

VIABILITY OF EXTERNAL SHARIAH AUDIT PRACTICE: SMALL AND MEDIUM AUDIT PRACTITIONERS' VIEWPOINTS

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Abstract: *The current trend in Shariah governance and assurance has now gone beyond internal Shariah audit to external Shariah audit (ESA). At the international level, the move towards enhancing Shariah governance in Islamic financial institutions (IFIs) were made by mandating ESA function by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI) in its auditing standards in year 2019. Then, in year 2023 Islamic Financial Services Board (IFSB) jointly collaborate with AAOIFI on issuing an exposure draft on Shariah governance framework which suggested as best practice for ESA to be conducted not just for IFIs but also for Islamic capital market. As there is increasing number of institutions offering Shariah compliant products and services, there is also the need for ESA to provide assurance in sectors beyond IFIs. Besides big audit firms, the supply of ESA can be offered by small and medium audit practitioners (SMPs) as well. A focus group discussion was held to study this issue with 17 SMPs on the viability to venture into the Shariah audit industry. The findings indicate challenges to SMPs as there is no regulatory requirement for the conduct of ESA in Malaysia; there is debate on the audit scope and a need for human capital development to develop required skillset for external Shariah auditors that includes knowledge in Shariah principles, Shariah compliant contracts, Shariah risk management and Islamic capital market related products and services.*

Keywords: External Shariah audit, small and medium audit practitioners, institutions offering Shariah compliant products and services

1. Introduction

Global Islamic finance industry is projected for growth to USD5.9 trillion by 2026 from USD4 trillion in year 2021, which is mainly driven by its biggest segments Islamic banks and sukuk (Refinitiv, 2022). This sector of the Islamic finance industry is most advance in terms of market size and regulatory governance. Hence, it is not surprising many regulations on Shariah governance and internal Shariah audit are directed towards Islamic financial institutions (IFIs). Apart from this sector, other Islamic financial institutions which comprise of financial technology companies, investment firms, financing companies, leasing and microfinance

firms, and broker and traders grew by five percent to USD169 billion worth of assets (Refinitiv, 2022). With large amounts of funds, imperative for the establishment of sound Shariah governance mechanisms that ensures holistic Shariah compliance not just for Islamic financial institutions (IFIs) but other institutions that offers Shariah compliant products and services.

One of the current developments in Shariah assurance is the introduction of external Shariah audit (ESA) in addition to the function of internal Shariah audit for IFIs. ESA is gaining support in Islamic finance as consumers and regulators seek more transparency and accountability. Pressure for more external oversight has been building in several countries that have major Islamic finance industries. Central Banks of Kuwait, Oman, Pakistan and Bahrain made the practice of ESA compulsory to strengthen their Shariah governance practice.

ESA provides an additional layer of independent assurance to stakeholders of IFIs due to their position as an external party to the institution (Ahmed, 2017; UKIFC & ISRA, 2016; Islamic Finance Council & ISRA, 2012). Many of earlier research on ESA focused on IFIs covering Islamic banks and takaful operators. In recent time, institutions involved in Shariah compliant activities are not limited to Islamic banks and takaful (Refinitiv, 2022). Therefore, Shariah assurance should be extended beyond IFIs. It is possible that ESA be offered to provide independent assurance for other institutions such as Islamic cooperatives, Shariah compliant companies, and public institutions involved in managing Shariah compliant funds. With the introduction of ESA for IFIs and other Islamic institutions, it will expand the scope of existing audit firms by providing them new opportunities to venture into the Shariah audit industry (Zubair & Muneeza, 2021).

The idea of internal and external shariah assurance was introduced by the Britain's UK Islamic Finance Council (UKIFC) and Malaysia-based International Shariah Research Academy (ISRA) joint research paper published in year 2016. This joint paper urged that ESA should become mandatory globally to help the growth of Islamic finance as well as provide reassurance to scholars, financial institutions and customers (Vizcaino, 2016).

AAOIFI in year 2019 made effective its Auditing Standards for IFIs No. 6 External Shariah Audit (Independent Assurance Engagement on an Islamic Financial Institution's Compliance with Shariah Principles and Rules) (AAOIFI, 2019). This standard was also developed in conformity with the International Standard on Assurance Engagements (ISAE) 3000 to enable worldwide adoption. In March 2023, Islamic Financial Services Board (IFSB) and AAOIFI jointly issued an exposure draft (ED) on Shariah governance framework that include the conduct of ESA (IFSB & AAOIFI, 2023). This ED also mentioned conformity to ISAE 3000 and the applicability of having of ESA practice in the Islamic capital market industry.

In year 2019 in Malaysia, Bank Negara Malaysia (BNM) issued Shariah Governance Policy Document where Clause G19.5 and G19.6 recommends as best practice for the Board to appoint an independent party for external Shariah audit on the operations, business, affairs and activities of the IFIs with the objective to provide assurance on the effectiveness of Shariah governance practiced by the IFIs (BNM, 2019). This requirement is aligned with the section 37 of the Islamic Financial Services Act (IFSA), which similarly allow appointment of independent audit on Shariah compliance by the IFIs (IFSA, 2013). Further, Malaysia's Islamic banking and takaful industry have robust third party annual Shariah inspection by BNM of all IFIs and in normal circumstances the results of the audit is not publicly communicated (Kabati, 2017).

Despite ESA's benefits, the move towards ESA does not come with ease. There are challenges highlighted by countries that had adopted ESA for the IFIs. Ahmed (2017) raised the issue of availability of human resources as he had interviewed regulator and industry practitioner in Pakistan where they had taken the initiatives to train professional accountants and Shariah experts to equip them with necessary skills to conduct effective ESA. Further, in

Pakistan ESA report will remain as off-limits to the public. The ESA report are to be submitted to the State Bank of Pakistan and the board of directors of respective banks. This is due to the anticipated sensitivity of the audit opinion. Other issue raised by Kabati (2017) is the determination of audit scope as most IFIs expect the external Shariah auditor to review, discuss and report any Shariah non-compliances. However certain regulators deem the external Shariah auditor's role to check the institution's compliance with Shariah scholar's fatwas.

Based on the current trend at global level, it is evident that ESA is seen to be viable for independent assurance beyond Islamic banking and takaful sectors. Now, the issue is who would be the suppliers of ESA function. In Malaysia, SMPs are an integral segment of the accountancy profession and an important category of MIA members. In year 2021, there are 2,889 SMPs registered with Mia, excluding firms registered with the Audit Oversight Board (MIA, 2021). SMPs can provide accounting and audit services to a variety of client and this may include institutions that offer Shariah compliant products and services such as Islamic cooperatives or even Shariah compliant companies endorsed by the Securities Commission.

2. Method

This study aims to explore the opinion of SMPs on the possibility of implementing ESA in Malaysia. The study uses focus group discussion (FGD) as it intended to illicit responses from a group of SMPs who may be able to provide ESA in the future. This method is chosen because it is a good way to gather people from similar backgrounds or experiences to discuss a specific topic of interest. The group of participants is guided by a moderator who introduces topics for discussion and helps the group to participate in a lively and natural discussion amongst them (Mishra, 2016). In addition, it is useful to explore and generate new ideas and issues through group interactions and capture certain elements such as thoughts, feelings, and intentions that are impossible to be observed or measured using other methods (Patton, 2002). Another advantage relates to the position of participants in the FGD. This technique also provides insight into the participant's thoughts, ideas and memories in their own words rather than those of the researchers' (Reinharz and Davidman, 1992).

A total of 67 invitations were sent to registered SMPs with Malaysian Institute of Accountants as accounting firms. A total of 17 representatives from 16 SMPs attended the FGD. The participants comprise of Audit Partners, Chief Executive Officer and Audit Principals of the SMPs. Interview questions were distributed earlier before the FGD session for respondents to provide their feedbacks. During the online FGD session, respondents further elaborated and provided additional inputs about ESA. Notes taken during the FGD was further refined by cross-verifying with recording of the session. The areas that were discussed during the FGD included value proposition of ESA, challenges in implementing ESA and ESA skillset.

3. Results and Discussion

Based on the roundtable discussion, the findings are grouped into three main areas, value proposition of ESA, challenges in implementing ESA and ESA skillsets.

3.1 Value proposition of ESA

The supply of ESA for institutions offering Shariah compliant products and services can be made possible with the provision of independent assurance service from SMPs licensed by MIA. However, there are some concerns from the SMPs as currently, there is no mandatory

regulation for the performance of ESA as what is practiced in statutory audit. It is evident that without acts or regulation mandating the performance of ESA, SMPs would not have reference point to justify ESA practice. In addition, there are no specific Islamic accounting standards to cater for accounting and reporting Islamic financial products and services offered and managed by the institutions in Malaysia. Despite challenges, SMPs believe that ESA is required as a test of robustness on the work of internal Shariah audit. Further, with ESA, the issuance of an independent Shariah assurance report would provide engagement with shareholders and stakeholders.

3.2 Challenges in implementing ESA

SMPs highlighted some issues in implementing ESA which include inadequate knowledge in operational Shariah issues and knowledge on key Shariah non-compliance risk areas. Further, in the market there is limited training programmes related to ESA. Apart from this, SMPs opined that it is difficult to define the audit scope that should be audited by the external Shariah auditors.

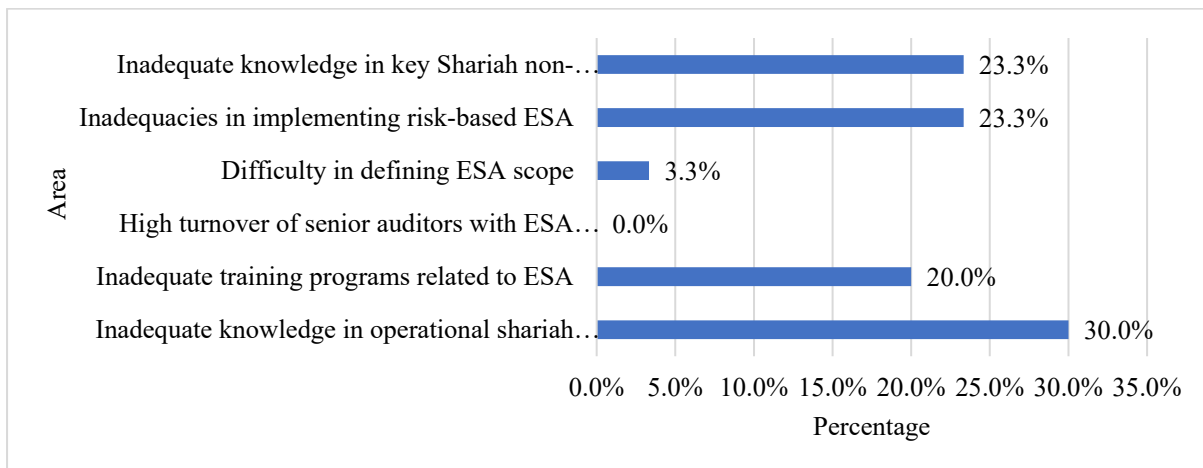


Figure 1. Challenges in implementing ESA

It was also found that one of the major concerns is related to knowledge and competencies of the external auditors that will be entrusted with the responsibilities to conduct ESA. Hence, it is imperative to identify the audit scope, processes and skillset that should be developed first as the foundation for the development of ESA practice in the Islamic finance industry in Malaysia.

3.3 ESA Skillset

Based on the Roundtable discussions participants agreed that ESA scope should cover Shariah risk management, Shariah governance, effectiveness of Shariah Committee in ensuring Shariah compliance, determination of ta'widh, gharamah and ibra for financing given, determination and reporting of zakat, Shariah non-compliance events and disposal of Shariah non-compliance income and lastly on the movement of assets, distribution of dividends/income, accounting records with regards to commodity Murabaha.

The audit process would be similar to the conventional audit, which is focused on performing risk assessment on Shariah governance, organisational structure, product structure and operations; and development of audit programme based on Policy documents or Shariah

Standards issued by the BNM. Further, as there is increasing numbers of Shariah compliant companies that can be potential clients of SMPS, SMPs also need to have knowledge in areas of Islamic capital market products and services.

The auditor skillset should comprise of knowledge in Shariah principles, Shariah risk management, accounting and auditing. The auditor skillset is suggested to match with the proposed ESA scope. With such identification, it can serve as baseline in determining training content and module development by universities and training providers.

Since SMPs members are already professionally qualified with accounting and auditing professional certification, hence, it is imperative to leverage on the existing SMPs and equipped them with professional Shariah qualifications.

4. Conclusion

It is a challenge for the Islamic finance industry in Malaysia as there is no issued regulation on the implementation for ESA whereas at the global level, ESA was made mandatory by various regulators, namely Central Banks of Kuwait, Oman, Pakistan and Bahrain. Despite such challenges, there are signs of viability as SMPs are professionally qualified with auditing techniques and need to be equipped with Shariah related knowledge. There are many training centres such as IBFIM to provide required training. Further, SMPs believed that ESA is the tool to provide the link for a holistic Shariah assurance for institutions involved in Shariah compliant business activities.

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