

SHARIAH GOVERNANCE FRAMEWORK: THE ROLES OF SHARIAH REVIEW AND SHARIAH AUDITING

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ABSTRACT

The growth of the Islamic finance industry around the world is due to the unique features of Islamic Financial institutions(IFIs) that emphasize on the fairness and justice in their operations. Al Quran and As-sunnah be the main rules to be followed. The IFIs are responsible to ensure they comply with the Shariah principles in its products, instruments, operations, practices, management, etc. As for that reason, Shariah governance is another component that is peculiar exclusively to IFIs. Hence this conceptual paper attempts to highlight the roles of Shariah Review and Shariah Auditing and thus discuss on the issues and challenges related to Shariah review and Shariah Audit in Islamic Financial Institution(IFIs).

Key Words: *Shariah Governance, Shariah Review , Shariah Auditing*

1. INTRODUCTION

The growth of the Islamic finance industry had led to the development of Islamic finance products and its governance. Increasing demand on Islamic Financial Institutions(IFIs) enforce IFIs to be regulated through a set of standards. In the early operation of the Islamic finance in the market, there is no formal entity or special body to supervise the IFIs on the Shariah matters or resolve the Shariah issues. However started in 1976, the first Shariah Supervisory Board (SSB) in IFIs has been set up by Faisal Islamic Banks of Egypt and followed by Jordan Islamic Bank and Faisal Islamic bank of Sudan in 1978. In Mei 1997, Bank Negara Malaysia established the Shariah Advisory Council (SAC) on Islamic Banking and Takaful. The SAC is the highest body for Islamic banks, Takaful companies, Islamic financial business, Islamic development financial business, or any other IFIs which is based on Shariah and supervised by Bank Negara Malaysia(Hasan, 2010) and require all the IFIs to fully implement in year 2011.

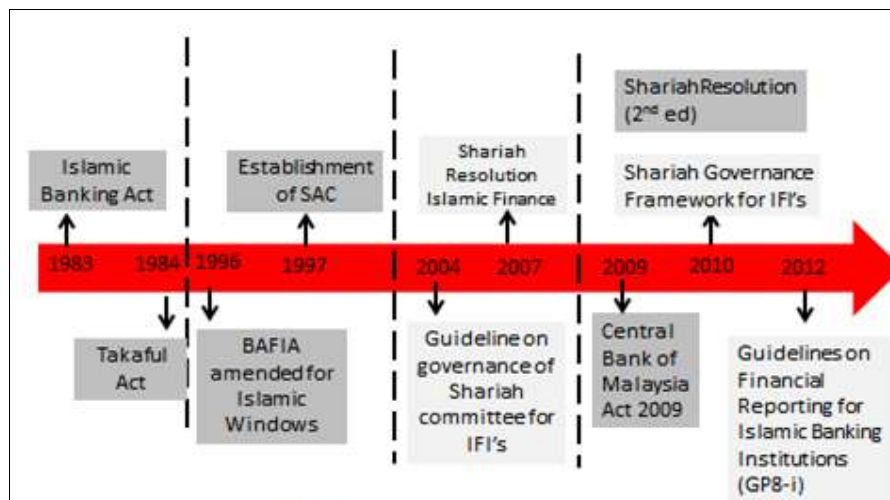
In year 2010, Shariah Governance Framework(SGF) has been introduced to set out the rules, regulations and procedures in the establishment of a Shariah committee, the role, and scope of duties of the committee as well as the relationship between the institutional the institutional Shariah committee and the SAC of the central bank (Grassa, 2013). The purpose of the establishment of the guideline is to ensure the effective functioning of the Islamic financial system and promoting its integrity. It can only be

sustained if there is a good corporate governance practice by IFIs that comply with the Shariah guidance. As defined by IFSB -10 shariah governance is a set of institutional and organisational arrangements through which IFIs ensure that there is effective independent oversight of shariah compliance over the issuance of the relevant shariah pronouncements, dissemination and information and an internal shariah compliance review. Therefore Shariah Advisory Board was established to oversee and supervise the shariah compliance and being an authority body on ensuring shariah compliance. The establishment of SAC is statutory requirements for all IFIs. A comprehensive shariah governance system depends on the following:

- i. management and supervision
- ii. Shariah Advisory Board
- iii. Shariah compliance and review
- iv. transparency and disclosure

Harmonise Shariah governance rules like their counterpart in corporate governance rules are needed to assure a high level playing field to improve transparency and enhance trust hence safeguard the interest of investors and other stakeholders in IFIs. Ineffective or weak governance has always been the cause of financial failures in financial markets. History of failures can be explained by the failure of few IFIs such as Ihlas Finance in Turkey, Islamic Bank of South Africa and Islamic Investment Companies of Egypt, the commercial losses of Dubai Islamic Bank. An effective function of the Shariah governance system able to mitigate the non compliance risk and uphold the reputation of IFIs in the market. Figure 1 shows the milestone of shariah governance in Malaysia started from the establishment of first Islamic Banking Act 1983 until the year 2012.

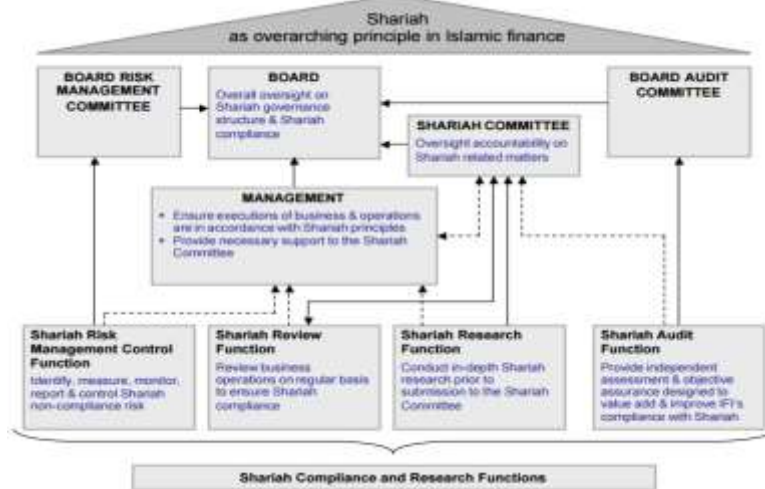
Figure 1: The Shariah Governance Milestone



Started with the establishment of the first Islamic bank in Malaysia Bank Islam Malaysia Berhad, Islamic Banking Act was set up in the same year to supervise the operation of IFIs. Furthermore, in 1997 Shariah Advisory Council has been proposed as the highest authority to ascertain Islamic law for the purpose of Islamic banking business, Takaful business, Islamic finance business or any activities or business which is based on Shariah principle. This reflects the uniqueness of IFIs compared to conventional banks. In year 2010, SGF has been introduced and implemented in year 2011 by IFIs.

The framework shows that a sound and robust Shariah governance framework is reflected by effective and responsible board and management, an independent Shariah Committee that is both competent and accountable, supported by a strong internal Shariah research capacity, and monitored through active Shariah review, Shariah audit and Shariah Risk Management Department. Figure 2 exposed to the current Malaysia's Shariah Governance Framework for IFIs.

Figure 2: The Malaysia's Shariah Governance Framework



An effective practice of good governance requires all those involved to carry out their responsibilities in the best manner possible with the infrastructure support in the form of procedures, processes and oversight mechanisms. For an IFIs, the oversight mechanism is usually done by their Shariah department and in Malaysia this is further strengthened by the Central Bank's requirement that all IFIs are required to have a Shariah Committee. To date, 27 SAC members had been appointed starting from 1999 until the year 2016.

2. LITERATURE REVIEW ON SHARIAH GOVERNANCE

Shariah governance is a governance system that ensures all activities and business transactions by IFIs are free from non-allowable elements such as *riba*, *gharar*, *maisir* and other similar attributes. According to IFSB, Standards 10 (2009) "*Shariah governance system refers to the set of institutional and organizational arrangements through which an IIFs ensures that there is effective independent oversight of Shariah compliance*". Mizushima, (2013) studies on the relationship between shariah governance and corporate governance. Finding disclose that western capitalism purposely to realize social justice and welfare, but neither of which has been its main purpose. On the contrary, the main focus in Shariah governance is on Shariah compliance, and its function at financial institutions looks passive. For that reason it is important and responsibility of an IFI to establish a sound and robust Shariah governance with emphasis on the roles of key functionalities in ensuring effective implementation of the Shariah governance framework. Shariah committee or Shariah Board play a vital function to safeguard the IFIs to comply with the Shariah ruling and fulfill the philosophy of IFIs in the operation, business and procedure to adhere with Shariah requirement.

Haji Besar, Abd Sukor, Abdul Muthalib, & Gunawa(2009) discuss the roles and responsibilities of Shariah Supervisory Board(SSB) in two selected bank which are Bank Islam Malaysia Berhad and Bank

Muamalat Malaysia berhad. Kasim, Ibrahim, & Sulaiman(2009) examine the expectations and the actual practice of shariah audit function in Islamic financial institutions (IFIs) in Malaysia and disclose some issue in shariah auditing interm of framework, the scope, the qualification and the issue of independence. All the four pertinent issues of discussion show that what is actually desired does not coincide with the actual practice. This indicates that the practice of Shariah auditing has not seriously taken an impact in IFIs in Malaysia despite it being a crucial monitoring tool for shariah compliance. Furthermore, Hasan (2014) conducted semi-structured interviews with fourteen Shariah scholars from different IFIs in three selected countries Dubai, United Kindom and Malaysia. The study shows that there are exist gaps and shortcomings in the existing Shariah governance practices of IFIs, particularly the aspects of the general approach to Shariah governance, the internal Shariah governance framework, the attributes of the Shariah board in terms of mechanisms of competence, independence and transparency and confidentiality, operational procedures and Shariah board's assessment. The respondents affirms that regulatory frameworks affect and influence the degree of disclosure and transparency of Shariah governance practice in IFIs. Other research carried out by Lahsasna & Saba(2014) and Bash, (2015) highlight on the issues and challenges in Shariah Governance. Bash (2015) interviewed seventeen Chairman of the Shariah Committee of Islamic Banks in Malaysia to explore the challenges of Shariah committees in Islamic Banks in dispensing their responsibilities and in the process mitigating the non-compliance risks.

3. SHARIAH REVIEW AND SHARIAH AUDIT FUNCTIONS

The introduction of Shariah review and Shariah auditing is mainly due to ensure the business and operation of IFIs fulfill the requirement of shariah. As described in the Accounting and Auditing Organisation for Islamic Financial Institution(AAOIFI) GSIFI No 2: Shariah review plays a significant role to ensure all the activities adhere to shariah rules and regulations as reflected in fatwa, rullings and guideline issued by he Shariah Supervisory Board(SSB). The effective Shariah review will consulate and collaborate with the advisors such ass external auditor and shall report concurrently to the Shariah Committee and Management. Hence the review procedure will be documented in proper working papers as a guidance to the Management of IFIs for the further action. As suggested by AAOIFI Shariah review Report will be prepared by the Shariah officer or Shariah committee to the shareholders and will be read at the IFIs annual general meting and will reported in the annual report. Zulkarnain et al., (2015) interviewed 16 Shariah Committee on the roles and duties of shariah review. The study disclose that Shariah review officer obligate to examine the flow of operation and investigates on non-compliance incidence. Shariah review officer will visit all branches and division and perform relevant examinations and in case the Shariah review function found any non-compliance incidence, they will provide feedback and require the respective branch or department to rectify the non-compliance. It is more towards an internal consultative nature as compared to audit findings, which are more towards reprimanding or penalizing the non-compliance.

Despite the vital function of Shariah review, Shariah Audit had been highlighted in the Shariah Governance Framework on it vital function. Shariah refers to the periodical assessment from time to time, provide independent assessment and improve the degree of compliance in IFIs. Despite, AAOIFI elaborate on the primary objective of shariah audit is *“to ensure that the management of an IFI discharge their responsibilities in relation to the implementation of the Shariah rules and principles as determined by the IFI's Shariah Supervisory Board (SSB)*. Unlike financial auditor, Shariah Auditor carries huge obligation whereby they perform audits on both objectives which is on financial information and shariah information (Rohman, 2008). The following Table 1 summaries the functions of Shariah Review and Shariah Audit in IFIs.

Table 1: The summary of Shariah Review and Shariah Audit Function

	Shariah Review	Shariah Audit
Objective	To ensure the activities and operation do not contravene with the Shariah	To provide independent assessment and objective assurance to make sure an effective and sound internal control system
Scope	Overall business operation, including end to end product development process	All aspects of IFIs business operation and activities including auditing of financial statements, compliance audit on organizational structure, people, & It application system and review of adequacy of the Shariah governance process
Process	i.Planning the review program including SOP, reporting, rectification and follow up action by the execution of the program ii. Documentation of the process involved iii. communicating the outcome & highlighting any noncompliance to the Shariah committee and the management iv. Rectifying any mistakes of Shariah non compliance.	i. Develop comprehensive audit program ii. Understanding the business activities of IFI iii. Obtaining and making reference to his relevant sources iv. communicating result or findings to the Board Audit Committee and the Shariah Committee v. provide recommendation or rectification measure taken as well as following up on the implementation by the IFIs

4. ISSUES AND CHALLENGES

From the previous literature some issues and challenges relates to Shariah Review and Shariah Audit had been highlighted by the analyst.

i. The Shariah Review report is not mandatory

As mention in the BNM guideline 2004, the opinion of the shariah committee pertaining the Shariah matters only required to report to the Board of directors (BODs) of the IFIs and the final decision on any operation or product will be decided by the BODs. Until now, there is no standard format report issued by the Bank Negara Malaysia to be included in the annual report and shariah review report is not mandatory to be prepared by the IFIs (Haji Besar et al., 2009).

ii. Reliance on Internal Audit of IFIs

Although the Shariah board is expected to supervise the ex post Shariah governance processes, such as the Shariah review, it is observed that Shariah scholars rely heavily on the internal audit department of

IFIs. This practice indicates that the ex post processes of Shariah compliance are greatly determined by the internal audit function of IFIs and not the Shariah board itself.

The analysis findings indicate that there are gaps and shortcomings in the existing Shariah governance practices of IFIs, particularly the aspects of the general approach to Shariah governance, the internal Shariah governance framework, the attributes of the Shariah board in terms of mechanisms of competence, independence and transparency and confidentiality, operational procedures and Shari'ah board's assessment. Different Shariah scholars have dissimilar views on particular issues, and they have also admitted that there are serious gaps and weaknesses in all these six major areas of Shariah governance. The regulatory frameworks affect and influence the degree of disclosure and transparency of Shariah governance practice in IFIs (Hasan, 2014).

iii. Independence of Shariah Auditors

The most important issue in Shariah audit is that the independence of Shariah auditors or Shariah committee. Independence is a fundamental concept in audit, be it conventional or Islamic. But members of Shariah Supervisory Board, who are involved in audit as is then practiced by some IFI, are paid by the same institution whose audit they conduct. In other words, they also audit their own work which raises the issue of independence as well as conflict of interest (Lahsasna, Ibrahim, & Datuk Syed Othman, 2011). In addition, although the Shariah board is expected to supervise the ex post Shariah governance processes, such as the Shariah review, it is observed that Shariah scholars rely heavily on the internal audit department of IFIs. This practice indicates that the ex post processes of Shariah compliance are greatly determined by the internal audit function of IFIs and not the Shariah board itself (Muneeza & Hassan, 2014). The Shariah committees can only express opinions, or expert testimony but do not have the legal authority to force the management to follow-through with the opinion (Bash, 2015).

iv. Shortage of Shariah expertise

The fourth issues relate to the competency of the Shariah committee members. Shariah members should ideally be knowledgeable in both Islamic law and the banking and accounting field. This is due to the unique and important responsibility play by the shariah members. Farooq, (2013) examines the issues on the shortage of shariah expertise and outline the qualification framework for the requirement of shariah expertise. As mentioned in SGF 2010, all the Islamic financial institutions require to provide the shariah officer in their institution. Furthermore, Hameed (2008) raises the issue of the competence of SSB members when it comes to the performance of conducting Shariah audit. He argues that although the members of SSB are well qualified in the task of issuing fatwas about the permissibility or otherwise of any financial product, they cannot stand as qualified auditors because they do not have the necessary qualification and training. The scarcity of professionals with combined shariah knowledge and financial skills also affects the process of internal Shariah review. Due to the lack of expertise and limited numbers of qualified practitioners, repeat name of shariah scholar in many Shariah Board doesn't only happen in Malaysia but in GCC countries. This will decrease level of confidence in the eyes of the customer on the Islamic financial system although the same shariah scholars provide greater efficiency and vast experience in shariah governance (Grassa, 2013).

v. Shariah Committee report

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 connotes a greater duty of not only endorsing and approving the Bank’s products but ensuring its compliance through directing, supervising and importantly reviewing its operations.(Haji Besar et al., 2009), However study by Bash, (2015) mention that the Shariah committees can only express opinions, or expert testimony but do not have the legal authority to force the management to follow-through with the opinion.

vi. Competency of Shariah committee

Hameed (2008) raises the issue of the competence of SSB members when it comes to the performance of conducting Shariah audit. The author argues that although the members of SSB are well qualified in the task of issuing fatwas about the permissibility or otherwise of any financial product, they unable to stand as qualified auditors because lack of necessary qualification and training. In addition, it is observed that periodically scheduled meetings may not be sufficient to resolve some urgent issues faced by the bank. Therefore, the authors suggest that the Shariah Committee must conduct a comprehensive audit for a period of one year and statement of Shariah opinion must be included in the annual report. Rapid development of the products leads to difficulties to fit the new banking products into the Shariah context since most of the members of the Shariah Committee have the technical background of Islamic law. Some case such as issues with the conflict of laws or *iktilaf*, fact that shariah opinions solely based on Shafiie scholars cannot be accepted globally. Hence, it is a challenge to the Malaysian practitioners considering opinions (*Fatws*) that are more globally acceptable.

5. CONCLUSION

One of the unique features of Islamic Financial Institutions as compared to conventional system is IFIs has their own rules that derived from Al Quran and As Sunnah. The initiative of Malaysia government to set up Shariah Governance Framework in the year 2010 provide better improvement to the IFIs to comply with the shariah rules. The function of Shariah Review and Shariah Audit is clearly mentioned in SGF as an authority body to play as supervisory body that ensures the business, activities and products fulfill Shariah principles. Despite some issues and challenge arises, SGF brings positive improvement to the IFIs.

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