

# Shari'ah Audit: A Comparative Perspective

**Prof. Dr. Abdul Rahim Abdul Rahman**

International Islamic University Malaysia (IIUM)

& Research Fellow of ISRA

E-mail: [abdulrahim@iiu.edu.my](mailto:abdulrahim@iiu.edu.my)

# What is Shari'ah audit?

## Broad definition

- The accumulation and evaluation of sufficient and reliable **evidence** to determine and report on the degree of correspondence between information and **established Shari'ah criteria** and reporting the opinion thereon to the appropriate authority.
- Shari'ah auditors perform audits on both **objective** information (financial information/standard e.g. profit distribution) and **subjective** information (Shari'ah opinion/fatwa/standard) to ensure Shari'ah compliance.

## General scope

- Shari'ah audit of the **financial operations** of the IFIs that involved Shari'ah matters (e.g. profit distribution policy).
- Shari'ah audit of the **operational aspects and policies** of the IFIs (e.g. penalty charge for late payment).
- Shari'ah audit of the **products compliance** according to the established Shari'ah criteria recognised by the IFIs and the regulatory authorities.

## Effective Implementation

- Shari'ah auditors need to understand the business of the IFIs including the nature of contracts used for different types of Islamic financial services.
- This auditing process can be undertaken **internally** by the internal auditors with the help of Shari'ah officers.
- **Externally**, it can be undertaken by a qualified audit firm, Bank Negara Malaysia (BNM), or/and other independent institutions.

# Why do IFIs need Shari'ah Audit?

## Context

The Shari'ah Committee evaluates and approves Islamic financial products, prepare draft of Shari'ah opinions and prepare contracts in collaboration with legal advisor of the bank etc.

So far Shari'ah Committee members are not carrying out thorough and comprehensive internal Shari'ah audit on the operations of IFIs due to their restricted scope of work.

As required by the Companies Act, IFIs are subjected to financial audit conducted by external auditors which are normally carried out by professional accounting firms.

## Gap

Shari'ah Committee of the IFIs normally expressed their opinions on the Shari'ah compliance of the products and services offered (ex-ante compliance).

However, a comprehensive and well-guided audit of the Shari'ah legal contracts, documentations and operations so far has not been properly conducted (ex-post compliance).

**Without Shari'ah audit function, there is a functional gap of Shari'ah compliance in the Islamic financial system.**

# Shari'ah Audit Requirements

## Scope

- To ensure transactions, operations policies and activities comply to Shari'ah principles.

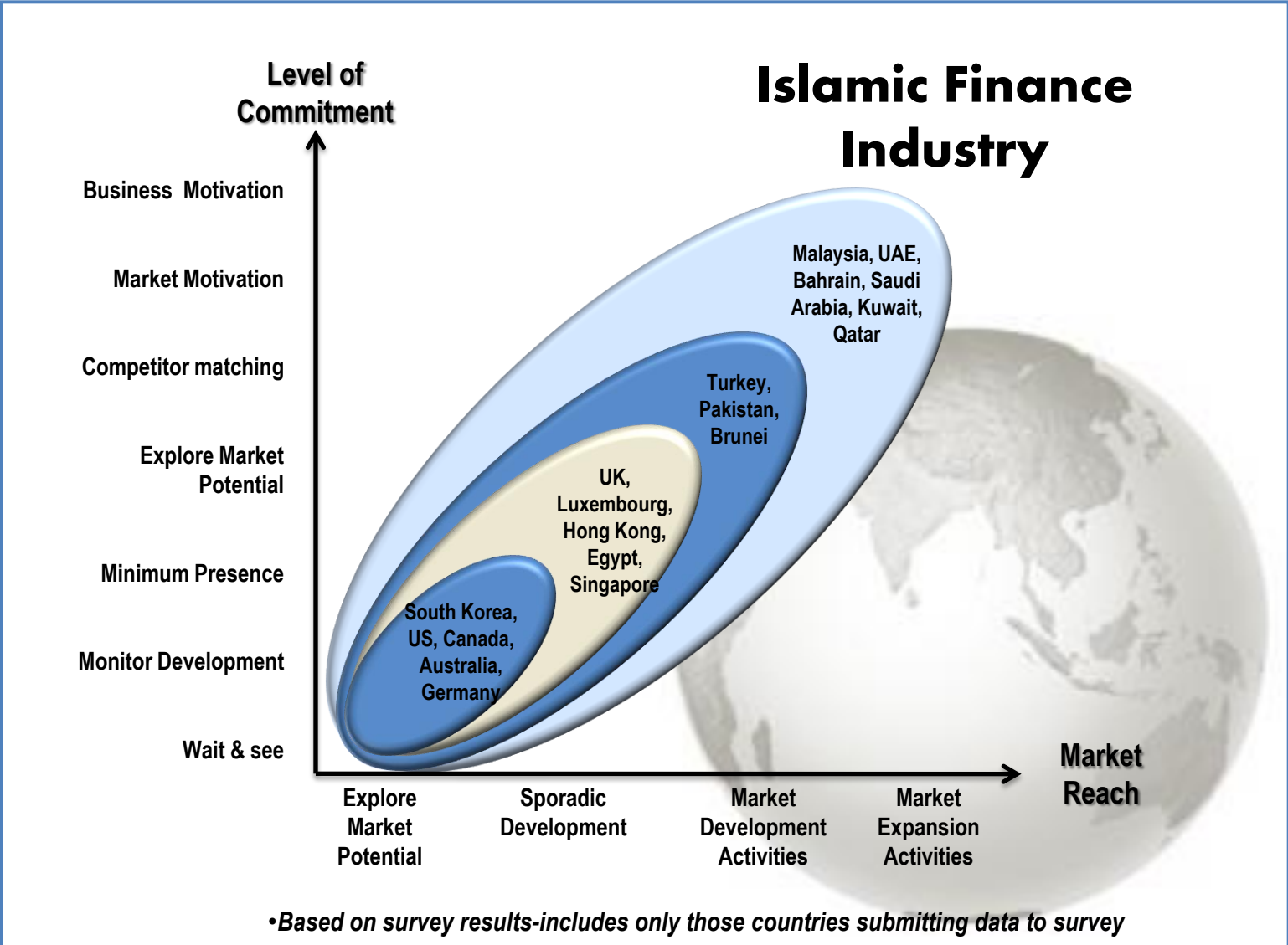
## Audit programs

- Shari'ah audit program is a manual-based document that clearly spells out step-by-step and list of Shari'ah audit procedures and policies.
- An audit program is designed to audit a particular area. Common to have several audit programs for various departments, operations & products offered.
- Internal auditors, Shari'ah department & Shari'ah Committee must work closely to develop the audit programs

## Shari'ah established criteria

- Written opinions issued by the Shari'ah Committee
- Shari'ah opinions of the National Shari'ah Advisory Council or/and parameters/standards e.g. as issued by BNM
- Product manuals specifying the flow of processes, legal documentations, accounting standards, Standard operating procedures (SOPs) etc.

# Global Comparative Analysis on Commitment & Market of Islamic Finance Industry



# Approaches to Shari'ah Governance

## Centralised or State Control

**Countries such as Malaysia, Indonesia, Iran, Indonesia & Sudan**

Government or its agencies regulates Shari'ah compliance.

Shariah Advisory Council established at the National level.

Centralised appointment of Shari'ah Committee.

Issue guidelines on Shari'ah governance and audit.

## Laissez Faire or Free Market

**Most of GCC countries e.g. Saudi Arabia, Kuwait, Qatar etc. & new entrants to Islamic finance e.g. UK, Turkey, Singapore etc.**

Self regulated.

Shari'ah compliance is a reputational issue.

No National level of Shari'ah Advisory Council.

Decentralised appointment of Shari'ah Committee.

Minimum guidelines on Shari'ah compliance.

## Mixed or Hybrid

**Countries such as Pakistan & UAE**

Self regulated but reporting to the central regulatory authority.

Central regulatory authority issued guidelines on Shari'ah compliance.

IFIs are free to appoint members of Shari'ah Committee & at least 1.

In UAE, they have the National Shari'ah Advisory Council.

# Approaches to Shari'ah Audit

## Centralised or State Control

Government or its agencies regulates Shari'ah audit practices.

Ensure stakeholders are protected by rules & regulations.

Regulation on Shari'ah audit such as initiated by Malaysia & Indonesia will push IFIs to ensure compliance.

Certification for Shari'ah auditors may be initiated by the regulatory agency or/and the Islamic finance industry.

## Laissez Faire or Free Market

Shari'ah audit is a reputational issue and optional.

No guidelines expected on Shari'ah audit.

Stakeholders will have to demand & pressure for stricter Shari'ah compliance.

No demand for certification for Shari'ah auditors.

Mostly, ad-hoc Shari'ah audit on case per case basis.

## Mixed or Hybrid

Shari'ah audit will be self-initiated but reporting to the central regulatory authority.

Central regulatory authority issued guidelines on Shari'ah audit such as in Pakistan.

Industry is expected to initiate private sector Shari'ah audit such as in UAE.

Certification for Shari'ah auditors most likely will be initiated by the industry.

# Determinants of Shari'ah Audit

## Centralised or State Control

The role of regulatory authority is critical to ensure effective Shariah audit.

The extent of practices will depend on how effective is the supervision & Shari'ah appetite of the regulatory authority.

The effectiveness of Shari'ah audit guidelines & framework issued the regulatory authority will determine the quality of Shariah audit.

## Laissez Faire or Free Market

The role of IFIs is critical to ensure effective Shari'ah audit.

The extent of practices will depend on the Shari'ah appetite of the IFIs.

The effectiveness of the internal Shari'ah risk management & internal control systems will determine the quality of Shari'ah audit.

## Mixed or Hybrid

The role of the Islamic finance industry will be critical to ensure effective Shari'ah audit.

The extent of Shari'ah audit practices will depend on the maturity & commitment of the Islamic finance industry towards Shari'ah compliance.

The involvement of the external professional bodies & private firms will determine the Shari'ah audit quality.



# Implications of Shari'ah Audit on IFIs

Shari'ah audit, in theory, should enhance the shareholders' value and confidence of the stakeholders of the IFIs

If stakeholders (i.e. customers, depositors etc.) are suspicious of Shari'ah compliance, it will seriously affect the integrity of Islamic finance

Shari'ah non-compliance risk is a major challenge for both the IFIs and the regulators.

Adequate internal systems and controls are required to ensure compliance with the Shari'ah i.e. the rulings and fatwa of the SSC are implemented throughout the financial institution.

Shari'ah risk management system and internal control should supplement the external and internal Shari'ah audit requirements.

# Requirements for Shari'ah Audit

## Shari'ah Auditors

- Fundamental knowledge on **Shari'ah & Fiqh Muamalat**
- Good understanding of **Islamic financial products**
- Knowledge and skills in **auditing**

## Shari'ah Audit

- **Resources:** Who are qualified to conduct Shari'ah audit?
- **Approach:** What is our approach to audit (product based; operation based; branch based; etc.)?
- **Procedures:** How many procedures to test for each product; or for each operation?
- **Evidence:** How much evidences needed to be satisfied?
- **Time and Cost:** How much time available and cost to be incurred?