariah audit and discusses Shariah audit practice as required by the regulators and guidelines providers in the Islamic finance industry. Section Three discusses country-specific practices on Shariah assurance, by examining the the guidelines issued by the regulators and examinations on the annual reports of Islamic banks in the relevant countries. Methodology of this paper is discussed in Section Four. Section Five provides the analyses and discussions on the proposed model. Finally Section Six concludes the paper.
2. Definition and Scope of Shariah Audit

The term Shariah audit (التدقيق الشرعي) is a relatively new term (Chik, 2011). Islamic religious auditing or Shariah audit monitors the performance of IFIs’ state of Shariah compliance. For example, the Islamic Shariah prohibits, among other things, the payment and receipt of riba or usury (Quran 2: 275-276), gambling (Quran 5:90), hoarding (Quran 9:34) and speculation (Qureshi, 1976). Besides that, Islam also forbids any investing or dealing in alcohol, pork and other activities which are considered unlawful from the Islamic perspective.

The need for Shariah audit stems from the requirement that the IFI should comply with the Shariah. If religious auditors find any violation of the Islamic principles in the operation of organization, then this should be reported as in the case of external auditor reporting their opinion on the true and fair view of the organization’s financial position. The definitions and related operationalization of Shariah by the regulators and standard setters in Islamic finance is reported in Table 1.

Table 1: Shariah Audit Definition, Responsibilities, Scopes and Reporting Prescribed by BNM, IFSB and AAOIFI

<table>
<thead>
<tr>
<th>ITEMS</th>
<th>BNM (Bank Negara Malaysia)</th>
<th>IFSB (Islamic Financial Services Board)</th>
<th>AAOIFI (Accounting and Auditing Organisation For Islamic Financial Institutions)</th>
</tr>
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<tbody>
<tr>
<td>Definition</td>
<td>▪ Periodical assessment to provide independent assessment and objective assurance to add value and improve IFIs compliance in ensuring sound and effective internal control system for Shariah compliance.</td>
<td>▪ Internal Shariah Review/ Audit Unit (ISRU) to verify Shariah compliance has been satisfied.</td>
<td>▪ Expression of opinion on financial statement that need to be prepared in all material respects, in accordance with the fatwas, rulings and guidelines issued by the SSB, accounting standards of the AAOIFI, national accounting standard and practices, and relevant legislation and regulations applied in the country.</td>
</tr>
<tr>
<td>Responsibility</td>
<td>▪ To provide independent assessment and objective assurance to add value and improve IFIs compliance in ensuring sound and effective internal control system for Shariah compliance.</td>
<td>▪ Record and report any incident of any non-compliance.</td>
<td>▪ Review of Internal Controls (including internal audit).</td>
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<td>▪ Address and rectify any non-compliance.</td>
<td>▪ Review of accounting practices and audit plan.</td>
</tr>
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<td>ITEMS</td>
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| ensuring sound and effective internal control system for Shariah compliance includes:  
  a. Assess efficiency and effectiveness of internal control system;  
  b. Assess compliance to guidelines set by regulator; and  
  c. Assess compliance to internal policies & procedures.  
  ▪ Develop comprehensive internal audit program or plan:  
    - Objective, scope, personnel assignment, sampling, control & duration  
    - Establish proper audit processes.  
  ▪ Obtain and make reference to relevant references – Shariah Advisory Council rulings, Shariah Committee decision, fatwas, guidelines, Shariah audit results & internal Shariah checklist.  
  compliance activity.  
  ▪ Shall require or recommend the management to address and rectify any issues of Shariah compliance.  
  ▪ Review of interim and annual accounts and financial reports (inclusive of matters arising from the audit).  
  ▪ Ensure IFIs adheres to AAOIFIs’ Code of Ethics for Accountants and Auditors of IFIs.  
  ▪ Review the compliance with Shariah rules and principles.  
  ▪ Review the use of restricted investment accounts’ funds.  
  ▪ To assist the BOD in exercising independent and objective monitoring as follows:  
    a. Preserving the integrity of financial reporting process.  
    b. Safeguarding the interests of shareholders, investors, and other corporate stakeholders.  
    c. Providing additional assurance on the reliability of |
<table>
<thead>
<tr>
<th>ITEMS</th>
<th>BNM (Bank Negara Malaysia)</th>
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<th>AAOIFI (Accounting and Auditing Organisation For Islamic Financial Institutions)</th>
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<tbody>
<tr>
<td></td>
<td>▪ Provide recommendations &amp; follow up on rectification measures taken by IFIs.</td>
<td></td>
<td>financial information presented to the BOD.</td>
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<td></td>
<td>▪ To be performed by internal auditors, who have acquired Shariah related knowledge and training. The internal auditors may engage expertise of Shariah officers in performing the audit.</td>
<td></td>
<td>d. Acting as an independent link between the IFIs’ management and its stakeholders.</td>
</tr>
<tr>
<td>Scope</td>
<td>▪ Audit of financial statement of IFIs.</td>
<td>▪ ISRU will review the products and services and see if it adhered to the opinions of Shariah board.</td>
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<td></td>
<td>▪ Compliance audit on organizational structure, people and information technology application system.</td>
<td>▪ Review adequacy of Shariah governance process.</td>
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<td></td>
<td>▪ Review adequacy of Shariah governance process.</td>
<td>▪ ISRU shall report to the Shariah board.</td>
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<td></td>
<td>▪ The subject matter of Shariah Audit not only cover the financial statement but also akhlaq (ethics), internal processes, personnel, financial and non-financial performance, financial position, information and IT systems, marketing and other relevant issues pertaining to Shariah.</td>
<td>▪ Produce reports indicating whether the Shariah audit will provide additional assurance on the reliability of financial information.</td>
<td></td>
</tr>
<tr>
<td>Reporting</td>
<td>▪ Shariah Audit findings shall be reported to the Board of Committee and Shariah Committee.</td>
<td>▪ ISRU shall report to the Shariah board.</td>
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<td></td>
<td>▪ Produce reports indicating whether the Shariah audit will provide additional assurance on the reliability of financial information.</td>
<td>▪</td>
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</table>
The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), established in 2006 has the objective to maintain and promote Shariah standards for Islamic financial institutions, participants and the overall industry. For that, it ensures the participants in the IFIs conform to the regulations set out in Islamic finance. The founding and associate members, as well as the regulatory and supervisory authorities of the AAOIFI, define the acceptable standards for various functions. Up to now, AAOIFI produced Shariah, accounting, governance, ethics and audit standards.

As highlighted in Table 1, according to AAOIFI’s Auditing Standard for Islamic Financial Institutions No. 1 (ASIFI 1), the objective of audit is to enable the auditor to express an opinion that the financial statement are prepared in all material respects, in accordance with the fatwas, rulings and guidelines issued by the Shariah Supervisory board of the Islamic financial Institutions, AAOIFI accounting standards, national accounting standards and practices, and relevant legislation and regulations applied in the country in which the Islamic Financial institution operates. Referring to the definition provided by AAOIFI, the standard refers audit as an expression of opinion on the financial statement whereas the scope should be expanded to cover the overall activities and operations of the IFIs that in accordance with Shariah rulings of a country. The subject matter of the Shariah audit should be wider than a financial statement audit. In line with the broader scope of the Shariah including akhlaq (ethics) not only should the financial statements, but the IFIs internal processes, personnel, financial and non-financial performance, financial position, information and IT systems, marketing of the IFI’s product and other relevant issues pertaining to Shariah.
ASIFI 1 quotes that the audit conducted should adhere to Shariah principles, AAOIFI and other relevant accounting standards and practices in the country which the IFIs operate. However, there is argument that the necessity to comply with two sets of criteria (AAOIFI and national) might lead to conflicts because when national jurisdiction require banks to follow International Financial Reporting Standards, then IFRS does not allow mutual existence and tolerance of other standards. At current, among countries that adopt AAOIFI standards as part of their regulatory framework for IFIs are the GCC countries, Sudan and Jordan.

In Malaysia, Shariah Governance Framework (SGF) issued by Bank Negara Malaysia (BNM) in 2010 addressed the implementation of Shariah audit function in IFIs. The SGF is a set of organizational arrangements through which IFIs ensure effective oversight, responsibility and accountability of the Board of Directors, management and Shariah Committee. The framework serves as a guide towards ensuring an operating environment that is compliant with Shariah principles at all times. In measuring the IFIs compliance to the Shariah, SGF requires regular internal Shariah reviews and Shariah audit, supported by an appropriate risk management process and research capability. International Shariah scholars and bankers believe that given the systemic approach of Malaysia in developing its Islamic finance sector, the SGF is the best of its kind and could become a blueprint for other countries to follow.

Furthermore, recent issuance of Islamic Financial Services Act (IFSA) in Malaysia outlines the more stringent and detailed requirement especially towards the Shariah governance function and duties of the Board of Directors, senior officers and members of the Shariah Committee. It is interesting to note that any person mentioned, who fails to comply with any standard issued by Bank Negara Malaysia, or commit an offence, upon conviction, shall be liable to imprisonment for a term not exceeding eight years or to a fine not exceeding twenty-five million ringgit or both (Section 29 (6), IFSA 2013).

Table 1 also summarises the Shariah audit definition provided in Paragraph 7.7 of SGF (2010) that states that ‘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’.

Given the statement above, it can be concluded that Shariah audit can best be defined as a process of accumulating and evaluating evidence that relates to the overall activities and operations (process, personnel, financial and non-financial performance, financial position, systems, marketing, etc.) of the IFIs in which the information gathered must be in adherence to the Shariah principles. Shariah audit in the IFIs shall be performed by independent auditors who are also competent in addressing Shariah matters.

In term of scope, SGF by Bank Negara Malaysia (2010) explains that Shariah audit would covers all aspects of the IFI’s business operations and activities, including:

i. Audit of financial statements of the IFI;

ii. Compliance audit on organisational structure, people, process and information technology application systems; and

iii. Review of adequacy of the Shariah governance process.

SGF further extended that the scope of the internal Shariah audit shall include any area which involves Shariah compliance issues such as products and services, Shariah review function,
financial reporting, Shariah governance practices, organizational structure, human resources (people), processes, marketing and information system. In addition, SGF also suggested that the Shariah audit may be conducted as part of the IFI’s thematic audit on specialized areas such as management audit and Anti-Money Laundering (AML) audit. Shariah audit on critical areas shall be conducted.

A recent study by Kasim et.al (2013) explained that there is a different practice among the Islamic banks in Malaysia especially regarding the scope of the audit of financial statements. Furthermore, the internal Shariah auditors in certain Islamic banks justified that the audit on the financial statements is not covered since it should be covered by external auditors.

3. Shariah Audit Practices in GCC, Sudan, Pakistan, Indonesia, and Malaysia

This study identifies the practice of Shariah audit in GCC countries, namely Bahrain, Saudi Arabia, Kuwait, UAE and Qatar by examining the annual reports of selected Islamic banks in the respective countries. As regulators in GCC adopt minimalist approach to Shariah governance (Hasan, 2010), the review of Shariah governance and assurance practices will provided the way of financial and non-financial reports of leading Islamic banks in each countries in GCC. In addition the paper examines the regulatory requirements and guidelines by the regulators in in countries where Islamic finance is adopted as part of the mainstream finance, i.e. Sudan, Pakistan, Indonesia and Malaysia.

3.1 Shariah Audit Practices in GCC Countries

The majority of the IFIs in GCC countries have developed their own Shariah guidelines and standard processes on Shariah compliance. From the examinations of the financial and non-financial statements of leading Islamic banks in each of GCC, it was found that most of the banks in GCC countries conducted Shariah review rather than Shariah audit. Shariah review in the Islamic banks in GCC are conducted by the Shariah Supervisory Board of the IFIs. However, in terms of auditing, only minimal percentage of IFIs’ Shariah Supervisory Board in Islamic banks in GCC indicated that the functions had been delegated to internal Shariah compliance unit. Table 2 provides the summary of the framework of Shariah assurance in GCC.

<table>
<thead>
<tr>
<th>IFIs, Country</th>
<th>Regulatory Authority</th>
<th>Islamic Banking Law</th>
<th>Shariah Committee At Central Bank</th>
<th>Shariah Committee At Bank Level</th>
<th>Shariah Standard s</th>
<th>Accounting Standard</th>
<th>Shariah audit practices</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bahrain Islamic Bank, Bahrain</td>
<td>Central Bank of Bahrain</td>
<td>Not disclosed</td>
<td>Shariah Supervisory Committee</td>
<td>Shariah Supervisor Board</td>
<td>AAOIFI</td>
<td>AAOIFI</td>
<td>Internal Shariah audit Dept.</td>
</tr>
<tr>
<td>Al-Rajhi Bank, Saudi Arabia</td>
<td>Saudi Arabian Monetary Agency (SAMA) &amp; Capital Market</td>
<td>Banking Control Law</td>
<td>Shariah Supervisory Board</td>
<td>Shariah Authority</td>
<td>Not Disclosed</td>
<td>IFRS</td>
<td>Not disclosed</td>
</tr>
</tbody>
</table>
IFIs in GCC disclosed significant findings in its Shariah Supervisory Report that includes the results of Shariah review. This effort shows that the IFIs in the GCC countries promote transparency in Shariah compliance aspects.

As reported in Table 2, our analysis of the annual reports of Bahrain Islamic Bank (BISB) found that the SSB in BISB acts as monitoring function included the checking of documents and procedures to scrutinize each operation carried out by the Bank, whether directly or through the Shari’a Internal Audit department. The SSB of BISB planned with the Shari’a Internal Audit department to carry out monitoring functions by obtaining all the information and clarifications that were deemed necessary to confirm that the Bank did not violate the principles and provisions of Islamic Shari’a. The Shari’a Internal Audit department in BISB audited the Bank’s transactions and submitted a report to the SSB. The report confirmed the Bank’s commitment and conformity to the SSB’s opinions.

Al-Rajhi Bank in Saudi Arabia established an independent Shariah Board, formed and ratified by the Constituent General Assembly with the objective of ensuring that all Bank activities are subject to the approval of the Shariah Board. The Juristic Control Department is responsible for exercising the necessary controls and reports directly to the Shariah Board. The Juristic Control Department is responsible for supervising the activities of the Bank in terms of verifying the implementation of the Shariah Board’s decisions. In 2011, over 300 visits were made to branches, transfer centres, and trading rooms and training sessions were conducted for 340 new employees with 15 courses held. However, in Al-Rajhi’s annual report 2011, the Shariah Supervisory Board report was not been disclosed to the public.

In Kuwait Finance House, through the Shariah Supervisory, review has been conducted on a random basis on samples of operation which provided returns to all transactions of KFH with shareholders, investors and others. This is based on the annual Shariah audit plan on all departments, periodic reports submitted by Shariah Supervisory Department regarding the auditing operations, field visits and on the operation and the correct implementation of fatwa and resolutions issued by the Shariah Board.
The practice held in Qatar Islamic Bank through its Executive Committee and Shariah Audit Department, the Shari’a Supervisory Board has directly supervised the Bank’s activities and are satisfied that its resolutions have been righteously executed. The Shari’a Supervisory Board confirms that the responsibility for applying the Shari’a norms and controls lies mainly on the Bank’s Management, as the Shari’a Supervisory Board’s liability is confined to giving relevant jurisdictions (fatwas) and reviewing the transactions referred to it, whether they were addressed to it directly or through the Shariah Audit Department as implied by the authorities vested in the Shariah Audit Department. In addition, Qatar Islamic Bank played an equally important role in developing AAOIFI standards working closely with the Accounting and Auditing Standards Council for Islamic Financial Institutions. Finally, Dubai Islamic Bank’s annual report was limited to the financial reports only. Thus, information on Shariah governance and audit in Dubai Islamic Bank were very limited.

3.2 Shariah Audit Practices in Sudan
The Central Bank of Sudan was established in 1959 to undertake the functions of the Central Bank stipulated in the Bank of Sudan Act. These functions included oversight and supervision of the banking system and its development and promotion, issuance and management of the national currency, management of the exchange rate, maintaining stability of the economy and other functions carried out by the central banks as a primary body contributing in the economic turnover of the economic wheel in the country. There are two unique and important characteristics associated with Sudanese Banking System, namely, it’s the first banking system in the world based on the rules of Shariah which prohibit interest rates. Since 1983 Sudan had adopted a purely Islamic banking system from the signing of the Comprehensive Peace Agreement (CPA) between Sudanese Government and the Sudanese People's Liberation Movement in 2005, according to the CPA the south was exempted from conducting an Islamic system and instead to operate a conventional system. Sudan Central Bank operates within two systems: Islamic in the North and conventional in the South, which represent the second characteristic of Sudanese banking system, the feature of conducting a single monetary policy governing two banking systems.
In Sudan, the term Shariah audit is not being mentioned, neither in the annual report of the Islamic Bank nor the website of central bank of Sudan. However, they conducted Shariah review as a commitment to show their responsibility in determining Shariah compliance in the Islamic Bank. However, the Shariah Supervisory report in the annual report of its Islamic Bank did not thoroughly disclosed on the findings of Shariah Review. At current, there is no disclosure on the Shariah non-compliance activities arise in the Islamic Bank in Sudan.

3.3 Shariah Audit Practices in Pakistan
The Islamic banking movement in Pakistan was a nationwide and comprehensive. As it was a mammoth task, the switch-over plan was implemented in phases. The process was started by transforming the operations of specialized financial institutions like National Investment Trust (NIT), Investment Corporation of Pakistan (ICP), and House Building Finance Corporation (HBFC) to the system conforming to the Islamic principles with effect from July 1, 1979. Separate Interest-free counters started operating in all the nationalized commercial banks, and one foreign bank from January 1, 1981, to mobilize deposits on profit and loss sharing basis. As from July 1, 1985, all commercial banking operations were made ‘interest-free’. From that date, no bank in Pakistan, including foreign banks, was allowed to accept any interest-bearing deposits. All existing deposits in banks were treated to be on the basis of profit and loss sharing. However, foreign

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4 Sources from annual report of Faisal Islamic Bank Sudan retrieved at http://www.fibsudan.com
currency deposits/loans were continued to govern on interest basis. The government meanwhile also passed Mudarabah Companies Act 1984, enabled financial institutions or business groups to setup special Mudaraba Companies in a country\(^5\).

The regulatory authority related to Islamic banking in Pakistan is the State Bank of Pakistan. The State Bank of Pakistan (SBP) has established a dedicated Islamic Banking Department (IBD) that operates in close coordination with Policy and Regulatory Department and Inspection and Supervision departments to facilitate IFIs development. The IBD coordinates with rest of the SBP and banking industry to provide valuable regulatory guidance related to overall Shariah Compliance and specific issues/challenges being faced by the Islamic banks in Pakistan\(^6\).

SBP has put into place a comprehensive and robust multi-tiered Shariah compliance mechanism to lend customers and investors confidence in the Islamic banking industry. Shariah compliance mechanism has three main pillars: (i) a Shariah Board at SBP which approves policies and guidelines as well as the fit and proper criteria for Advisors; (ii) Shariah Advisors in all banks to provide guidance to banks and comfort to customers on Islamic financial services; and (iii) a Shariah audit system. Shariah Audit System is develop based on the inspection manual, which is very comprehensive, was compiled by Ernst & Young out of Bahrain in collaboration with their affiliate in Pakistan.

The Shariah Audit system is needed to ensure that specific terms of Islamic contracts, *fatwa* on the transaction, as well as the sequence of execution of the agreement are conducted according to Shariah principles. The preparations of the financial statements in are based on AAOIFI standards and the inspection is geared towards auditing the transactions according to these standards. In addition to the normal SBP inspection, all banks conducting Islamic banking will also have to undergo the Shariah Compliance Inspection. Shariah compliance inspection of Islamic banks covers a review of the Islamic banks’ arrangements and operations, their services and products, financial statements and accounting records to ensure that all transactions are being carried out in accordance with the injunctions of Shariah.

In order to strengthen the Shariah compliance mechanism in Islamic Banking, the SBP ensure that all relevant Islamic banking regulations are complied with in letter and spirit and shall be adherence to the Shariah Compliance framework. The Shariah Compliance framework in Pakistan specifically emphasis on Shariah aspects with relevant provisions of existing laws, rules, regulations, policies and procedures related to Islamic Banking. The laws and provisions need to be embedded in the IFI’s processes in such a manner that monitoring and reviewing of issues related to Shariah compliance forms part of internal control structure. Monitoring and reviewing for Shariah Compliance should cover all activities, products and locations of the IFI. The basic purpose of this responsibility is to ascertain whether the transactions, processes and products undertaken by the IFI are Shariah compliant and all related conditions are being met, as approved by Shariah Advisor.

In terms of auditing, the IFIs in Pakistan introduces a system of internal Shariah audit, so as to ensure that the goals and objectives of Shariah compliance are achieved. Internal Shariah Audit of IFIs is part of the regular internal audit or as a separate unit depending upon size of operations of the IFI. The primary objective of the Internal Shariah Audit is to ensure that the management of the IFI is discharging its responsibilities in compliance with Shariah rules and principles as

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6 Keynote address delivered at Annual Corporate Governance Conference Dubai on November 27, 2006 by Dr. Shamsad Akhtar, the Governor of State Bank of Pakistan on ‘Shariah Compliant Corporate Governance’. 
prescribed by SBP and the Shariah Advisor of the IFI. The purpose of the Internal Shariah Audit is to ensure that the system of internal control for Shariah Compliance is conceptually sound and effective in implementation, so as to ensure that the goals and objectives for Shariah compliance are achieved. The Internal Shariah Audit is carried out in conformity with Shariah rules and principles, guidelines and instructions issued by SBP. The internal Shariah auditors have direct and regular communications with all levels of management and Shariah Advisor. There is no scope limitation and restriction of access to information, documents, reports and etc.

In terms of reporting, the report of Internal Shariah Audit contains observations and assessment of systems and controls in place for Shariah compliance. The Internal Shariah Audit report will also include recommendations for potential improvements and corrective actions to be taken. Any disputes or differences of opinion between management and Internal Shariah auditors on matters relating to Shariah interpretation is referred to the Shariah Advisor of the IFI for decision. The report of the Internal Shariah Audit is tabled before the Shariah Advisors for advising the appropriate corrective action and then before the Audit Committee of the IFI for consideration and appropriate remedial action as advised by the Shariah Advisors.

The report from Shariah audit findings are extensively highlighted in the IFIs of Pakistan through the Shariah Supervisory report. For example in the annual report of Meezan Bank, in the Shariah Supervisory report there is specific paragraph emphasizing on the Shariah audit matters. Areas that been covered during Shariah audit were disclosed extensively. This reflects transparency in reporting on Shariah compliance. Shariah audit practices conducted in Meezan Bank covers all major branches, to ensure and evaluate the overall Shariah compliance of the bank’s operation and their alignment with the guidelines given by the Shariah Advisor and the Shariah Supervisory Board. In the audit process areas covered in Shariah auditing are as follows:

- Agreements for Murabaha, Ijarah, Diminishing Musharakah, Istisna, Tijarah and Bai Salam;
- Declaration, description of Assets, relevant purchase invoices, sequence and order of the documents and time differences between purchases and declaration in Murabaha;
- Murabaha monitoring Sheets and delayed Declaration reports;
- Ownership ratio in Diminishing Musharakah for Housing and issuance of timely unit sale receipts;
- Investment made in stock with reference to the stock screening criteria;
- Import Finance transactions and related documentations;
- Extensive reviews of client payment, purchase cycle and periodic assessment of client’s processes;
- Other related documents and procedures followed by different functional areas; and
- Profit-sharing ratio, profit weightage, pool working, asset & deposit allocation for deposit products.

SBP instructed all IFIs to dedicate few members of IFIs’ Internal Audit Department for Shariah Audit or create a separate Shariah Internal Audit Department, depending upon the size of the bank. The main responsibility lies with this department for Shariah Audit. There are some areas like PLS profit distribution, where SBP instructed banks to audit the whole process jointly from Shariah Advisor (SA) and external auditors. Thus, one can say that in Pakistan, Shariah Audit is done by both internal and external Auditors.
In addition, the external auditor report in Islamic Banking in Pakistan did not mentioned on Shariah audit findings. The rationale behind this is that Islamic Banking is at nurturing stage, and any such type of Shariah observations will not only hurt the bank but also hurt the perception of Islamic Banking Industry. Thus, it is not enforced by the law to mention Shariah findings in the report. Further, if Shariah observations are found by internal or external auditors, then they highlight these to SA to take action, what he deems fit. Furthermore, SBP Banking Inspection team also inspects Shariah Compliance of the bank and if any observations, highlighted to SA, and impose penal action.

3.4 Shariah Audit Practices in Indonesia
The development of modern Islamic banking in Indonesia was formally initiated in 1991, in line with the enactment of Banking Act No. 7 of 1992 which includes provisions to develop interest-free banking. Indonesia's first Islamic bank was Bank Muamalat, which was established in 1991. It operates according to the tenets of Shariah law, which prohibits charging interest on loans and paying interest on deposits. Based on the Banking Act No. 7 of 1992, Indonesia recognized the existence of a dual banking system, that is, a system where conventional banking grows side by side with Islamic banking to serve the economy.

On 25 June 2003, an agreement was signed between Bank Indonesia and The Indonesian Institute of Accountants (IAI) to structure the accounting standard for Islamic banks (including the implementation of research and training cooperation for the field that relates to the competency of IAI). Since 2001, Audit Guideline for Islamic banks, Review on Guideline of Financial Accounting Standard (PSAK) 59 and Financial Accounting Standard for Islamic Bank in Indonesia (PAPSI) have been issued by IAI. In drafting the Shariah financial accounting standards, IAI works with Bank Indonesia, National Shariah Board and Shariah banking practitioners. Standards released by the International Shariah financial accounting body such as AAOIFI are used as a benchmark.

Islamic Banking in Indonesia conducted Shariah review. Shariah audit work is reported to be conducted in Indonesia’s Islamic Banks. Shariah review are conducted by the Shariah Committee of the IFIs and been declared in the annual report. The findings arise from Shariah review conducted, was not been disclosed in the annual report7.

3.5 Shariah Audit Practices in Malaysia
The Islamic financial system in Malaysia was first introduced in 1963. It started from a modest beginning with the establishment of the Malaysian Pilgrims Fund Board (Tabung Haji), to the setting up of the country’s first Islamic bank, Bank Islam Malaysia Berhad (BIMB), which commenced business on 1 July 1983. Bank Negara Malaysia (BNM) adopted a step-by-step approach to introduce Islamic banking. The first step to spread the virtues of Islamic banking was to grow Islamic banking operations to the national level with as many players as possible and to be able to reach all Malaysians. After a careful consideration of various factors, BNM decided to allow the existing banking institutions to offer Islamic banking services using their existing infrastructure and branches. The option was seen as the most effective and efficient mode of increasing the number of institutions offering Islamic banking services at the lowest cost and within the shortest time frame. At current, Malaysia has 17 full-fledged Islamic financial Institutions operating parallel to conventional financial system.

7 Sources from annual report of Bank Shariah Mandiri, Indonesia
Shariah Governance Framework (BNM, 2010) issued by the Central Bank of Malaysia has enlightened the practice of Shariah governance in ensuring Shariah assurance in the IFIs. The framework highlights that 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. The function of shariah audit should be performed by internal auditors, who have acquired adequate Shariah-related knowledge and training. In addition, the internal auditors may engage the expertise of the IFI’s Shariah officers in performing the audit, as long as the objectivity of the audit is not compromised. Shariah audit in the IFI shall be conducted at least on an annual basis, verifying that the IFI’s key functions and business operations comply with Shariah. Figure 2 features the Shariah Governance Framework that should be established in every Islamic Financial Institutions (IFIs) in Malaysia.

![Shariah Compliance Framework for Islamic Financial Institutions](image)

**Figure 2: Shariah Compliance Framework for Islamic Financial Institutions**

**Source:** Shariah Governance Framework (BNM, 2010)

The demand for Shariah audit practices is mainly to strengthen the Shariah compliance and enhance the integrity of the IFIs. Shariah audit arise due to the different nature and characteristics that exists in the Islamic banking practices. Many Islamic banking scholars, identified that the nature of Islamic banking is to be different from the conventional banks (Chapra and Ahmed, 2002, Iqbal and Mirakhor, 2007, Dusuki, 2007, Dusuki, 2011). The absence of proper Shariah governance in the institutions will lead to the collapse of the whole Islamic Financial system in the
institutions. Thus, Shariah audit is deemed significant since the absence of it poses a serious loophole in the Islamic financial system that is now fast expanding, with 17 stand-alone Islamic banks in Malaysia (Abdul Rahim, 2009).

In general, Shariah audit is established to ensure that the products, services and all activities by IFIs do not violate the Shariah. There are several scopes of Shariah audit, which includes audit of the financial statement, operational audit, structure and people audit and finally the information technology audit (Sultan, 2007).

Previously, the practice of Shariah audit in IFIs in Malaysia is on voluntary basis. The practice of Shariah audit in Malaysia is limited to Shariah compliance of the products only. This is because Shariah Committee of the IFIs normally expressed their opinions on the Shariah compliance of the products and services offered (ex-ante compliance). At current, a comprehensive and well-guided audit of the Shariah legal contracts, documentations and operations so far has not been properly conducted. The ex-post compliance stage is absence in the practise. However, since Bank Negara Malaysia has launched its new Shariah Governance Framework by the end of June 2011 each IFI authorized and operating in Malaysia is required to confirm the status of compliance with the Framework, which was adopted pursuant to section 59 of the Central Bank of Malaysia Act 2009, section 53A of the Islamic Banking Act (IBA), section 69 of the Takaful Act (TA), section 126 of the Banking & Financial Institutions Act (BAFIA) and section 126 of the Development Finance Institutions Act (DFIA). This shows that all IFIs in Malaysia need to consider the seriousness in implementing Shariah audit in the institutions.

Many Islamic Banks in Malaysia attached Shariah audit function to the internal audit department. Shariah audit function is one of the internal audit function in performing check and balances in the IFIs. Shariah audit function is lead by Shariah audit manager which assist the Chief Internal Auditors (CIA) in establishment of the scope of Shariah audit work, organize and manage the audit to achieve the audit plans and activities. Shariah audit function in IFIs also review the risk assessment of Shariah compliance audit and ensure the audit program comprehensively covers the area of audit work. Shariah audit manager of an IFI is also responsible to provide guidance and consultation on Shariah compliance to internal auditors in the department. At the end of auditing process, Shariah audit manager of an IFI shall draft the audit report on Shariah audit findings and submit to the CIA. In addition, Shariah audit manager is also responsible to updates on Shariah matters in respect to BNM guidelines and regulatory requirements.

From the review on the practices of Shariah review and Shariah audit in the jurisdictions practicing Islamic finance, there is a need to establish a holistic model in order to integrate the internal Shariah audit and external Shariah audit function, as proposed in this study.

4. Methodology

To conceptualise an integrated model of Shariah audit, this paper adopts qualitative library research approach. The research first identifies the differences of the internal and external Shariah audit functions by critically analyses the scope of each function. This is to ensure that no overlapping of works exists between the two, and to establish a holistic model that consists of both the internal audit and external audit function. The sources of information sought in this research include the relevant resolutions on Shariah governance by regulators in Islamic finance jurisdictions discussed in Section Three. To explore the function of internal auditors in relation to Shariah audit, the International Standards for the Professional Practice of Internal Auditing, known as International Professional Practice Framework (IPPF) issued by Institute of Internal Auditors (IIA) is examined. In addition, International Financial Reporting Standard (IFRS) are also
examined, in order to study the issues of IFRS adoptions in Islamic financial institutions. The standards and guidelines would provide guidance to the establishing the roles of internal and external Shariah auditors.

5.0 Discussion and Findings
From the analysis of relevant regulations and guidelines by the regulators in the Islamic finance jurisdictions, examinations of annual reports of Islamic banks, IPPF guidelines and selected IFRS, this study establishes general and specific scopes of internal and external audit. Further discussions are provided in the next sub-sections.

5.1 General scope of Internal and External Audit
The International Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors (IIA) defined internal audit as:

“an independent, objective assurance and consulting activity designed to add value and improve an organization’s operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes.”

Furthermore, the International Standard on Auditing (ISA 610, Revised 2013 – “Using the work of internal auditors”) defines internal audit function as “a function of an entity that performs assurance and consulting activities designed to evaluate and improve the effectiveness of the entity’s governance, risk management and internal control processes”.

The importance of the relationship of internal audit and external audit is reflected by the International Standards of Audit (ISA 610 – “Considering the work of internal audit”) and Malaysian Institute of Accountants, “Internal auditing guidelines”, which foresees, among others:

i. The role of internal auditing is determined by management, and its objectives differ from those of the external auditor who is appointed to report independently on the financial statements. The internal audit function’s objectives vary according to management’s requirements. The external auditor’s primary concern is whether the financial statements are free of material misstatements;

ii. The external auditor should obtain a sufficient understanding of internal audit activities to identify and assess the risks of material misstatement of the financial statements and to design and perform further audit procedures;

iii. The external auditor should perform an assessment of the internal audit function, when internal auditing is relevant to the external auditor’s risk assessments;

iv. Liaison with internal auditing is more effective when meetings are held at appropriate intervals during the period. The external auditor would need to be advised of and have access to relevant internal auditing reports and be kept informed of any significant matter that comes to the internal auditor’s attention which may affect the work of the external auditor. Similarly, the external auditor would ordinarily inform the internal auditor of any significant matters which may affect internal auditing.

v. The relationship between internal and external audit needs to take account of their differing roles and responsibilities. Internal audit is an independent appraisal function within the organisation and internal auditors are direct employees. The external auditor usually has a statutory responsibility to express an independent opinion on the financial statements and stewardship of the organisation.
vi. The aim should be to achieve mutual recognition and respect, leading to a joint improvement in performance and the avoidance of unnecessary overlapping of work. It should be possible for the external and internal auditors to rely on each other's work, subject to limits determined by their different responsibilities, respective strengths and special abilities. Consultations should be held and consideration given to whether any work of either auditor is adequate for the purpose of the other. The internal auditor does not automatically have a right of access to the records of the external auditor. However, the relationship between the internal and external auditor will usually be such that the external auditor will be able to allow access to the necessary records.

vii. Since internal audit evaluates an organisation's internal control system the external auditor may need to be satisfied that the internal audit function is being planned and performed effectively. This review needs to be seen by both parties as a necessary part of the working relationship.

viii. Regular meetings should be held between internal and external auditors at which joint audit planning, priorities, scope and audit findings are discussed and information exchanged. The benefits of joint training programmes and joint audit work should also be considered. Following the recommendation by the IIA as above, ideally, Shariah audit performance could be planned during periodical meetings between internal Shariah auditors and external auditors to discuss common interests; benefit from their complementary skills, areas of expertise, and perspectives; gain understanding of each other's scope of work and methods; discuss audit coverage and scheduling to minimize redundancies; provide access to reports, programs and working papers; and jointly assess areas of risk.

SGF 2013 also provides some guidance to the auditors in relation to the processes of Shariah audit. The framework states that the process of Shariah audit should cover, but is not limited to, the following:

i. Understand the business of IFIs to allow for better scoping of an audit exercise;

ii. Develop a comprehensive internal audit program or plan including objectives, scope, personnel assignment, sampling, control and duration as well as establish proper audit processes, policies and procedures of IFI’s operations;

iii. Obtain and make references to relevant sources (i.e. SAC’s published rulings, the Shariah Committee’s decisions, fatwas, guidelines, the Shariah audit results and the internal Shariah checklist);

iv. Conducting Shariah audit on periodic basis;

v. Communicate to Board Audit Committee and the Shariah Committee for any result on assessment or findings;

vi. Provide recommendations on rectification measures taken as well as follow –up on the implementation by IFIs.

IPPF provides standards expressing the nature of work of internal audit under the section ‘Nature of Work’. That section too, provides vital guidelines for auditors to perform their job. Nature of works, by definition also could provide guidelines to auditors on how to perform the audit. The coverage of audit according to the Standard is specified as follows:
Thus, in fulfilling its oversight responsibilities for assurance, the board should require coordination of internal and external audit work to increase economy, efficiency, and effectiveness of the overall audit process.

5.2 The Proposed Integrated Model of Shariah Audit Function
Based on the above similarities and differences of the internal and external audit function, the authors believe that an integrated model for Shariah audit function in Islamic financial institutions could be adopted. The proposal also in line with the proposed convergence of conventional internal and external audit functions as suggested by Rittenberg, L.E. & Covaleski, M. (1997), as depicted in Figure 4.
Adapting the model of Rittenberg and Covaleski (1997), the authors will explain further on the sample of areas that differentiate the internal and external Shariah audit functions and how both functions could be integrated greater efficiency and effectiveness of Shariah audit conduct within IFIs. The proposed integrated model is shown in Figure 5.
The model suggested by Rittenberg & Covaleski (1997) provides the legitimacy of our proposed model of integrated internal-external Shariah audit practice. The integrated model also accommodates the observation of Chapra (2014) that states that the IFIs currently have to deal with too many inspectors that check Shariah compliance in the IFIs. Inspections of Shariah compliance consists of the inspectors from regulators, Shariah firm and external certified audit firms. The proposed model suggests dedicated functions for internal auditors and external auditors. Internal auditors will focus on the reviewing the state of internal control of Shariah compliance (BNM, 2010) and conducting operational issues, i.e, whether Shariah resolutions are complied with. On the other hand, external auditors will focus the audit of financial statements in the IFIs. They will focus on auditing the financial statements that are prepared according to IFRS standards. However, external certified auditors have to be in the know of the Shariah issues that are unique to Islamic banking operations, when auditing the IFIs. The dedicated functions for internal and external auditor rendered that there will be no additional parties that will be performing Shariah audit inside the organization, not crowding the employees in IFIs to deal with additional inspectors as discussed in Chapra (2014). The scopes of internal Shariah auditors and external Shariah auditors are discussed in the next sub-sections.

5.2.1 Shariah Audit Scopes on Financial Statements by Internal Shariah Auditors
The scope of internal Shariah audit function would focus mainly on few areas such as internal control, risk management, and governance in order to ensure that the organization continuously applies the best practices in ensuring Shariah compliance. This section provides few examples on

Figure 5: Proposed Integrated Model for Shariah Audit in Islamic Financial Institutions
the areas that would be covered by the internal Shariah audit function. The focus of the scope should be on the assurance that the control mechanisms such as policies, procedures and guidelines issued by the regulator are adhered to, by the organization.

For example, pursuant to the decision of the Shariah Advisory Council (SAC) of Bank Negara Malaysia in its 95th meeting held on 28 January 2010, that *ta’widh* (compensation) may be imposed on late payment of financial obligation arising from exchange contracts (such as buy and sell and hire purchase) and *qard* (loan). Nevertheless, *ta’widh* may only be imposed upon the lapse of the repayment period agreed by both contracting parties. The amount of *ta’widh* received may be recognised as income by the seller/financier/creditor on the basis that it is imposed as compensation for actual loss incurred by the seller/financier/creditor. The rate of *ta’widh* shall be determined by the authority, namely Bank Negara Malaysia.

Pursuant to that, the SAC in its 101st meeting held on 20 May 2010 had agreed at the following decisions:

i. *Ibra’* (Rebate) for Financing based on Buy and Sell Contracts:

   In line with the need to safeguard *maslahah* (public interest) and to ensure justice to the financiers and customers, Islamic banking institutions are obliged to grant *ibra’* to customers for early settlement of financing based on buy and sell contracts (such as *bai’ bithaman ajil* or *murabahah*). In order to eliminate uncertainties pertaining to customers’ rights in receiving *ibra’* from Islamic banking institutions, the granting of *ibra’* must be included as a clause in the legal documentation of the financing. The determination of *ibra’* formula will be standardised by Bank Negara Malaysia.

ii. Late Payment Charges Mechanism for Islamic Banking Institutions:

   As a deterrent mechanism against cases of default by customers in discharging their financial obligation arising from Islamic contracts, the imposition of late payment charge by Islamic banking institutions that comprises both concepts of *gharamah* (fine or penalty) and *ta’widh* (compensation) is allowable. *Gharamah* is not allowed to be recognised as income, and it must be channeled to specified charitable bodies. However, Islamic banking institutions may recognize *ta’widh* as income on the basis that it is imposed on the customers as compensation for the actual loss incurred by the Islamic banking institutions. As a measure to protect the customers’ interest, the imposition of late payment charge by Islamic banking institutions should consider the customers’ financial capability. The maximum rate of *gharamah* and *ta’widh* that may be imposed by Islamic banking institutions will be determined by Bank Negara Malaysia.

Based on the above decision of the SAC, it is expected that the internal Shariah audit function should assure that the organization has applied an appropriate measure of control and risk mitigation tools in order to making sure that the recognition of the above are properly recognized and in line with the SAC decision. This is highly important in ensuring that the requirements of Shariah being addressed at all times.

Another example of internal Shariah audit scope is with regards to the disclosure of Zakat. It is required that the IFIs stipulated the policies of zakat computation and the manner it is distributed as agreed by the Shariah Committee in the notes to the account. PricewaterhouseCoopers (2010) and the AOSSG Research Report (2010) similarly asserted that certain aspects of the financial statements will be particularly relevant to users who want to assess the performance and direction of the company from an Islamic perspective. Thus, it would be enhancing users’ decision making by disclosing information that is important to Muslim users or stakeholders. For example, *zakah* (poor due) is not a concept dealt with by accounting standards for conventional firms. Muslim users would however want to have information on *zakah* calculations.

According to Islamic texts, *zakah* ought to be computed based on the current (or fair) value of the assets. Although IFRS either require or permit fair valuation for many types of assets, this information may sometimes not be available. For example, International Accounting Standards (IAS) 2 on Inventories requires inventories to be carried out at the lower of cost or net realisable value. Hence, an entity may or may not disclose the fair value of the inventories, which is an asset subject to *zakah*.
In summary, the scope of internal Shariah audit on financial statements can be shown in Figure 5 below:

![Figure 3: Central Shariah Issues in Financial Statements](image)

Source: Hanefah et al. (2010)

In conclusion, the internal Shariah audit on financial statement which to verify that they are adhered to the requirements of Shariah would definitely involve many Shariah issues. It is essential to have the audit performed on the operation related to financial statements in order for to ensure the transactions in IFIs carried out, recorded and reported in the manner compliant to Shariah. In addition, it is worth to note that the above mentioned issues, although been assured by the internal Shariah audit function, it would still be reviewed by the external Shariah audit function, normally during the planning stage of the external Shariah audit.

5.2.2 Shariah Audit Scopes on Financial Statements by External Shariah Auditors

Meanwhile, the scope for external Shariah audit, as proposed in Figure 3, would mainly focus on the audit of financial statements. The audit of financial statements, from the view of the external Shariah auditor, would focus more into the items in the financial statements and the related International Financial Reporting Standards (IFRS) that will affect the preparation and presentation of the financial statements, inclusive of the notes to the accounts. In this regard, the authors would discuss examples on the two related standards that would affect the preparation and/or presentation of financial statements of IFIs.

For instance, the adoption of IFRS 9 Financial Instruments on Islamic financial transactions. Generally, IFRS 9 deals with the classification and measurement, impairment and hedge accounting of financial instruments. The standard finalized in July 2014 is to be mandatorily to be
adopted on 1 January 2018 with the option of early adoption. IFRS 9 prescribed that financial assets are to be categorized as instruments reported at fair value through profit and loss and assets initially measured at fair value, plus transaction costs and subsequently measured at amortized cost. In the context of Islamic financial institutions (IFIs), Islamic financial assets consist of various types of financing instruments that are designed using various Islamic concepts as well as financial assets that are held to collect cash flows and for sale.

Financial assets usually consist of financing given out to customers. In the Malaysian context, with the IFSA 2013, the asset side can also include equity and partnership financing contracts such as musharakah mutanaqisah, lease-based financing contracts such as ijarah muntahiyah bi al-tamlik, and fee-based activities under wakalah contracts (BNM, 2013).

The recognition of a financial asset under IFRS 9 Financial Instruments would require it to be measured under amortised cost or at fair value.

Paragraph 4.1.2 of IFRS 9 states:

A financial asset shall be measured at amortised cost if both the following conditions are met:

a) The asset is held within a business model whose objective is to hold assets in order to collect contractual cash flows.

b) The contractual terms of the financial asset give rise on specified dates to cash flows that are solely payments of principal and interest on the principal amount outstanding (IFRS Foundation (2012), Paragraph 4.1.2 of IFRS 9).

Paragraph 4.1.4 further states: “A financial asset shall be measured at fair value unless it is measured at amortised cost in accordance with Paragraph 4.1.2.”

In general, financial assets should be measured at fair value unless they are measured at amortised cost in accordance to the above conditions. The method of determining the value of financial instruments depends on the nature of the asset. If the asset depends on the profit generated by the investee, it falls under fair value because the cash flow may not represent ‘solely payments of principal and interest’ (AOSSG, 2010; KFH Research, 2012). On the other hand, if it is arranged on an indicative rate of return based on an actual previous rate of return paid to the investors, it may be possible to be measured at amortised cost because the cash flows may be said to closely resemble ‘payments of principal and interest’ (AOSSG, 2010; KFH Research, 2012). In this regard, the external Shariah auditor should concern more towards the recognition and measurement of such Islamic financial assets related to the organization (IFIs).

Another good example to show the specific function of external Shariah audit is through the IFRS7 Financial Instruments: Disclosures. Financial instruments is defined in IAS 32 Financial Instruments: Presentation, paragraph 11 (IFRS Foundation, 2012) as any contract between parties that results in either a financial asset of an entity or a financial liability or equity instrument of another entity. Similarly construed by Ismail (2010), financial instruments specify the rights and obligations of the contracting party in the financial contracts or ‘aqd. Islamic financial instruments mainly consists of deposits, investment deposits, Islamic unit trust, equity, home and car financing, Islamic accepted bills and equity financing.
With regard to Islamic financial instruments, three issues would raise the attention of the external Shariah auditor; i) Classification and Presentation of Mudarabah Investment Accounts in the Financial Statements, ii) Profit Equalisation Reserves under Mudarabah Investment Accounts and iii) Impairment of financial assets.

For issue i) Mudharabah investment reflects the relationship between the bank and the investment account regardless of whether it is restricted or unrestricted investment account because IFRS treats both similarly for consolidation based on control. On issue ii) Bank Negara Malaysia (2011) in its Guidelines for Profit Equalisation Reserve proposed an accounting treatment where there would be a debit to the statement of comprehensive income, instead of income statement. In this recognition, the bank’s portion is recognised in reserves and the account-holders’ portion is recognised as a sub-classification of customers’ deposits.

On issue iii) the application of expected credit loss might trigger Shariah concern as the bank may have to recognise credit losses (i.e. cash shortfall) over the lifetime of the financing even before it occurred. This would impact the amount of profit to be distributed to the bank and maybe to the respective investment accounts which have been matched to provide such financing in the first place.

6. Conclusion
It is the requirements of an IFI to carry out their activities in accordance with the principles of Shariah. Thus, it is imperative to have well planned and executed Shariah audit function within IFIs. In this regard, it is essential to have a comprehensive, robust and well-functioning Shariah control system to ensure that Shariah is upheld at all times. The integrated internal-external Shariah audit model proposed in this paper could fill in the gap of Shariah audit practice with regards to the audit of financial statements, especially to mitigate Shariah non-compliance risk and possible litigation from depositors, shareholders and investors.
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