

# External Shariah Audit Services from Practitioners' Views: The Case of Malaysian Islamic Banks

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## ABSTRACT

**Objective** – This paper investigates the possibility and feasibility of Malaysia's Islamic banking industry hiring external Shariah audit (ESA) services in the audit fraternity as one of the Shariah governance mechanisms. Some of the scholars argued that ESA is more independent and is able to strengthen the existing Shariah compliance in the industry.

**Methodology** – This study employs a qualitative method by utilising semi-structured interviews with nine key industry players: Shariah auditors, Heads of Shariah audit, Shariah Committee (SC) Member, and Chief Shariah Officer. Data gathered from the interviews was transcribed and analysed using Atlas.ti software.

**Findings**– A series of interviews reveal that given the current practices by the Islamic banking industry, it could be inferred that the Malaysian Islamic banking industry is not ready to exercise the ESA practices. This unreadiness is due to several factors, such as ESA costs outweighing its benefits, the fear of reputational risk, and anxiety of leaking confidential information to rivals.

**Novelty** – The Shariah audit research especially relates to external Shariah audit is considered limited.

**Type of Paper:** Empirical

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**Keywords:** External Shariah audit; Islamic Banks; qualitative method; Shariah governance; Malaysia

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## 1. Introduction

Islamic banks appoint a Shariah Committee (SC) to oversee Shariah compliance of the respective banks (Bank Negara Malaysia, 2019). On top of that, Shariah mechanisms such as Shariah risk management, Shariah review, and Shariah audit are established to support the role of SC in strengthening the Shariah governance in the industry. However, an additional layer of assurance of Shariah compliance by an independent party such as an external Shariah auditor will provide greater assurance to stakeholders of the Islamic banks (Ahmed, 2017).

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To date, the Shariah audit research especially relates to external Shariah audit is considered limited and requires greater attention from the Islamic finance scholars. In this regard, the role and responsibility of the external Shariah auditor is to provide an opinion on whether the products, contracts, activities, and operations of the Islamic banks are in accordance with the Shariah principles in general and with the resolutions of the bank's SC in particular. In addition, the external Shariah auditor should also ensure that the bank adheres to the Shariah advisory council (SAC) resolutions and circulars of the central bank, i.e., Bank Negara Malaysia (BNM). Thus, this paper attempts to investigate practitioners' perception in the Islamic banking industry as to whether the external Shariah audit (ESA) services in their institutions are relevant and necessary based on the current circumstances.

The next section reviews previous studies on the importance of the Shariah audit and justify the needs of the external Shariah audit in the Islamic banks in Malaysia. Then, we explain our research methodology. With regards to the findings, we provide some arguments and justifications from the interviews from both arguments either supports or against the external Shariah audit services. Finally, the conclusion is drawn by summarizing the possibility of implementing this service in the Malaysian Islamic banks.

## 2. Literature Review

The main objective of IFIs is to fulfill society's needs, which looks at ethical and permissible products and services in the banking and finance industry (Shahar et al., 2018). In this regard, SC and the internal Shariah audit (ISA) play a significant role in ensuring that the IFIs operate in accordance with Shariah principles. However, questions arise regarding the accountability and independence of the internal Shariah auditor in auditing their products and operations. Because they are full-time employees in the IBs, their perceived independence has been infringed (Nawal Kasim, 2013). Hence, it is argued that there is a need for the external Shariah auditor, an independent party, to verify the business undertaken to ensure all the banks' activities and operations are in accordance with Shariah principles (Shahar et al., 2018). This exercise intends to maintain the credibility of Shariah compliance in the Islamic banks, which is often seen with scepticism (Ahmed, 2017).

Obviously, the need of ESA services is in line with the stakeholders's theory. According to this theory, Islamic banks should consider other stakeholder groups with whom the organisation is affiliated and contributes to its success. Besides, companies must handle and align the needs of their stakeholders of different classes properly. The companies take on the public stakeholders by presenting the extra facts to illustrate how accountable the business is to society to prevent more reporting legislation from public pressure on the government (Hameed, 2001). From the banking perspective, the stakeholder theory's purpose is to create consciousness and obligation that banks must have to internal and external stakeholders (Al-Shamali et al., 2013). This theory asserts that all parties that affect a company's performance are essential to its success (Al-Nasser Mohammed & Muhammed, 2017). These parties could be customers, trade associations, suppliers, external auditor, and so forth. The theory suggests that all people who have a stake in the organisation participate in its activities because all participants have the commitment towards the organization (Bhatti & Bhatti, 2009).

Additionally, the role of external Shariah auditors explained by the Islamic Financial Services Board (IFSB) includes: (i) conducting annual Shariah compliance review; (ii) identifying significant breaches in Shariah compliance with the potential to transform into reputational risk; (iii) and if required by the supervisory authorities, reporting to them any material Shariah non-compliance (SNC) identified when auditing the Islamic banks (Salleh et al., 2019). An ESA team should consist of experts in various fields such as accounting, auditing, Shariah, legal, and banking. Indispensably, the members must possess sufficient and relevant experience as well as qualifications.

Nonetheless, given that the ESA is considered new in the audit fraternity, the availability and competency of human resources could be a challenge (Ahmed, 2017). In this regard, IFIs may develop internal and external Shariah auditors who can carry out financial, management, and Shariah audits. Similarly, obtaining the required expertise and resources to perform a Shariah audit is essential for chartered audit firms (Karim Ginena, 2015). In the meantime, non-compliance with Shariah standards poses a risk that could jeopardise IFI operations and have a negative impact on the entire Islamic financial system. The legal aspect, image, and reputation of IFIs in the market, as well as the credibility of Islamic finance in the eyes of its stakeholders, are all at risk. As a result, a reliable ESA appears to be vital to the Islamic financial system's strength (Grassa, 2013).

However, to date, IFIs in Malaysia do not need to hire ESA services. According to Bank Negara Malaysia (2019), through its Shariah Governance Policy Document, internal Shariah auditors are responsible for conducting and perform the Shariah audit function. This practice is considered a standard in which failure or non-compliant to do so would result in enforcement action by the regulator. Nonetheless, the IFIs' board of directors may appoint any person to conduct an independent ESA on the operations, business, affairs, and activities of the IFI. This guidance is to provide objective assurance on the effectiveness of Shariah governance implementation within the IFI. If the BNM thinks it appropriate for compliance with Shariah by an IFI, the BNM may require the IFI to appoint any persons to conduct an independent audit on Shariah compliance in the IFI. This practice is also in line with section 37 of the Islamic Financial Services Act (2013).

Moreover, both Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and Islamic Financial Services Board (IFSB) highly recommend Shariah governance's instructional exercise by combining external and internal resources (MIFC, 2014). The external structural services of Shariah governance, to name a few, consist of SC, external auditors, ESA, and consulting firms, which support IFIs to ensure the Shariah compliance of IFIs from outside (Hilmy & Hassan, 2019). In this respect, the AAOIFI and the IFSB have comprehensively provided guiding principles for the ESA. For instance, AAOIFI, through the Auditing Standard for Islamic Financial Institutions No. 6, proposes a standard, namely, External Shariah Audit (Independent Assurance Engagement on an Islamic Financial Institution's Compliance with Shariah Principles and Rules). According to the standard, there are two types of engagement, namely a direct ESA (preferred by the standard) and an attestation ESA, in cases where needed by the regulators of the respective jurisdictions.

The recommendation of ESA implementation is encouraged to be adopted because it is crucial to uphold and preserve the integrity of the Shariah principle in Shariah auditing. This exercise is due to the fact that, to date, a review on the Shariah matters of IFIs by external parties is conducted only by the Shariah Advisory Council of BNM. Accordingly, International Shariah Research Academy for Islamic Finance (ISRA) in 2016 had made a strong call for mandatory independent Shariah audit for IFIs (ISRA, 2016). Hence, given many benefits that may obtain by the IFIs, this paper strongly argues that implementing the ESA service would be the next agenda in the Islamic banking industry in creating robustness in the industry and eventually gaining market confidence in the services.

### 3. Research Methodology

This study explores the practitioners' view concerning the relevancy of the ESA in Islamic banks. In order to achieve this objective, a series of in-depth interviews were conducted at the end of the year 2019. Though about 27 institutions offer Islamic banking products and services in the country, only a few agree to participate in these interview sessions. Below is a basic conceptual framework of the study that underlies the significance of the study:

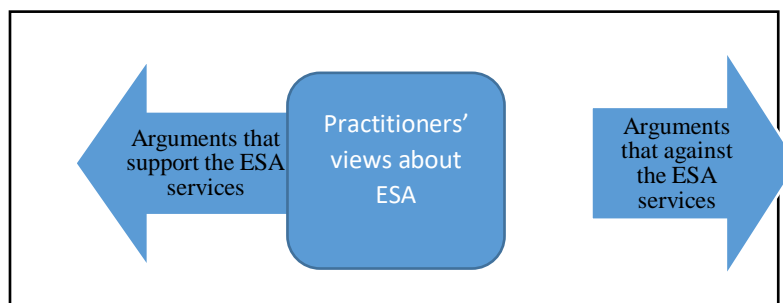


Figure 1: The Conceptual Framework for the Study

Before data could be collected, the study has developed the research instrument based on few stages as presented in the Figure 2 below:

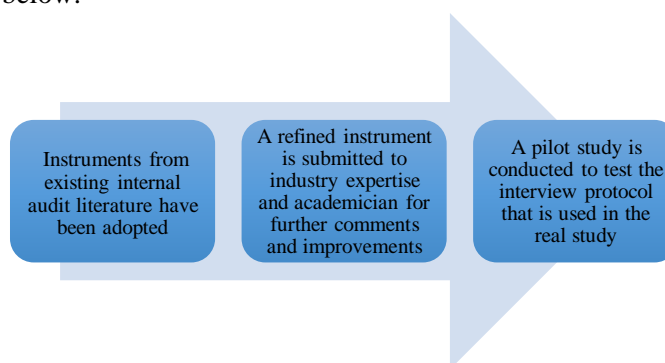


Figure 2: The Process of Developing the Research Instrument

As illustrated in Figure 2 above, in the first stage of the process, a few instruments from the internal audit literature have been adapted and fulfilled this study's objectives. Second, the developed interview questions have been submitted to expertise scholar and industry's practitioner in the Shariah audit area as a subject matter expert. Finally, to validate the final set of interview protocol, the researcher conducts a pilot study with one of the Head of Shariah audit in IB. This pilot study is conducted before pursuing a real study to test and construct the effectiveness of the research tool (Marican, 2005).

In developing the attributes of reliability and validity while at the same time minimizing risky in committing mistakes in this study, the researcher employed few strategies as proposed by Creswell (2014) and Lietz, Langer, & Furman, (2006). These strategies are field notes, respondents' confirmation, and pilot interviews.

According to Bogdan and Biklen (2007), having rigorous data accumulation or systematic gathering in the field can also help qualitative investigations achieve a high level of reliability. Fieldwork such as appointments, formal interviews, unofficial interviews, observations, and the gathering of documents will all help to improve the reliability. The researcher utilises a little notebook to record all actions that take place in the field for this study. This remark is transmitted to the computer and saved in the appropriate location for future reference.

Furthermore, member's checking, or verification from respondents about the interview's data, is a technique for transferring legitimacy from the researcher to the respondents (Mulhall, 2003). However, due to low answers or poor input from interviewees, the current study did not obtain satisfactory verification. Surprisingly, only two out of nine interviewers have validated the interview material and offered some enhancement ideas. Most likely, they are all preoccupied with their work, and they believe they have already contributed by spending so much time with the researcher during prior interview sessions.

Finally, a pilot study is necessary to emphasise the creation of the research instrument, the practicality of the actual research, the suitability of the research design, sampling technique, data processing technique, and the suitability of the research questions (Neuman, 2014). As a result of this strategy, the data's reliability will improve. The goal of this pilot study is to identify potential problems that the researcher may encounter during the actual interview sessions.

There are four groups involve in this study, namely full-fledged Islamic bank (FFIB), Islamic banking subsidiary (IBS), development financial institution (DFI), and Islamic window (IW). Table 1 below presents a list of interviewees involved in this study. The respondents were coded based on the position and types of group. For instance, HSA-FFIB will be referring to the Head of Shariah Audit from FFIB without specifically mention the institution's name. This approach certainly is to keep the confidentiality of the data.

Table 1: Interviewees for the Study

Types of Groups	Position	Respondent Code	Total
Full-fledged Islamic Banks (FFIB)	Chief Shariah Officer	CSO-FFIB	1
	Head of Shariah Audit	HSA-FFIB	1
	Head of Officer and Shariah Audit	HOSA-FFIB	1
Islamic Banking Subsidiaries (IBS)	Head of Islamic Banking Audit	HIBA-IBS	1
	Senior Director of Islamic Business Unit	SDIBU-IBS	1
Development Financial Institutions (DFI)	Head of Shariah Audit	HSA-DFI	1
	Shariah Auditor	SA-DFI	1
	Shariah Committee Member	SC-DFI	1
Islamic Windows (IW)	Head of Shariah Audit	HSA-IW	1
			9

Purposive sampling was used to identify respondents for this study. Even though the number of respondents in a qualitative study is limited, it is regarded normal because they are chosen based on criteria that would provide relevant information on the topic under inquiry (Creswell, J. W., & Poth, 2018). The combination of Shariah auditors and Heads of Shariah Auditors gives useful information when considering ESA services (Nor Aishah Mohd Ali et al., 2015). Furthermore, the views of other relevant actors, such as the Chief Shariah officer and the SC member, are important in establishing the need for external Shariah auditors in the Islamic banking industry.

Before beginning the analysis, all interview sessions are verbatim transcribed using the Computer Assisted Qualitative Design Analysis Software (CAQDAS), specifically Atlas.ti version 8.0. This programme is used to make the process of transcribing and coding the audio from the interviews easier. Regardless of the analytical techniques used, the transcribing method, according to (McLellan et al., 2003), assists the researcher in systematically organising and analysing textual data.

#### 4. Results and Discussions

A series of interviews produced fruitful information from both side, either supporting the ESA services or against this service. Concerning the views that support the ESA services, some interviewees shared their views about ESA services provided by professional audit firms in the market. HSA-IW highlighted that it would be beneficial to check the quality of the internal Shariah auditor's assurance considering the ESA's presence. ESA will also suggest some recommendations to the organisation for improvement in the future:

"...The appointment of an external examiner or auditor at this bank is to perform quality assurance checking. This external auditor will assess the work of the internal auditor, including the Shariah auditor. Eventually, they will provide some recommendations for the betterment of the bank's operations..." (HSA-IW).

The above quote is supported by (Arwani, 2018) that external Shariah auditors should not only perform a financial audit but also carry out Shariah compliance audit according to a fatwa (verdicts) and SC guidelines.

In the meantime, HSA-DFI suggested that it will be better if the Shariah audit tasks could be given to external Shariah auditors due to their independent status compared to internal Shariah auditors (as depicted in Table 2 below). The reason is that ESA can be seen as more independent since IFIs do not hire them as full-time staff and they are also more experienced due to greater exposure to the industry (Fatihu Shehu Isa et al., 2020). (Falah Al Samara et al., 2019), Al Ali, and Hassan Al Afeef (2019) contended that ESA positively affects IBs' performance efficiency due to its independent status. Besides, the position of the Shariah audit firm is almost similar to public accountants' firm, although they have different paths (scope and coverage) (Omar, 2019).

Table 2: Multiple views on ESA services.

Support ESA Services	Against ESA Services
ESA may check the quality of the ISA's assurance	ESA cost might exceed its benefits
ESA is more independent than ISA	Different ESA will have a different methodology
ESA serves a check-and-balance mechanism	Different risk measurement of SNC due to different interpretations
ESA might share vast knowledge and experience of auditing other banks	ESA appointment will jeopardise the image and reputation of the IBs
	The anxiety of leakage of commercially confidential information to rivals

However, IBs should not only concern about the independence status of ESA, but they must also consider the benefits that must outweigh the costs of hiring the ESA service. This concern is due to the fact that the cost to hire this external Shariah auditor is high, as HSA-DFI remarked:

"...The level of independence is higher if the external auditor conducts the Shariah audit, which will be better. However, it is quite costly for the bank because we need to spend at least RM300, 000 to hire them..." (HSA-DFI).

The above finding is supported by Haji Besar et al. (2009) and (Arman, 2013) said that ESA is essential to enhance the independence and transparency of the IFIs. (Arwani, 2018) also supported the above that the assessment of external auditor based on cost, quality, and pace of the audit work.

On the same ground, HSA-FFIB was also inclined to support the notion of the appointment of an external Shariah auditor in the IBs in the sense that they may serve as a check-and-balance mechanism. Apart from that, the external Shariah auditors might share their vast knowledge and experience since they have many engagements with other companies in conducting ESA:

“...Actually, it is good to have an external Shariah auditor because they may serve as a check-and-balance mechanism. Besides financial statements, this external Shariah auditor may conduct an audit exercise in another relevant section. They might share the knowledge or technique by performing the audit since they visit and audit many companies and institutions. By doing that, they can share the other institutions’ experience and knowledge in conducting audit...” (HSA-FFIB).

HSA-FFIB’s view is supported by (Arman, 2013) that external Shariah auditors will acquire a broader range of experience while conducting the ESA among auditees in the industry. However, SC-DFI said that despite the good qualifications of external Shariah auditors in Shariah, such as Amanie and ISRA, it is crucial to identify their methodology since different external Shariah auditors will have their methodology. The various approaches in audit methodology might result in different audit findings:

“...In terms of effectiveness, it is considered good because it depends on the team members’ qualifications who conduct the Shariah audit, whether they have Shariah background because they are auditors. For instance, most of Amanie and ISRA’s auditors are from Shariah background. However, in the case of methodology, there will be a problem because let’s say we choose a different external Shariah auditor for another year, they might employ a different methodology in performing audit...” (SC-DFI).

SC-DFI added that since there is no proper framework for Shariah audit, there might be differences in terms of the risk measurement of SNC because of differences in their interpretation:

“...Due to different auditors who serve as external Shariah auditors, they do not have a single Shariah audit framework. This scenario might be a problem for the institutions that hire external Shariah auditors. The external Shariah auditors will also need to develop a risk measurement of SNC, whether high, medium, or low. That will be another issue because different external auditors have different interpretations...” (SC-DFI).

The above argument is in line with (Fatihu Shehu Isa et al., 2020) which argue that standalone Shariah audit framework was among the main concerns of the Shariah audit player due its function to harmonise the risk measurement process. Moreover, SDIBU-IBS presented a different opinion that if the internal Shariah auditor's role is not good, the BNM will interfere and suggest the IBs to appoint an external Shariah auditor. Thus, she concluded that the IBs must perform as best as they could since the appointment of this external Shariah auditor will jeopardise the image and reputation of the IB itself:

“...In Shariah Governance Framework 2011, it is stipulated that if BNM is not happy with internal Shariah auditor, they may appoint external Shariah auditor to conduct the audit at the respective bank. So, in IFSA 2013, it is documented that BNM could appoint an external Shariah auditor to audit the bank. Thus, that is why we put in our best effort to make sure that BNM will not appoint this external Shariah auditor...” (SDIBU-IBS).

In addition, (Zakaria, N., Shafii, Z., & Salleh, 2021) assert that despite many benefits of ESA, the industry players believed their current practice of ISA is reliable and strong enough and thus do not require for ESA. This is due to the fact that the existing practice of Shariah assurance in their institutions is adequate with the existence of other Shariah organs such as Shariah Committee, Shariah review as well as Shariah risk management.

Moreover, IFIs might not enter into collaboration with external Shariah auditors due to anxiety of leakage of commercially confidential information to rivals. In addition, (Arwani, 2018) added that the task of the external auditor regarding Shariah compliance is only to review the compliance-based outlines given by the SC. Hence, IFIs follow the specified rules and procedures with no added value or achieving the objective of Al Maqasid as Shariah (Omar, 2019). On the contrary, in practice, external Shariah auditors should make an objective compliance decision instead of relying heavily on the SC's fatwa due to their lack of expertise (Zakaria et al., 2019).

To sum up, there are pros and cons to hiring and using ESA services in IBs. Accordingly, if the management of IB is considering hiring and using ESA services, they should ensure the benefit received by the IBs in hiring ESA services outweighs the cost incurred. In addition, as long as the ISA framework is yet to be provided by the regulator for the IBs, it is challenging for the IBs to hire the ESA services. This scenario is because, as discussed previously, the non-existence of a specific Shariah audit framework will lead to inconsistencies in the Shariah audit risk measurement and interpretation by IBs.

## 5. Conclusion

The ESA purpose does not intend to find a fault of Islamic banks and take disciplinary actions against them, except there is intentional negligence on Shariah compliance. However, the purpose shall be to determine the areas and issues that impede an Islamic bank from being fully Shariah-compliant and eventually suggest an improvement to Islamic bank management and regulators to overcome the barriers gradually.

As one of the Shariah governance mechanisms, ESA aims to strengthen Shariah compliance in the industry. However, findings from the interviews reveal that the Malaysian Islamic banking industry is not ready to exercise the ESA practices. This unreadiness is due to several factors, such as ESA costs outweighs its benefits. In addition, each external Shariah auditor may have its methodology that might lead to a different risk measurement of SNC due to various interpretations. Besides, some contended that external Shariah auditor's appointment would jeopardise the image and reputation of the IBs since their appointment reflects the ineffectiveness or weaknesses of internal Shariah auditor. Finally, an external Shariah auditor's appointment may increase the anxiety of leaking commercially confidential information to rivals.

As for the recommendations, the regulator should gradually increase the awareness of the importance of ESA among the industry player to strengthen the Shariah governance and Shariah compliance in the future. Additionally, establishing the Shariah audit framework itself is also necessary to harmonise the measurement and interpretation of SNC risk. Moreover, initiatives are to be taken up to train professional accountants and Shariah experts to equip themselves with the necessary insights to conduct an effective ESA.

The current study acknowledges the research limitation due to limited interviewees from various relevant parties. Thus, future research may consider views from other relevant parties such as the regulator and external auditors to produce a more comprehensive result.

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