

EFFECTIVENESS OF SHARI'AH AUDITOR IN MALAYSIAN TAKAFUL INDUSTRY: A PROPOSED FRAMEWORK

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ABSTARCT

Research on internal shari'ah compliance effectiveness is an important path that will improve the existing conditions of internal shari'ah compliance function particularly shari'ah audit and shari'ah review in Takaful industry. Besides, it will contribute in reducing shari'ah non-compliance risk that probably would be face by this Islamic institution. Therefore, the aim for this paper is to examine the determinants of internal shari'ah compliance effectiveness in Malaysian Takaful industry. This paper is conceptual paper and it is the ongoing phD thesis of the researcher.

Keywords: *shari'ah compliance, Takaful*

1. Introduction

1.1 Background of the study

Corporate governance can be defines as the process and structures used to direct and manage the business and affairs of the company towards enhancing business prosperity and corporate accountability with the ultimate objective of realizing long term shareholder value, whilst taking into account the interest of other stakeholders (Sulaiman & Juriah,2012). Basically corporate governance was setting up in order to solve the agency problem. As for Islamic financial institutions including Takaful Operator, there is special additional layer governance required for shari'ah compliance. This basic foundation leads to the need of setting up the institutional arrangements to watch over shari'ah compliance aspect of their business and operations (Dusuki, 2011). Basically, the shari'ah governance system was presented to complement the existing corporate governance framework for Islamic financial Institutions. Thus, shari'ah governance system can be regard as something that very unique and meet the characteristics of the Islamic financial institutions which could distinguish from the conventional system.

The shari'ah governance framework which was introduced in 2010 was circulated to all Islamic banks and Takaful institutions in Malaysia and shall take effect starting 1st January. It is the responsibility for Islamic Financial Institutions to adapt the framework and improve their shari'ah governance structure (R. Hassan et. all, 2012). As stated in the guideline, the objectives of Shari'ah Governance Framework are to establish a robust shari'ah governance structures of Islamic Financial Institutions, to provide a comprehensive guidance to the board, Shari'ah committee and management of the Islamic Financial Institutions in discharging its duties in matters relating to shari'ah and to outline the functions relating to shari'ah review, shari'ah audit, shari'ah risk management and shar'ah research. In the development of Islamic finance sector in Malaysia, it is very essence to have very good and vibrant shari'ah governance (Zulkifli, 2009). Islamic financial institutions have the duty to ensure the compliance with Shari'ah principles in all aspects of their products, instruments, operations,

practices and management which will be achieved by the establishment of a proper Shari'ah governance framework (Surianom & Amrullah, 2013). The good shari'ah governance can ensure the Islamic financial growth. In addition, the Shariah governance system would help Islamic financial institutions to mitigate Shariah non-compliance risk that may incur unimaginable potential of loss and at the same time effect the credibility of the institutions (Dr. Mahmood Ahmed, 2013). Islam stresses the practice of justice and equity, truthfulness and transparency, and protection of minorities, accountability and adequate disclosure, just as it prohibits all forms of exploitation, in all walks of life including business dealings (Abbas et al., 2013). All these principals have become tools to measure the level of shari'ah governance practice.

Recently, Bank Negara Malaysia has announced the new act for Islamic financial Institution known as Islamic financial services Act (2013) replacing the Islamic banking Act 1983 and the Takaful Act 1984. The new Act provides a comprehensive legal framework that is in full compliance with Shari'ah in all aspects of regulation and supervision, from licensing to the winding up of the Islamic financial institutions. This validate that the issue of shari'ah governance has getting greater attention and become very significant (Surianom, 2013). People may realize the fact that the Takaful industry gives important synergy to the growth of Islamic finance in Malaysia (BNM, 2013). Takaful Operator, particularly through the general Takaful services has contribute a lot by managing some risk in financing transaction especially in Islamic bank and indirectly strengthen the resilience in Islamic financial system. This leads to the expanding of Takaful industry market. Many studies have done to find the determinants on choosing Takaful product and the results shows that the major determinant was the shari'ah compliance characteristics. Due to that, shari'ah governance framework is really needed in ensuring that the Takaful Operator has really complied with shari'ah. In measuring the IFI's compliance to the shari'ah, SGF requires internal shari'ah review and shari'ah audit (Zurina,S. et all, 2013). Thus, this research will focus on the role of shari'ah audit to see the effectiveness and then to determine the factor that lead to the success of shari'ah audit function particularly in Takaful industry.

2. Problem statement

The regulatory and supervision in Malaysia entering the new phase of its development as the Financial services Act 2013 (FSA 2013) and Islamic Financial Services Act 2013 (IFSA 2013) come into force on June 2013. The enactment of these two acts will probably putting the governing and supervising framework in Malaysia to the higher level which gives the positive impact to the governance area. These efforts also will ensure to maintain the financial stability, support inclusive growth in the financial system as well as in the economy and providing adequacy protection to the customers (BNM, 2013). Among the key features of new act contains of greater clarity and transparency, a clear focus on shari'ah compliance and governance in the Islamic financial sector including Takaful industry and strengthening business conduct and customers protection (IFSA, 2013). The new IFSA gives significant impact on Takaful and Retakaful Operators in Malaysia (Borneo News, 2013). These will lead to the substantial changes in the industry and definitely will set the new benchmark for the Takaful industry as a whole (Omar, 2013). In addition, the enforcement of the new laws is expected to strengthen and grow the Takaful Business.

However there are several issues that have been raised up regarding shari'ah governance framework. Among the issues is in term of the establishment and formalization of shari'ah governance framework. The preparation and updating the framework are solely performed by

shari'ah department with little or no input from other department and it is like more skewed towards shari'ah as the real objective of having shari'ah governance framework is for Islamic Financial Institutions to have a comprehensive policies and procedures in place as well as a point of reference to guide all staff related to shari'ah matters (Ismail & Razak, 2014). Another issue is related to the competency of the shari'ah compliance unit (Zurina et al, 2013). They need to have the right personnel supervising and managing shari'ah department that will lead to an effective support to shari'ah committee in arriving to a sound shari'ah decision presented to them (Ismail & Razak, 2014). Based on the current situation and issues arises, it give the idea to the researcher to explore the role of internal shari'ah compliance unit and the current practice as well as to examine the determinants of the effectiveness internal shari'ah compliance function. Sufficient adoption of the internal shari'ah compliance function is expected to promote stakeholders' confidence and the integrity of Islamic Financial Institutions besides reducing shari'ah non-compliance risk (Rusni et al.2011). Amalina (2013) agreed that the failure to comply with shariah for Islamic institutions definitely will expose the institutions to reputational risk. If Takaful Operator have consistencies in implementing good shari'ah governance, it will definitely increase the reputation and trust towards Takaful operators. Takaful industry in Malaysia also aims at increasing their market share and could replace the conventional insurance market.

3. Aims and objectives of the study

The three main objectives of this study are:

1. To explore the role of internal shari'ah compliance in managing the non-shari'ah compliance risk in Takaful industry.
2. To see the current practices and process of shari'ah auditing and reviewing in Takaful industry.
3. To identify the factor of effectiveness of internal shari'ah compliance function in Takaful industry.

4. Contribution of the study

In order to guarantee implementation of best practice for effective corporate governance, an essential requirement for Takaful Operator is the establishment of a shari'ah governance mechanism that ensures the operations are shari'ah compliant. Among the important elements is the role of internal shari'ah compliance function which includes of shari'ah reviewer and shari'ah auditor.

This study also will be advantageous in assuring the stakeholders especially the participants with the respect on how Takaful Operator is governed, which could influence the way resources entrusted to them are managed. It is hoped that it will provide contribution to improve the shari'ah governance practice and help in reducing shari'ah non-compliance risk especially from Malaysian Takaful Operator perspective for strengthening their relationship with customers. Thus, it can enhance the trust of customer and increase the credibility of Takaful Operators so that Takaful industry share market can compete with conventional insurance share market. It is, therefore, expected that this study will not only have implications towards Malaysian industry, but will also useful to other countries.

5. Literature review

5.1 Historical Development of Takaful In Malaysia

The development of the Takaful industry in Malaysia in the early 1980s was inspired by the prevailing needs of the Muslim public for a Shari'ah-compliant alternative to conventional

insurance, as well as to complement the operation of the Islamic bank that was established in 1983 (Bank Negara Malaysia, 2005). It was first setup in 1984 as the compliment services of Bank Islam. From a single Takaful operator in 1984, the Central Bank of Malaysia has further awarded Takaful licenses to conventional financial Institutions, thus by 2006, there were the total of 8 Takaful providers until 2008 (Yon, Zaleha, Shahida, 2009). The sudden increase in the number of Takaful is in line with the nation's aspiration to be the centre of Islamic Finance as well as to attract new players of strong capacity in product development (Jaffer, 2006). A Special Task Force was established by the Government in 1982 to study the viability of the setting up of an Islamic insurance company. Following the recommendations of the Task Force, the Takaful Act was enacted in 1984 and the first Takaful operator was incorporated in Malaysia in November 1984 (Bank Negara, 2005). Currently, there were twelve Takaful Operators in Malaysia as listed below:

1	AIA AFG Takaful Bhd.
2	AIA PUBLIC Takaful Bhd
3	AmFamily Takaful Berhad
4	Etiqa Takaful Berhad
5	Great Eastern Takaful Sdn Bhd
6	HSBC Amanah Takaful (Malaysia) Sdn Bhd
7	Hong Leong MSIG Takaful Berhad
8	MAA Takaful Berhad
9	Prudential BSN Takaful Berhad
10	Sun Life Malaysia Takaful Berhad (formerly known as CIMB Aviva Takaful Berhad)
11	Syarikat Takaful Malaysia Berhad
12	Takaful Ikhlas Sdn. Bhd.

5.2 Significance of sharia'h compliance

The word shari'ah literally means "a waterway that leads to a main stream, a drinking place, and a road or the right path." From this meaning, the word shari'ah was used to refer to a path or a passage that leads to an intended place, or to a certain goal. (Mohsin, 2007). Thus, based on the definition, it can be understood that conceptually, shari'ah refers to a set of rules, regulations, teachings, and values governing the lives of Muslims. shari'ah embraces worship, morals, individual attitude and conduct, as well as the political, social, economic, criminal, and civil spheres.

By having shari'ah, it will help in removing all the hardships form people and providing them with solutions. The main objectives of shari'ah are to protect our religion, our faith, our life, our property and our lineage. In modern business environment, the challenge for Islamic scholars is to interpret Islamic principles in a manner that meets the modern day requirements but at the same time does not jeopardise the protection and promotion of the Islamic identity.

The distinguishing feature of Takaful is that it is a commercial venture which should be undertaken in accordance with shari'ah principles. Thus, for Takaful business to become a viable and the preferred alternative in the present competitive business environment, its implementation must comply with shari'ah rules (Aziah, 2012). Usually, the disclosure of shari'ah compliance in the annual report will reflect the level of shari'ah compliance by the Takaful companies.

5.3 Shari'ah governance

Shari'ah governance is the salient feature in the management of Islamic Financial Institutions (IFI's) including Islamic bank and Takaful Operator (Shahida, 2012). Shari'ah governance also is a vital mechanism for the smooth and effective running of the Islamic corporate, especially the Islamic financial institutions. Munneza & Hassan (2010) opined that Shari'ah governance has the same objective with corporate governance which defining on how corporation should be directed, administrated or controlled. is a vital mechanism for the smooth and effective. However, the main different comes in term of the perspective and the modus operandi. Shari'ah governance takes into consideration the basic tenets of Islam or the objectives of shari'ah in addition to fulfill the interest of the directors and stakeholders. Islamic Financial Services Board (IFSB) defines shari'ah governance as:

“The set of institutional and organizational arrangements through which an IIFS (Institutions offering Islamic Financial Services) ensures that there is effective independent oversight of Shari`ah compliance over each of the following structures and processes:

- a. Issuance of relevant Shari`ah pronouncements/ resolutions.
- b. Dissemination of information on such Shari`ah pronouncements/resolutions.
- c. An internal Shari`ah compliance review/audit for verifying that Shari`ah compliance has been satisfied.
- d. An annual Shari`ah compliance review/audit for verifying the internal Shari`ah compliance review/audit.”

Based on the above definition, it can be conclude that good corporate governance must have several elements such as fairness, transparency, accountability, responsibility, morality, commitment and independent (Saputro, 2010). Basically, shari'ah governance focuses on the roles and responsibility of the shari'ah board members to ensure that the whole activities of IFIs are in line with Islamic principles (Sheila, 2013). In addition, the purpose of shari'ah governance framework is to ensure that all IFIs operations and business activities are in accordance with Islamic principles, to provide a comprehensive guidance to the shari'ah board members, shari'ah committee and management of the IFIs in discharging its duties in matters relating to shari'ah and to highlight the functions relating to shari'ah review, shari'ah audit, shari'ah risk management and shariah research.

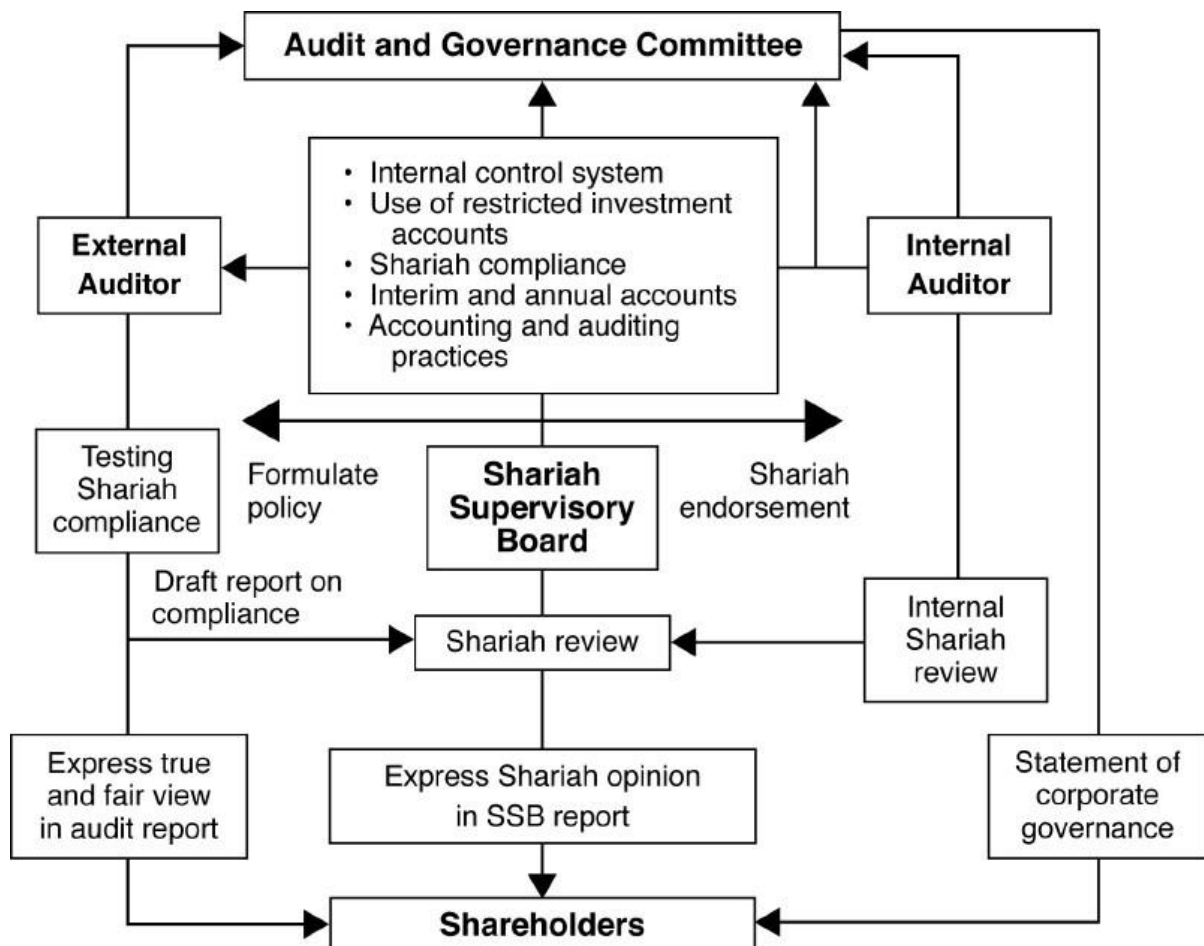


Figure 1: key player in auditing IFI

5.4 Effectiveness of internal shari'ah compliance function

As indicated above, none of the study has been done related to internal shari'ah compliance function effectiveness. In this study internal shari'ah compliance function is focusing on the role of shari'ah auditor and shari'ah reviewer. The processes of shari'ah audit and shari'ah review are complimentary in nature (Ismail & Razak, 2014). Currently, the shari'ah audit and shari'ah review process is just done internally, so the literature review related to the internal auditor effectiveness can be adapted. Badara & Zabeda (2013) in their research highlighted a few definition of the effectiveness term. Most of the researcher agrees that a program can be seen as effective if its outcome goes along with its objectives (Ahmad et al. 2009, Ussahawannitchakit & Intakhan, 2011). It means that internal audit effectiveness can be define as the degree to which established objectives are achieved (Badara & Zabeda, 2013). Among the recent research that have been done related to internal audit effectiveness are by Ahmad, Othman, & Jusoff, 2009; Arena & Azzone, 2009; Bota & Palfi, 2009; Arena & Azzone, 2010; Cohen & Sayag, 2010; Mihret, James & Joseph, 2010; Theofanis, Drogalas &

Giovanis, 2011; Unegbu & Kida 2011; Feizizadeh, 2012; Badara & Saidin, 2012; Badara & Saidin, 2013; Endaya & Hanefah, 2013).

5.5 Training and development

Ismail and Razak(2014) highlighted several issues regarding the competency of performing shari'ah review and shari'ah audit in Islamic financial Institutions. They opined that the qualified shari'ah auditor is the one that have accounting background and also must have knowledge in shari'ah. This is because as shari'ah auditors, they are required to verify the Islamic Financial Institutions key functions and business operation on an annual basis and to provide assurance whether it is in compliance with shari'ah (BNM, 2010). The effectiveness of internal audit depends substantially on the quality, training and experience in staff (Zurina et al, 2013). It shows that training and development is very important in order to have audit competence. As stated by the Institute Internal Auditors in the International Standards for the Professional Practices Framework of Internal auditing, the internal audit unit should be appropriately staffed in terms of numbers, grades, qualifications and experience, having regard to its responsibilities and objectives. The internal auditor should be properly trained to fulfill all his responsibilities.

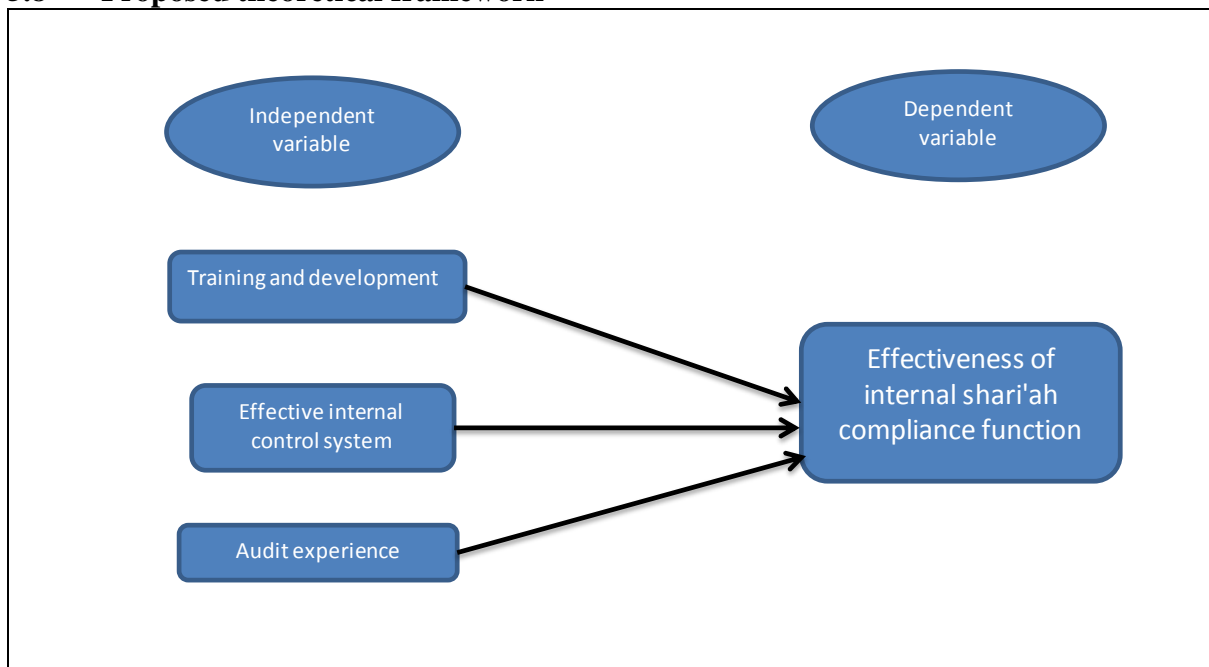
5.6 Effective internal control system

Jokiipi (2010) provided that internal control system serves as a process that guides an organization towards achieving its established objectives. Internal control also can be defined as the systems, process and procedures that organization establishes in order to ensure that its established objectives are met (Badara & Zabedah, 2013). Therefore, to ensure the organization is having good governance, they must improve their internal control system (Eko& Heriyanto, 2011). Few studies have been conducted on internal control systems. Among of them are Akkins (2011), Eko& Heriyanto (2011) and Nilniyom & Chantinok (2011). However, all these studies did not explore on the relationship between internal control system and internal audit effectiveness. Despite of that, there are studies that recommended more research should be done on the effective internal control system.

5.7 Audit experience

Intakhan & Ussahawanchkit (2010) defines audit experience as different kind of knowledge and skills which the auditors obtain as a result length of tenure of the job practice in the auditing professions. Auditors are required to utilize their experience toward achieving effectiveness. Audit experience is very important due to the fact that auditors that have well experience enable the provision of good quality audit findings (Badara & Zabedah, 2013). Several research conclude that audit experience can give impact on the internal audit issues. (Al-Twajjry, Brierley & Gwilliam, 2003; Bonner, 1990; Chung & Monroe, 2000; Chi, Myers, Omer & Xie, 2010; Intakhan & Ussahawanitchakit, 2010; Modlin, 2012; Ussahawanitchakit, 2012; Wang et al, 2012; Wright & Wright, 1997).

5.8 Proposed theoretical framework



Proposition:

P1 There is positive relationship between training and development with the effectiveness of internal shari'ah compliance function.

P2 There is positive relationship between effective internal control systems with the effectiveness of internal shari'ah compliance function.

P3 There is positive relationship between audit experiences with the effectiveness of internal shari'ah compliance function

6. Limitation of the study

The findings of this study are not without limitations. First limitation is in term of the number of sample size. This study was done for Malaysian perspective only. In order for having a more rigorous analysis with more conclusive findings, the study can be done in other Islamic countries such as Indonesia, Brunei and other GCC countries. In addition, the study was done in Takaful industry only. Thus, it provides opportunity for future research and perhaps the study on implications of shari'ah governance can be done by looking into other perspectives such as the performance of Takaful Operator. The moderating variables used also could be tested into another different viewpoint such as the role of Shari'ah committee or shari'ah supervisory board.

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