

***Shariah* governance for Islamic banking: What can be learnt from Malaysia?**

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Abstract

Islamic financial institutions have unique characteristics that avoid interest-based transaction and operate in accordance with Shariah principles. Therefore, the governance mechanism is also different with conventional institutions. One of important component in the governance structure in Islamic financial institution is the existence Shariah Supervisory Board (SSB). Shariah governance is the governance mechanism in Islamic financial institutions that involves the position of SSB as the guard of shariah compliance process. This paper is mainly discusses the implementation of Shariah governance practices by Islamic banks in Malaysia. Malaysia is one of the countries that seriously develops Islamic banking governance structure and Shariah governance mechanism. Thus, this paper will discuss several issues as follows: Firstly, the nature of Shariah governance and the roles of SSB members. Secondly, the Shariah Governance Framework in Malaysia. Thirdly, the practices of Shariah governance and auditing in Malaysia. Finally, this paper attempts to evaluate the Shariah governance practices by Islamic banks in Malaysia and describes some aspects that can be learnt from Malaysia.

Keywords: Islamic bank, Shariah Governance, auditing.

Abstrak

Lembaga keuangan Islam memiliki karakteristik unik yang menghindari transaksi berbasis bunga dan beroperasi sesuai dengan prinsip Syariah. Karena itu, mekanisme tata kelola juga berbeda dengan lembaga konvensional. Salah satu komponen penting dalam struktur pemerintahan di lembaga keuangan Islam adalah keberadaan Dewan Pengawas Syariah (SSB). Pemerintahan syariah adalah mekanisme tata kelola di lembaga keuangan Islam yang melibatkan posisi SSB sebagai penjaga proses kepatuhan syariah. Makalah ini terutama membahas implementasi praktik-praktik pemerintahan syariah oleh bank-bank Islam di Malaysia. Malaysia adalah salah satu negara yang secara serius mengembangkan struktur tata kelola perbankan Islam dan mekanisme pemerintahan syariah. Dengan demikian, makalah ini akan membahas beberapa masalah sebagai berikut: Pertama, sifat pemerintahan Syariah dan peran anggota SSB. Kedua, Kerangka Tata Kelola Syariah di Malaysia. Ketiga, praktik tata kelola dan audit syariah di Malaysia. Akhirnya, makalah ini mencoba untuk mengevaluasi praktik tata kelola syariah oleh bank-bank Islam di Malaysia dan menjelaskan beberapa aspek yang dapat dipelajari dari Malaysia.

Kata kunci: Bank syariah, Pemerintahan Syariah, audit.

Introduction

The distinctive feature of Islamic banks is that Islamic values govern all their financial transactions (Karim, 1990). Moreover, Karim (1999) said that Islamic banks are established with the mandate to carry out their transactions in strict compliance with Islamic *Shariah* (Islamic law).

It was generally believed that Islamic banking started taking off in the aftermath of the boom in the oil prices in 1973 – 1974. In addition, Karim (1999) noted that in certain countries (ex. Sudan and Iran) the whole banking system had been transformed to comply with *Shariah Islamiyah*. Farook and Lanis (2005) also argued that Islamic banks should ideally operate in accordance with the principles laid down by *Shariah* principles.

On the other hand, Maali et al. (2006) argued that Islamic society was affected by western cultural values, therefore it was difficult to implement a full Islamic system because the domination of capitalist system. Islamic banking accountability was also affected by western cultural values. Thus, its accountability focused on economic goals rather than social perspective because capitalist system only focuses on the wealth of certain group of people.

Accountability is one of the main issues in Islamic banking operation because Islamic banks must make sure that their operations do not go against *Shariah* principles. Thus, *Shariah* auditing is one of the important aspects in the operation of Islamic banks related to the way of Islamic bank's accountability (Daoud, 1996). In addition, Hameed (2008) defined *Shariah* auditing as:

'a systematic process of objectively obtaining and evaluating evidence regarding assertions about socio-economic, religious and environmental actions and events in order to ascertain the degree of correspondence between those assertions and Sharia (Islamic Law), and communicating the results to the users'

Based on above definition, it is clear that *Shariah* auditing has different perspective, comparing to conventional auditing, particularly the concern of enforcement of *Shariah* principles by Islamic institutions.

Therefore, it is interesting to discuss *Shariah* auditing in more detail, among others, the discussion of the current practices of *Shariah* auditing in certain country. Hence, this paper will discuss *Shariah* auditing in Islamic banks in Malaysia. It is fascinating because Malaysia is the most aggressive country in Asia in developing Islamic finance infrastructure particularly Islamic banks (Aziz, 2008). In addition, Wouters (2008) showed that Islamic financial assets in Malaysia are USD 34,543 millions.

The next part will discuss the nature of *Shariah* auditing and the roles of SSB members. *Secondly*, the *Shariah* Governance Framework in Malaysia. *Thirdly*, the practices of *Shariah* auditing in Malaysia. Finally, this paper attempts to evaluate the *Shariah* auditing practices by Islamic banks in Malaysia.

Literature Review and Discussion

The Role of Shariah Governance and Audit: Theoretical-Normative Approach

The Nature of Shariah Auditing

Hameed (2009, p. 434) defined *Shariah* Auditing or Islamic Auditing in the other perspective as:

"systematic process of obtaining sufficient and appropriate evidence to form an opinion as to whether the subject matter (processes, personnel, financial and non-financial performance, financial position, systems, marketing, products, transactions, contracts, etc) corresponds with the criteria (the Shariah rules and principles) which is broadly accepted by the Islamic community and to report to stakeholders thereon".

The second definition defined by Hameed (2009) has showed to us that *Shariah* auditing has very broad scope including the many aspects beyond the financial matter and products of Islamic financial institution. *Shariah* auditing also cover the other aspects related human resources development, marketing communication, and production process. However, Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has issued Governance Standards for Islamic Financial Institutions (GSIFI) No. 2 for conducting *Shariah* reviews to

Shariah Supervisory Board (SSB). In addition, Abdallah (n. d.) explained that there were several different types of SSBs, as well as different level of jurisdiction, namely: (a) *Shariah* consultant; (b) a *Shariah* Supervisory Board; (c) a Department of Fatwa and Research (DFR); (d) a Central Higher *Shariah* Supervisory Board.

GSIFI No. 2 defines *Shariah* Review as “an examination of the extent of IFI’s compliance, in all activities, with *Shariah*”. This examination includes contracts, agreements, policies, products, transactions, memorandum and articles of association, financial statements, reports (especially internal audit and central bank inspection), circulars, etc. The scope of *Shariah* reviews is also wide like what Hameed (2009) said earlier. However, the level understanding of “audit” and “review” is quite different. The sense of “audit” is stronger than “review” because American Accounting Association (AAA) defines “auditing” as the (as cited from Hameed, 2008):

“systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those established criteria, and communicating the results to interested users”

Compare to GSIFI definition of “*Shariah* review”, this definition has better understanding in operation. Though the *Shariah* review has limitation in using terminology, the spirit of *Shariah* review is also concern to the development of better operation of Islamic financial institutions in accordance with *Shariah* principles.

GSIFI No. 2 paragraph 4 stated that the objective of *Shariah* review is “to ensure that the activities carried out by an IFI do not contravene the *Shariah* principles”. Moreover, paragraph 5 stated that the SSB is “responsible for forming and expressing an opinion on extent of an IFI’s compliance with the *Shariah*”. The SSB is also encouraged to assist IFI’s in providing guidance, advice and training relating to compliance with *Shariah* principles. Therefore, the management has ability in operating and producing information relating to the IFI’s compliance with *Shariah*.

The important position of SSB inside organization has encourage the members of SSB to knowledgeable in many aspects such as *Shariah* sources (Al Qur’an and As Sunnah), business practices, financial, legal aspects, marketing, and even accounting. GSIFI No. 1 calls for the composition of SSB in IFI’s that it should be consist of at least three members (para. 7). In addition, the member of SSB should not include directors or significant shareholders of Islamic financial institution. Hence, the position of SSB must be independence in fact and appearance although the position is in organization. Karim (1990) asserted that composition of auditor independence, particularly SSB in IFIs, would enhance the credibility of organization reports both financial and non-financial.

Hameed (2009) explained that GSIFI No. 3 exposed the elements of internal *Shariah* control system as: (i) employees: An IFI shall have a system in place which ensures that only qualified and experienced, and committed employees are recruited and retained. The system shall ensure that employees are continuously trained and developed in related disciplines, especially *fiqh al-muamalat*. Their performance shall be regularly assessed and appropriate action shall be taken. Employees shall be honest and loyal to their IFI. In all cases, prior consent of IFI’s SSB shall be secured before any employee is appointed in internal *Shariah* review (in accordance with the by-laws of the IFI) in order to ascertain the employee’s positive attitude towards compliance with *Shariah* rules and principles; (b) segregation of duties: the internal *Shariah* reviewer shall not undertake any operational activities of IFI; (c) control procedures: an IFI’s management shall establish controls, policies and procedures, to achieve the IFI’s objective of compliance with *Shariah* rules and principles.

The Role of Shariah Supervisory Board

Hameed (2009, p. 438) argued that “a unique corporate governance mechanism of Islamic financial institutions is the SSB which is theoretically an independent external body akin to external auditors”. The qualification of SSB’s member is not easy to achieve because he should be at least a *fiqh* scholar who has sufficient *fiqh* knowledge particularly in *muamalah* area. Moreover, the member encourages learning about Islamic banking and finance, Islamic accounting, Islamic legal system/contract, and other knowledge related to the operation of Islamic financial institutions. To link between the “*Shariah* qualifications” and “professional qualifications” is a hard work. Therefore, SSB members should be working in full time in order to focus on their job. Sometimes, we find that the SSB members are only part time job. Even, they only come to the IFIs when assigning the *Shariah* opinions without scrutinizing the substances and effects of issuing it opinion. This can lead to the low quality of *Shariah* supervising and the credibility of IFIs would be questionable.

GSIFI No.1 paragraph 3 stated “Every IFI shall have a SSB to appointed by the shareholders in their annual general meeting upon the recommendation of the board of directors taking into consideration the local legislation and regulations. Shareholders may authorize the board of directors to fix the remuneration of the SSB”. The statement is very clear in order to regulate the recruitment system of SSB. The IFIs are not alone in deciding the members of SSB. The SSB members are not only approved by internal parties in IFI but also involved the external parties such as government as regulator. For example in Indonesia, Islamic banks are under supervised by Indonesian Central Bank. The IFI proposes several names to be members of SSB to Indonesian Central Bank. Then, Indonesian Central Bank will conduct fit and proper test to the SSB’s candidates so as to know the qualifications of each candidate. Finally, Indonesian Central Bank will decide the qualified candidates in order to be SSB members. Sometimes, there were no candidates passed the test because the candidates were under qualifications. Therefore, Islamic banks must propose the new name in order to fulfill the position of SSBs.

GSIFI No. 2 paragraph 7 underlines the *Shariah* review procedures that should be carried out in the following stages: (a) planning review procedures; (b) executing review procedures and preparation and review of working papers; (c) documenting conclusions and report. *Shariah* review should be well planned in order to cover the scope of review and understand the IFI’s operation. The planning will determine the nature, extent and timing of the *Shariah* review procedures. The execution process of *Shariah* review shall be documented in working paper and completed by several supporting documents related to *Shariah* issues. Finally, SSB shall document their conclusions and prepare their report to the shareholders based on the work done and discussions held. GSIFI No. 1 paragraph 9 stated that the SSB’s report should contain the following basic elements that are as follows: (a) title; (b) addressee; (c) opening or introductory paragraph; (d) scope paragraph describing the nature of the work performed; (e) opinion paragraph containing an expression of opinion on the compliance of the Islamic financial institution with *Shariah* rules and principles; (f) date of report; and (g) signature of the members of SSB.

However, because GSIFI is not compulsory for all IFIs, so that the practices of SSB’s reports are different one another depend on the requirement of local regulations. This make the current practices are not comparable. Moreover, the GSIFI does not specifically regulate the governance structure for IFI particularly in Islamic banking industry (Zurina, et. al., 2014).

***Shariah* Governance Framework for Islamic Financial Institutions**

Due to the weaknesses of the implementation of GSIFI and the structure of corporate governance for IFI, Bank Negara Malaysia (BNM) lauched the *Shariah* Governance Framework

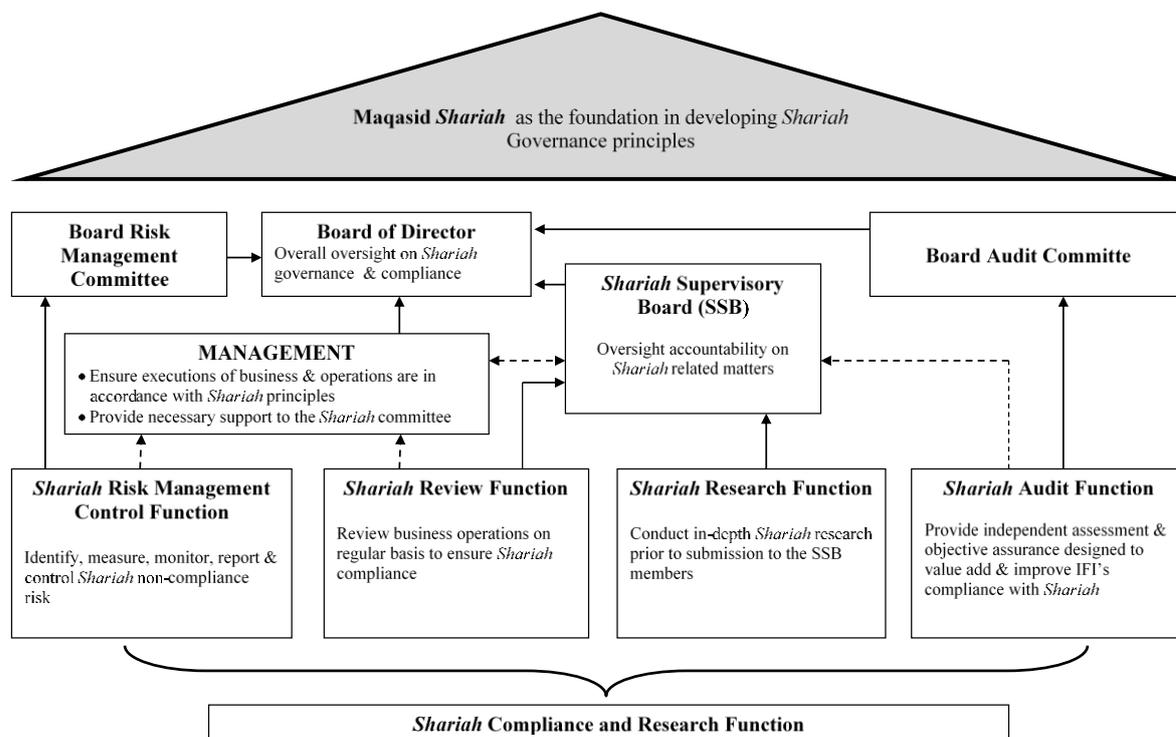
(SGF) and became effective as at 1 January 2011. The guideline has specifically ruled that Islamic banks in Malaysia need to appoint and elect SSB members that consist of competent person on *Shariah* affair which is responsible to liaise with other Board of Directors to ensure the banks is operating under *Shariah* principles. However, Malaysia is still facing lack of competent *Shariah* officer who are both skilled in *Shariah* as well as auditing (Kasim et al., 2009).

There shall be a robust *Shariah* compliance function, comprising review and audit functions, supported by risk management control process and internal research capacity. The IFI shall establish *Shariah* compliance functions to be carried out through the review and audit functions, and supported by the risk management control function and internal research capabilities.

In the event that any part of these functions is outsourced, the oversight, accountability and responsibility over these functions must remain with the IFI. The IFI must also ensure that the independence, competency, control, management reporting structures and activities of these functions meet the requirements of the Framework.

The *Shariah* Governance Framework (SGF) as depicted in figure 1 has taken *Shariah* issue seriously by establishing four (4) function of *Shariah* to be implemented in Islamic finance namely *Shariah* risk management control under the supervision of board risk management committee as well as management, *Shariah* review function governed by *Shariah* committee as well as the management, *Shariah* audit function also under the *Shariah* committee and lastly the *Shariah* audit function, which is the focus of this study to be reporting to the *Shariah* committee as well as the board audit committee. Whilst the *Shariah* research and *Shariah* review function are undertaken by the *Shariah* officers who are *Shariah* undergraduates in the respective IBs, *Shariah* risk function is usually performed together by the finance and *Shariah* officers who are usually undergraduates majoring in finance or *Shariah*, the *Shariah* audit function is currently performed by the internal auditor of the IBs with no specific guidelines on the ideal qualification of a professional to be appointed as the *Shariah* auditor of an Islamic bank.

Figure 1: *Shariah* Governance Framework for IFI



Source: BNM (2011)

Shariah Review

The *Shariah* review function refers to regular assessment on *Shariah* compliance in the activities and operations of the IFI by qualified *Shariah* officer(s), with the objective of ensuring that the activities and operations carried out by the IFI do not contravene with the *Shariah*. A qualified *Shariah* officer is an officer who holds at least a bachelor's degree in *Shariah*, which includes study in Usul Fiqh (the origin of Islamic law) and Fiqh Muamalat (Islamic transaction/commercial law).

The function involves the examination and evaluation of the IFI's level of compliance to the *Shariah*, remedial rectification measures to resolve non-compliances and control mechanism to avoid recurrences. The scope shall cover the IFI's overall business operations, including the end-to-end product development process, which start from product structuring to product offering.

The review process shall cover, but is not limited to, the following: (i) planning the review program which includes the objectives, scope, reporting, rectification and follow-up actions followed by the execution of the program; (ii) documentation of the processes involved in the review; (iii) communicating the outcome of the review and highlighting any non-compliances to the *Shariah* Committee and the management; and (iv) rectifying any instances of non-compliance with the *Shariah* to prevent such events from recurring.

Shariah Audit

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 shall 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. For group structure, the capabilities of the group's internal *Shariah* audit function should be augmented in line with its responsibilities of serving several financial entities in the group.

Shariah audit may be conducted as part of the IFI's thematic audit on specialised areas such as management audit and Anti-Money Laundering (AML) audit, according to the risk level and materiality of the impact of *Shariah* non-compliance in these areas. *Shariah* audit on critical areas shall be conducted at least once a year depending on the risk profile of the IFI.

The Board Audit Committee, upon consultation with the *Shariah* Committee shall determine the deliverables of the *Shariah* audit function. The deliverables shall be consistent with accepted auditing standards.

The scope of *Shariah* audit shall cover all aspects of the IFI's business operations and activities, including: (i) audit of financial statements of the IFI; In the event where the audit is undertaken by external auditors, IFI has to be satisfied that the scope of audit by the external auditor with regard to *Shariah* audit is comprehensive; (ii) compliance audit on organisational structure, people, process and information technology application systems; and (iii) review of adequacy of the *Shariah* governance process.

The process of *Shariah* audit shall be designed to enable the IFI to assess whether a sound and effective internal control system for *Shariah* compliance have been implemented, which should cover, but is not limited to, the following: (i) understanding the business activities of the IFI to allow for better scoping of an audit exercise, i.e. auditability and relevance of activities; (ii) developing a comprehensive internal audit program or plan. The program shall include

objectives, scope, personnel assignment, sampling, control and duration as well as establish proper audit processes, policies and procedures of IFI's operations; (iii) obtaining and making reference to relevant sources, including the 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 a periodical basis; (v) communicating results of any assessment or findings arising from the *Shariah* audit to the Board Audit Committee and the *Shariah* Committee; and (vi) providing recommendations on rectification measures taken as well as following-up on the implementation by the IFI.

The Bank may appoint or employ an external party or person to conduct a *Shariah* audit on the operations of the IFI, if the Bank considers it is desirable or in the interest of the IFI to do so, in which case the remuneration and expenses relating to the appointment shall be borne by the IFI.

Shariah Risk Management

Shariah risk management is a function to systematically identify, measure, monitor and control of *Shariah* non-compliance risks to mitigate any possible of non-compliance events. The systematic approach of managing *Shariah* non-compliance risks will enable the IFI to continue its operations and activities effectively without exposing the IFI to unacceptable levels of risk. The *Shariah* risk management control function shall form as part of the IFI's integrated risk management framework.

Due to the technicality and complexity in managing the risk of non-compliance to the *Shariah*, the function shall be performed by risk officers that have suitable qualifications and/or experience in the subject matter. *Shariah* risk management function involves: *Firstly*, Facilitating the process of identifying, measuring, controlling and monitoring *Shariah* non-compliance risks inherent in the IFI's operations and activities;

Identifying and understanding the inherent *Shariah* non-compliance risks in the IFI, taking into account existing controls that have been put in place and their effectiveness in mitigating such risks; The IFI shall take into account reputational risk as one of the possible risk implication of non-compliance with the *Shariah* principles, which includes failure to provide transparency and full disclosure. Furthermore, non-compliance to sound corporate governance and prudent management of risk-based information will also trigger reputational risk to the IFI

Measuring the potential impact of such risks to the IFI, based on the historical and actual de-recognition of income derived from *Shariah* non-compliant activities. Monitoring of *Shariah* non-compliance risks to facilitate efficient and effective management of such risks. A report on the *Shariah* non-compliance risks indicators shall be escalated to the board, *Shariah* Committee and management periodically. Controls to avoid recurrences. This involves keeping track of income not recognized arising from *Shariah* non-compliant activities and assessing the probability of similar cases arising in the future. Based on historical reviews and potential areas of *Shariah* non-compliance, the IFI may assess potential profits that cannot be recognized as eligible.

Secondly, formulating and recommending appropriate *Shariah* non-compliance risk management policies and guidelines; and *Thirdly*, developing and implementing processes for *Shariah* non-compliance risk awareness in the IFI.

Shariah Research

Apart from institutionalizing a robust *Shariah* compliance function, there shall be an internal unit comprising qualified *Shariah* officers to conduct pre-product approval process, research, vetting of issues for submission, and undertake administrative and secretarial matters relating to the *Shariah* Committee.

The IFI shall take into account reputational risk as one of the possible risk implication of non-compliance with the *Shariah* principles, which includes failure to provide transparency and full disclosure. Furthermore, non-compliance to sound corporate governance and prudent management of risk-based information will also trigger reputational risk to the IFI. Thus, *Shariah* research and secretariat functions shall ensure proper deliberation and dissemination of *Shariah* related matters.

This *Shariah* research function refers to the conduct of performing in-depth research and studies on *Shariah* issues, including providing day-to-day *Shariah* advice and consultancy to relevant parties, including those involved in the product development process.

The function shall be performed by qualified *Shariah* officers and the scope of work shall predominantly cover aspects of the *Shariah*. However, the function also requires experts on legal, operational, and other related aspects or issues to form part of the presentation to the *Shariah* Committee, for example a thorough research may be needed to review new products and business developments.

In undertaking such research, advice and input from experts on technical matters e.g. actuaries, accountants may be sought to ensure comprehensiveness and completeness in ensuring sound understanding of the relevant concepts and approaches.

In terms of advisory and consultancy roles, the function shall assist and provide advice to the relevant parties based on the decision of the *Shariah* Committee. For example, advice may be offered on the list of permissible investments, e.g. selection of permissible shares or stocks in the Bursa Malaysia stock market.

In addition to the *Shariah* Governance Framework for IFI, it better to consider the idea to have an effective for monitoring and evaluating the *Shariah* compliance (see figure 2.) that is proposed by Grais and Pellegrini (2006).

In the other side, the external audit process involves standard setter, *Shariah* audit firm, and rating agency for *Shariah* compliance. Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) actually has play a role as standard setter as the have issued *Shariah* standards and also Auditing standards for IFI. *Shariah* audit firm is relatively new idea that come up in order fullfil the gap from the side of external *Shariah* audit process. The role of *Shariah* audit firm actually is almost the same position with public accountants although they have different orientations. *Shariah* audit firm focuses on the *Shariah* compliance for IFI from external perspective. Rosly (n.d.) proposed four approaches for evaluating and auditing the IFI operations as follows: '*Aqad*, *Maqasid al-Shariah*, Financial reporting, and legal documentation. '*Aqad* is the legal contract for underlying the transactions between management of IFI and their clients. It should be evaluated before the '*Aqad* and also after the '*Aqad* signed by both parties. The *Shariah* audit firm has also review the financial reporting and the legal documentations in order to make sure that the '*Aqad* has been done in accordance with *Shariah* principles and also the agreement of both parties based on the '*Aqad* signed. Finally, the rating agency for *Shariah* compliance is important to monitor the activities of IFI and also determine the level of *Shariah* compliance of IFI based on specific criterias. Thus, the society will get information regarding the level of *Shariah* compliance of each IFI. It is also media for the competition among IFIs in attracting clients or customers as they can provide better products and services in accordance with *Shariah* principles.

The Current Development of *Shariah* Governance in Malaysia

Regulation by the Authorities

To date, the regulation of *Shariah* auditing is mild, only to cover the Islamic financial sector. The framework is governed by Bank Negara Malaysia (BNM), the Central Bank of Malaysia. Many

discussions relate to the *Shariah* Supervisory Board (SSB), which is in conventional term, it is called the audit committee. To our best knowledge, there is none of the literature talking about the use of external *Shariah* auditors in Islamic financial sector. Our belief is that there is still no external auditor having adequate knowledge in *Shariah* in existence in Malaysia.

BNM has circulated the Guidelines on the Governance of *Shariah* committee for the Islamic Financial Institutions to regulate the SSB of an Islamic financial institution (IFI). Its objectives are as follows:

- a) to set up rules on the establishment of an SSB;
- b) to define the roles and responsibilities of an SSB; and
- c) to describe the relationships between an SSB and the *Shariah* Advisory Council of BNM.

The obligation to set up an SSB for a financial institution is only for those mentioned in the guidelines. They are as follows:

- a) an Islamic bank licensed under the Islamic Banking Act 1983 (IBA);
- b) a financial institution licensed under the Banking and Financial Institutions Act 1989 (BAFIA) which participates in the Islamic Banking Scheme (BAFIA IBS bank);
- c) a development financial institution prescribed under the Development Financial Institutions Act 2002 (DFIA) which carries on Islamic Banking Scheme; and
- d) a takaful operator registered under the Takaful Act 1984 (TA)

Current Practices by the Islamic Banks

The practice of auditing in Malaysia is still very much conventional. *Firstly*, the regulators do not require *Shariah*-listed companies to be externally audited according to *Shariah*. In the Securities Commission of Malaysia (SC)'s list of *Shariah*-compliant companies, it does not mention that those companies must be audited by *Shariah* auditors. For those companies to stay enlisted, their operations must be *Shariah*-compliant to certain threshold amounts.

Secondly, as mentioned before, auditors are still being conventionally trained. This could be because there is still lack of demand for *Shariah* auditing, as there is no regulation. Even in the BNM's guidelines, the SSB must contain members with *Shariah* knowledge, but do not highlight that it must contain auditors. The only auditing mechanism that we can see to be *Shariah*-compliant is SSB, which will be the discussion of this paper.

Besar et al. (2009) mentioned that the function of SSB is to provide advisory opinions to the Board of Directors (BoD) of an IFI as to the operations, ensuring them to be in line with *Shariah*. The SSB is not obliged to give a detailed report on the operations and disclose it in the annual report, but the SSB should provide the *Shariah* Review Report, as suggested by the Accounting, Auditing and Governance Standards for Islamic Financial Institutions issued by AAOIFI, the pioneer in formulating accounting standards for IFIs.

Given that it is not mandatory for the *Shariah* Review Report to be prepared by the IFIs and the fact that there is no standard format issued by Bank Negara Malaysia on the report to be included in the annual report, currently, all the IFIs in Malaysia with the exception of Bank Islam Malaysia Berhad (BIMB) and Bank Muamalat Malaysia Berhad (BMMB) do not provide *Shariah* Review Report in their annual reports. Hence, the annual reports of the IFIs only contain the conventional audit report prepared by the Big Four audit firms and so forth.

The paper by Besar et al. (2009) also gives a very interesting case where BIMB and BMMB have made a significant progress in order to have their own SSB. BIMB has its own Internal *Shariah* Audit Section which is formed under the Internal Audit Department. This section is assigned to undertake internal *Shariah* audit or review of the bank transactions and operations. The findings from the *Shariah* review are reported to the *Shariah* Supervisory Council, the SSB of BIMB through the *Shariah* Compliance Department and the *Shariah* Department.

On the other hand, the *Shariah* Committee, the SSB in BMMB was established in accordance with the requirements of Islamic Banking Act 1983 and the Bank's Article of Association. The purpose of the establishment of this committee is to ensure that the bank conducts its affairs in accordance with the *Shariah* principles. All the bank's business activities are subject to the scrutiny of the committee to ensure *Shariah* compliance. This committee gives their report directly to the BOD of the Bank. From the interview with manager of Internal Audit Department of the bank, it is found that before coming out with the *Shariah* Committee report, the committee will review the principles and the contracts relating to the bank's transactions and operation provided by *Shariah* Review report.

In Bank Muamalat, the *Shariah* review is assigned to the *Shariah* Section of The Risk Management Department. The *Shariah* review entails in the examination and review of *Shariah* concepts and Islamic structures based on specific guideline for respective bank's products. According to the authors, the Bank did not follow any *Shariah* review standards issued by AAOIFI. However, the bank's Internal Audit Department assists the *Shariah* Section in undertaking any *Shariah* issues during regular audit.

From the review of the authors above, we analyze that those having the *Shariah* knowledge are the members of SSB, not the internal and external auditors. Although reviewing the bank's operations to ensure them abiding by the *Shariah* is part of *Shariah* auditing, it is not yet comprehensive. The auditors, internal and external, should also possess *Shariah* knowledge as well in order to apply it to the audit procedures conducted.

Other analyses that we can derive are, *first*, the role of SSB is limited to endorsing the compliance of Bank's operations, and *second*, the *Shariah* review is needed for the Islamic financial sector. With respect to the *Shariah* report currently provided by the respective banks' SSB, it lacks the depth of providing such assurance. It is merely an endorsement of the bank's *Shariah* compliance in general without any emphasize on the actual operational or conduct of the respective banks. The AAOIFI standard had emphasized that the *Shariah* committee "is entrusted with the duty of directing, reviewing and supervising the activities of the Islamic financial institution in order to ensure that they are in compliance with Islamic *Shariah* rules and principles". This suggests a greater duty of not only endorsing and approving the Bank's products but also ensuring its compliance through directing, supervising and importantly reviewing its operations.

On the other hand, The Islamic Banking Act 1983 had stated that "*the establishment of a Shariah advisory body is to advise the bank on the operations of its banking business in order to ensure that they do not involve any element which is not approved by the Religion of Islam*". Thus, the function of the SSB is more on an advisory role on the bank's operation. In order to effectively execute the advisory role, the *Shariah* committee still needs to have *Shariah* review as an indicator of the bank compliance with *Shariah* before giving out an advice. In addition to the above, the roles of the SSB as outlined in the BNM's guidelines are generally more on the *Shariah* compliance of the bank products apart from giving consultation and advise on any *Shariah* issues faced by the Bank. The minimum content of the *Shariah* report provided by BNM's guidelines had included that the operation of the bank is in compliance with *Shariah*. Though it is a general statement, this indicates that there must be sufficient *Shariah* review being conducted before the SSB can form an opinion that the operation is in compliance with *Shariah* principles.

Future Directions of Shariah Governance and Auditing

The Ought-to-be Nature of Work

There are three main areas of *Shariah* auditing, which should be spelt out in the Article of Association (AOA) of an Islamic company (Karim, 1990; Abdul-Rahman, 1998). They are:

- Provision of advice (*ex-ante* auditing)
- Monitoring performance (*ex-post* auditing), and;
- The audit of Islamic tax (*zakat*).

Ex-ante auditing, represented by the SSB, should advise the BoD in relation to the company's operations, contracts, and procedures. The SSB must ensure that these activities must conform to the principles laid down by the *Shariah*.

In the meantime, *ex-post* auditing is work done by the SSB to ensure that the advice given earlier is followed by the management. The purpose of the audit is to inform the shareholders that the company is run 'Islamically'.

Zakat, which is an obligatory payment by the Muslims who are capable, should be monitored by the SSB. This is important because the *Shariah*-compliant companies should pay *zakat* on behalf of their shareholders, as there is no separation between business and religion in Islam (Karim, 1990). The audit of *zakat* is to guarantee that its amount, derived from the company's net assets, will be properly calculated and administered. The results of the *zakat* audit should be reported in the annual report (Abdul-Rahman, 1998).

So far, based on the article by Besar *et al.* (2009), only Bank Muamalat and Bank Islam have their own SSB in Malaysia. From that, they mentioned that the two SSB have performed a full *ex-ante* auditing, to ensure the Banks' operations are *Shariah*-compliant. This is evidenced in the *Shariah* report provided by their respective annual reports.

As to the *ex-post* auditing and the audit of *zakat*, it was not mentioned explicitly. This is due to the fact that, perhaps, these two audits were done by the external auditors of these two banks. The problem will arise in *ex-post* auditing, where it should be based on the population, not samples (Abdallah, n. d.; Karim, 1990). The current practice of conventional auditing is that evidence is gathered based on the sampling of population, not population itself. Meanwhile, religious (*Shariah*) auditing, according to most *Fiqh* scholars, should be based on the whole population. The result is very much consistent with another study of *ex-ante* auditing conducted in the Islamic banks in Sudan (Abdallah, n. d.).

Continuous Professional Education of Religious Auditors

Another future concern of *Shariah* auditing is education. Besar *et al.* (2009) have mentioned in his paper that the problem of the SSB is the separation of work between it and external auditors. The external auditors will conduct the financial audit based on the standard conventional auditing procedures, which could be insufficient in *Shariah* auditing.

An example, let say, the SSB has issued the report that the Islamic bank it represents is fully *Shariah*-compliant. The external auditors, in doing the financial audit, might not foresee that the income statement contains elements, which are in contradiction to *Shariah*. This is because the external auditors know less or nothing about *Shariah*.

One probable solution is to educate the external auditors on *Shariah*. This might be difficult, given the fact that *Shariah* is complicated, but their chance of finding any misstatements will be greater if they are taught on *Shariah*. The education process for external auditors should be consistent in order to maintain and increase their knowledge about possible *Shariah* violations by Islamic financial institutions.

The radical solution might be proposed by Hameed (2008) that a *Shariah* auditor should be a new profession. His idea was based on Mulyani (2007) survey of accounting academics, audit practitioners and *Shariah* scholars in Malaysia. She found that most of the respondents agreed to propose a new discipline as called as a *Shariah* auditor. Therefore, a new education system should be built in order to produce *Shariah* auditors that have several qualifications including *fiqh muamalat*, accounting and auditing, business law, and human resources development. This idea

seems realistic because today Islamic business will face a huge challenge particularly the relation between Islamic business and conventional business. Islamic companies difficult to insulate their entity from conventional culture that brings “capitalist and secular worldview”. Therefore, *Shariah* auditing is the solution in guiding and protecting Islamic business to always follow *Shariah* rules and principles.

Conclusions and Recommendations

Based on the discussion above, there are several conclusions as follows: *Firstly*, the concept of *Shariah* auditing goes forward in following the development of Islamic business. The need for *Shariah* auditing was started from the first establishment of Islamic financial institutions because the founders realized that Islamic financial institutions have a unique characteristic particularly in accordance with *Shariah* principles in all business transactions. Moreover, academics and Muslim scholars have been trying to formulate the better mechanism in order to ensure that *Shariah* auditing would achieve the goal of *Shariah* (*maqasid Shariah*), so that would also create *falah* (the success in the world and the hereafter).

Secondly, the development of *Shariah* auditing in Malaysia was still far from the expectation. The problem is not only from the Islamic banks, but more important, the lack of the commitment of regulator in producing regulations that could encourage the management of Islamic banks in doing *Shariah* auditing properly. However, some Islamic banks initiatively developed their Internal *Shariah* division in order to conduct *Shariah* auditing for better improvement of *Shariah* audit quality.

Thirdly, Islamic banks will face challenging situations in the future because they must involve in free market business that dominated by secular worldview. Some Islamic banks will adapt the conventional system and some others will protect their self from the vague transactions. Therefore, *Shariah* auditors will give opinion, recommendations and guidance for them so as to direct for always following *Shariah* borders.

This paper will also give several recommendations as follows: *Firstly*, the idea of having a new discipline especially *Shariah* auditing should be appreciated by producing academic’s paper that discusses the idea of *Shariah* auditing in more detail in order to give comprehensive understanding the nature and role of *Shariah* auditing. This is not only the obligation of academics but also regulators, practitioners, and Islamic business associations.

Secondly, the short-term solution of having better *Shariah* auditing is *fiqh muamalat* education for external auditors and accounting and auditing knowledge for *Shariah* scholars that in charge as SSB’s. The exchange education process will help to improve the quality of *Shariah* auditing in Islamic financial institutions particularly and Islamic business commonly.

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