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-Read and spread the knowledge of Islamic Finance-

SHARIAH AUDIT: FRAMEWORK & METHODOLOGY



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EDITOR-IN-CHIEF KEYNOTE

Assalamualaikum WBT

Alhamdulillah...

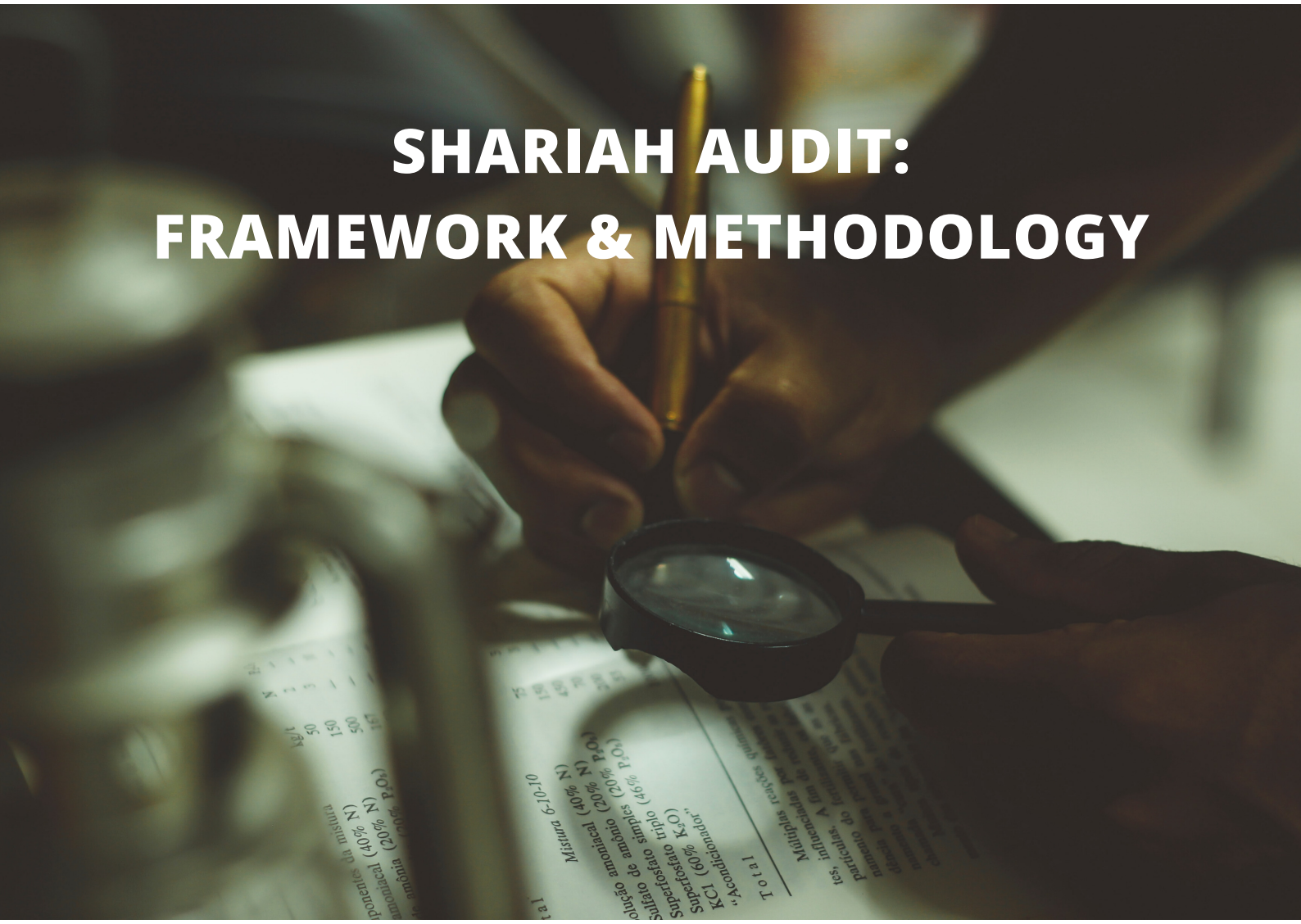
I am very delighted to present the second volume of SALIHIN Islamic Finance Bulletin, IQRA, which means read, the first verse revealed in Quran. IQRA bulletin series is an initiative by SALIHIN Research and Publication team.

IQRA is produced with the objective to disseminate knowledge of Islamic finance and to spread it among the stakeholders of Islamic finance communities. This bulletin will feature specific subject matters for every issues to benefit the readers, inshaAllah.

I hope IQRA bulletin will contribute a valuable insight, particularly in this issue, which focused on Shariah audit, a key pillar of the Shariah governance in providing assurance to stakeholders on the conformity of Islamic business operations to the Shariah principles.

Thank you.

"Let's Nurture the World of Islamic Finance"



SHARIAH AUDIT: FRAMEWORK & METHODOLOGY

INTRODUCTION

This bulletin attempts to deliberate some related aspects and issues pertaining to the Shariah audit which is the key element of Shariah governance in providing assurance on compliance to the Shariah requirements.

DEFINITION

According to the American Accounting Association, "**Auditing** is a systematic process by which a competent, independent person objectively obtains and evaluates evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to the interested users."

Bank Negara Malaysia (BNM), new Policy Document on Shariah Governance which take effect on 1 April 2020, defined **Shariah audit** as "A function that provides an independent assessment on the quality and effectiveness of the IFI's internal control, risk management systems, governance processes as well as the overall compliance of the IFI's operations, businesses, affairs and activities related to Shariah."

AAOIFI's Governance Standard for IFIs No. 3 elaborated the **objective of Shariah audit** as: "The primary objective of the internal Shariah review (carried out by an independent division or part of internal audit department) 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)".

IMPORTANCE OF AUDIT

To guarantee corporate accountability, enhance the stakeholders' faith in the company and comply with Maqasid al-Shariah, which aims to realize public interest as well as to remove hardship and harm.

PERSPECTIVE OF SSB (SHARIAH SUPERVISORY BOARD) ON AUDIT

Narrow View of SSB

Shariah Supervisory Boards (SSB) currently take a narrow view of Shariah audit and confine adherence to it in the form of technical compliance of the financial contracts to the fatwas (opinions) issued by SSB regarding what is permissible or otherwise.

Broad/ Holistic View of SSB

Audit exercise should take into consideration "the business policies, processes and procedures, contracts and agreements, financial systems and reporting, human resource management, social activities and contributions, marketing and advertising, reports and circulars, zakat calculation and payment, and IT systems."

OBJECTIVES OF SHARIAH AUDIT

To express opinions about the financial statements and other aspects of Islamic business operations of an organization .

To assess the effectiveness of internal controls in managing Shariah risk.

To assess the effectiveness of Shariah governance structure/ process and management oversight function.

To ensure the compliance of IFI / Islamic Business Entity and other entities with laws and regulations.

To ascertain the degree of compliance with Shariah principles/ requirements.

To ensure the compliance of IFI/ Islamic Business Entity with Shariah principles in all possible aspects.

To fulfill the code of conduct as professional accountant.

To prepare the reporting on identified Shariah non-compliant activities/ events/ transactions.

SCOPE OF SHARIAH AUDIT

- Financial statements of the IFI (e.g. profit distribution policy, zakat computation, imposition of ta'widh (compensation fee) and gharamah (penalty charges)).
- Documentation on products, services and marketing (e.g. policy documents, Product Disclosure Sheets, printed advertisement, brochures, social media posting).
- Organizational structure, human resource and information technology application systems (e.g. readiness of IT system to cater for Shariah features of a contract, for example non-compunding of ta'widh).
- Internal control system (e.g. operating and updated guidelines and Standard Operating Prodecures (SOPs)).
- Shariah non-compliance risk management function (e.g. no failure to identify and comply with purification process of business income arising from Shariah non-compliance business transaction activities).
- Adequacy of Shariah governance processes (e.g. review Shariah Secretariat functions, Shariah Committee minutes of meeting, attendance of SC, , documentation on Shariah resolution).
- Reports on identified Shariah non-compliant activities/ events/ transactions (e.g. investment activities in Shariah non-compliant businesses, failure to comply with the income purification requirement).
- Special or ad-hoc Shariah audit assignments as directed by the Board/ Shariah Board.

SHARIAH AUDIT METHODOLOGY

Shariah audit is a “systematic process” which means that it should have a proper design from the very beginning.

FIRST PHASE: PLANNING

- Understanding the Business of IFI/ Ilslamic Business Entity
- Understanding the Appropriate Contracts for the Business
- Identifying the Appropriate Techniques of Evidence Gathering
- Development of Proper Audit Plan

SECOND PHASE: EXAMINATION

- Examination of Documents
- Interview
- Inspection
- Data Mining
- Direct Observation
- Benchmarking
- Surveys
- Case Studies
- Flow Charts
- Statistical Analysis
- Walkthrough
- Questionnaires

THIRD PHASE: REPORTING

Shariah Audit Report:

Part 1: Executive Summary

- Introduction
- Shariah Audit Objectives
- Scope of Shariah Audit
- Methodology and Approach of Shariah Audit
- Risk Assessment and Risk Profile
- Overview of Previous Audit Findings
- Risk Areas within Scope of Shariah Audit
- Risk Assessment mapping within Scope of Audit
- Sample Account Details
- Summary of The Gaps
- Exit Meeting
- Shariah Audit Conclusion
- Description of Risk Rating
- Description of Audit Rating

Part 2: Details Finding

- List of Gaps and Management Responses

1. Observation
2. Risk Implication
3. Risk Rating
4. Recommendation
5. Management Comments
6. Shariah Auditor Comments

Part 3: Appendices

- Audit Evidence for Each Findings

SHARIAH AUDIT METHODOLOGY

DOCUMENTATION

(encompasses all phases during audit exercise)

Audit report is the last process of documentation which records the overall activities of the auditor during the auditing process and the results and conclusions drawn by him/ her from the audit evidence. This report can either be in the form of papers or in an electronic form.

Meanwhile, working paper performs different functions including:

- To serve as planning and performance of the audit. If the audit is to be planned and performed well, the required reference information and detail should be presented in the form of these papers.
- To serve as proof that the audit evidence which supports the opinion of auditor is valid and in accordance with the concerned regulatory requirements.
- To validate and confirm each process of audit too. It helps the supervisory authorities confirm whether the whole audit process was efficient and is reliable or not.
- To serve different parties for their own purposes like the tax regulators, government bodies and others.

As a general rule, the auditor should add anything that would be needed to provide another auditor with no past experience and knowledge of the entity to understand the performed audit work. The audit report should provide the ground for the decision that has been made.

AUDIT EVIDENCE

PRIMARY EVIDENCE

Primary evidence is gathered by auditors personally. The information can be gathered by using different techniques like interview, survey, observation and inspection. The most important element here is for the auditor to possess the right skills, expertise and attitude in applying different techniques of gathering information.

SECONDARY EVIDENCE

Secondary evidence can be categorized into two types; (1) information gathered by audited entity and; (2) information gathered by third parties. Since every business entity keeps records of its daily transactions, it produces ample amount of information that can be used in audit. Similarly, external authorities like regulators also have substantial information about the entity which constitute as evidence that can be utilized in audit.



RULES OF THUMB

(in selecting good audit evidence)

1. Documentary evidence is preferred over testimonial evidence.
2. Evidence obtained from different sources or of a different nature is preferred.
3. Original papers are better than photocopies.
4. Evidence collected from a third party is better than the evidence collected from within the organization.
5. Direct evidence obtained by the auditor through personal observation, inspection etc. is better than the evidence gathered indirectly.

TECHNIQUES OF COLLECTING AUDIT EVIDENCE:



INQUIRY



OBSERVATION



INSPECTION



RECALCULATION



CONFIRMATION



ANALYTICAL PROCEDURES

AREAS OF POTENTIAL SNC

(Shariah Non-Compliance Risk)

- **Shariah governance risk**
- **Shariah product approval risk**
- **Shariah documentation risk**
- **Shariah operational risk**
- **Shariah reputational risk**
- **Shariah treasury risk**
- **Shariah IT risk**
- **Shariah credit risk**
- **Shariah investment/ asset management risk**

COMMON ISSUES & FINDINGS IN SHARIAH AUDIT

Terminologies used in contracts and financial reports	Capital guarantee by the mudarib in mudarabah and partners in musharakah contracts
Promising fixed returns in mudarabah/ wadiah contracts	Character of customer/ nature of business/ purpose of financing
Calculation of profit rate in mudarabah contracts	Compulsary rebate in floating rate
Underlying asset in bay al-inah	Same asset in many transactions simultaneously
Liquidation issues in musharakah & mudarabah sukuk	Basic maintenance cost for assets in ijarah contracts

CONVENTIONAL AUDIT	VERSUS	SHARIAH AUDIT
Compliance of financial statements to be in accordance with GAAP (generally accepted accounting principles) and other relevant standards.		Compliance not only with relevant standards but also the Shariah framework in all of the transactions to achieve Maqasid al-Shari'ah.
Auditor is liable to the owner of the business, Board Audit Committee & Board of Directors and is not guided by religious principles.		Shariah auditor needs to assimilate different approach and objective i.e. upholding Shariah principles and be liable to Board of Directors, Board Audit Committee & regulatory bodies.
Internal control, financial control and operational assurances.		Shariah assurance on the end-to-end business activities.

SHARIAH REVIEW	SHARIAH AUDIT
Definition	
Regular assessement on Shariah compliance in the activities and operations of IFI by qualified Shariah officer(s).	Periodical asessment 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.
Objectives	
To ensure that the activities and operations carried out by the IFI/ Islamic Business Entity do not contravene with the Shariah principles.	1. To provide an independent assessment and objective assurance. 2. To ensure a sound and effective internal control system for Shariah compliance.
Scope	
Overall business operations, including the end-to-end product development process.	All aspects of the IFI/ Islamic Business Entity's business operations and activities including audit on financial statements, compliance audit on organisational structure, people and information technology application system and review on adequacy of the Shariah governance process.
Personnel	
Shariah qualified officer(s) within the Shariah Division of an IFI/ Islamic Business Entity.	Internal auditor or appointed external Shariah auditor.

INTERNAL AUDIT AND EXTERNAL AUDIT

Internal audit is designed to look at the key risks faced by the business and how the business is managing those risks effectively. It usually results in recommendations for improvement across departments including company's reputation as well as both financial and non-financial elements may be that factor can be assessed.

External audit focuses on financial and the key risks associated with the business. They are performed on at least an annual basis to provide the annual statutory audit of the financial accounts. This audit is designed to show whether the accounts are a true and fair reflection of where the company sits financially. External auditors will evaluate all the internal controls put in place to manage financial risk to assess whether they are working effectively.

FIELD AUDIT VERSUS REMOTE AUDIT

On-site (field) audit means an on-site examination of a company's records to verify information on which a permission is given, and to determine compliance with the audit requirements. **Remote audit**, also known as an e-audit or off-site audit, is an audit process utilizing an electronic means to obtain audit evidence remotely and evaluate it objectively in order to determine the extent of conformity to the audit criteria.

REMOTE AUDIT

Advantages

- Cost and time-efficient via technology
- Avoid travelling to difficult location
- Flexibility
- Competitive
- Alternative pathway for travel restriction (pandemic proof)

Disadvantages

- Technology issues (e.g. speed of internet connection)
- Lack of involvement & engagement
- Audit trust
- Auditor lacks of experience and training on remote audit

Key Points for A Well-Managed Remote Audit Exercise

- Good internet connection & IT facilities
- Catch-ups/ follow-ups with clients
- Check-ins with team members
- Stay connected with clients & team members
- Work as a team
- Embrace as a norm

CHALLENGES:
COVID-19 PANDEMIC

The current issue of Covid-19 pandemic that affected everyone requires countries to take major precautionary steps like lockdown which most businesses cannot operate as usual and restricted movement of its citizens that force almost all everyone to stay at home and work remotely. The pandemic issue paralyzed the norm of audit site-visit. The auditors must adapt to the new working environment and embrace the challenges of remotely auditing a business entity.

CHALLENGES	RECOMMENDED ACTION TO BE TAKEN
Inability to perform on-site visit.	Engage early with Management and Audit Committee Chairperson to agreed changes. Prioritise availability of evidence and systems.
Timeliness of receiving information.	List all document required, with clear deadlines defined for receipt. Retain all requests in a single document and share this with Management daily. Consistently follow-ups with the business entity on the requested documents.
Limited access to the documentations.	Understand the level of electronic-based and paper-based evidence, explain to Management the requirement for electronic copies and request evidence in advance to allow for scanning paper documents. May also utilise the technology (e.g. MiniBridge Ai Auditor). MindBridge
Less engagement between staff or team members.	Conduct daily or weekly follow-ups and virtual coffee breaks to maintain motivation. Aware and concern on employee wellness, and have contingency plan for some level of illness.

Difficulty to coach the team members.	Pre-fieldwork coaching through video (eg. Zoom, BlueJeans Network) allows for more effective feedback. The team leader should hold calls with each team member in advance to walkthrough their scope area and work programme. Technology used need to be introduced and guided utilization for members on the usage for more effective and less time consuming results.
Difficulty to keep track on the progress of each team members on the assigned tasks.	Scheduled regular team catch up calls in advance (e.g. daily stand-ups to share progress and findings; more detailed weekly meetings and prior to the close meeting) to promote collaboration. Progress can be shared via technology (e.g. Inflo platform).
Work is less structured when working remotely.	Adopt a set of guiding principles: • Support flexibility for where, when, and how work is performed; • Promote open communication and clearly defined work deliverables ; • Encourage remote workers to disengage as appropriate and maintain work life balance; • Proactively discuss tools and technologies and be open to more efficient technologies (e.g. CaseWare & Microsoft Power BI) to improve the audit.
Time consuming to review the reports and paper works.	To improve efficiency, a video-meeting should be scheduled with the auditor to review reports and work papers in real-time. Advise to use technology to reduce time taken (e.g. Financials Checker).

The critical success factor of remote auditing is to invest in the right technology software as it helps to conduct audit more efficiently & effectively, but an inappropriate one will lead to unnecessary expenses.

RECOMMENDATIONS

Shariah compliance is the essence of Islamic finance. It is the foundation and the primary objective for the inception of the entire industry. Shariah audit is one of the important tools to achieve the objective of ensuring Shariah compliance. The absence of Shariah audit might make the companies overlooked at the overall aspects and operations of the businesses especially in the area of Shariah compliance. The practice of Shariah audit provide certainty and assurance that the businesses are operating based on the Shariah principles.

The current pandemic issue has led audit exercises, be it conventional or Shariah can be performed well even without the fieldwork. It can be done remotely with auditors stay at home and stay connected with the engaged entities despite restriction on the movement put in place by the authority. It is proven that audit exercise is less affected during the current pandemic issue.

CONCLUSION

Shariah audit is a more comprehensive and broader scope of audit exercise compare to the traditional one. Its coverage is not limited to the perspective of financial but, the scope is wider to include other areas such as governance, people, process and Information Technology (IT). Being an expert in both fields, conventional audit and Shariah audit give an extra credit to an auditor as he/ she is able to provide complete perspectives both in financial and Shariah areas for objective judgement; financial perspective and Shariah perspective. The report generated from the exercise itself becomes more comprehensive and distinctive compare to the usual audit report. Moreover, audit firm which provide both audit services; financial audit and Shariah audit services are open to more businesses as it can handle wider range of customers.

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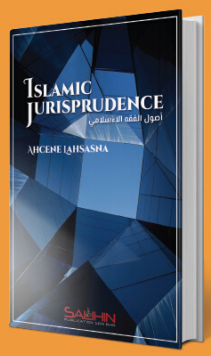
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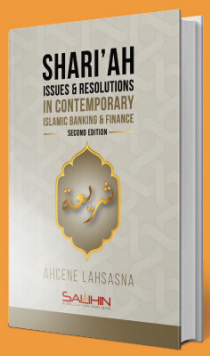
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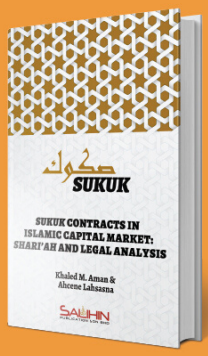
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- Shariah Standards & Shariah Governance (SS&SG) - Standard 1 to 48
- Shariah Control Book

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