

## **Post Implementation of Shariah Governance Framework: The Impact of Shariah Audit Function Towards the Role of Shariah Committee**

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**Abstract:** Recent issuance of Shariah Governance Framework by Bank Negara Malaysia has shown a significant impact towards the establishment of the Shariah audit and consequently, towards the role of the Shariah Committee. It is the aim of this paper to study on the impact of the Shariah audit function towards the role of Shariah Committee with regards to the post implementation of the Shariah Governance Framework. The study adopts a single case study research. Findings from in-depth interviews reveal that the Shariah audit function has an added value in ensuring the compliance towards the Shariah principles. This study also provides challenging issues faced by the Shariah Committee of the selected establishment. Hence, it is believed that this study can be benefited by other IFIs in improving their Shariah Committees structure. Future studies could be done to examine post implementation effect of the adoption of Shariah governance framework in the context of other functions such as Shariah research, Shariah risk management and Board of Directors.

**Key words:** Shariah audit • Shariah Committee • Shariah Governance Framework

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### **INTRODUCTION**

Bank Negara Malaysia had issued Shariah Governance Framework recently in January 2011 and all Islamic Financial Institutions (IFIs) in Malaysia have to comply with this framework in six-month period from its issuance. The primary objective of the issuance of the Framework is to strengthen the Shariah governance structure, processes and arrangements in order to meet the needs of Shariah principles. Industry players are, however facing difficulties to implement the requirements of the Framework because of the short timeframe given. The issuance of this framework is very crucial in order to enhance the Islamic finance industry

and more importantly, to preserve the public's confidence on the Shariah compliance of the operations and activities of the IFIs. An additional feature of the Shariah governance structure spelled out by the new Framework is the Shariah audit function.

The Shariah audit function is defined in the framework as an independent assessment that is conducted on a periodical basis in order to improve the degree of compliance and to ensure a sound and effective internal control system for Shariah compliance in the institution [1]. Interestingly, the Shariah audit function, is not just communicating the result of the assessment directly to the Board Audit Committee, as practiced in the conventional audit function, but at the

same the same time it indirectly may communicate with the Shariah Committee. Besides that, all the deliverables to the Shariah Committee should be determined by the Board Audit Committee in order to ensure the consistency with the accepted audit standard. The communication with the Shariah Committee is perhaps due to the function of the Shariah audit which to ensure that a proper internal control is in place in the institution, so that the Shariah Committee can comfortably disclose sufficient information related to Shariah compliance of the institution in the annual report.

A survey conducted at the end of 2011 by one of the four biggest audit firms in Malaysia found that more than half of the total population (more than eight out of 16) of Islamic Banks in Malaysia has implemented the Shariah audit function in their organization. Thus, it is believed that the issuance of the Shariah Governance Framework by Bank Negara Malaysia recently has shown a significant impact towards the establishment of the Shariah audit function within the IFIs.

The objective of this paper is to study on the post implementation of the Shariah Governance Framework, particularly, on the Shariah audit function, in order to examine the impact of this function towards the role of the Shariah Committee. The rest of the paper is structured in the following order. The next section review the literature followed by the discussion on the methodology employed for this research. The paper then discusses on the findings. The final section concludes the paper.

**Literature Review:** More studies have been devoted to Shariah audit as compared to two or three years back as confirmed by Mulyany and Mohamed Ibrahim [2]. Many papers have addressed the Shariah audit issues like the issue of the separation between conventional and Shariah audit as mentioned in Karim [3], the issue of human capital in implementing Shariah audit [4] and the issue of gap between the actual and the desired in implementing Shariah audit [5].

Although many studies that have been implemented, as mentioned above, it is indeed difficult to find field studies on the Shariah auditing. Hence, this study attempts to explore the writings which can be related to the field of this study and at the same time, to narrow the gap between theoretical and field study research. One of the early empirical studies has been initiated by Hood

and Bucheery [6] on audit expectation gap between financial and religious (Islamic) auditors in Bahrain. Hood and Bucheery [6] further argued that religious audit in Bahrain seems to complement financial audit by external auditors. Nevertheless, they questioned whether or not religious auditors have a set of religious statements to audit as compared to financial statement audit by financial auditors. In this study, they found that financial audit expectation gap does exist in Bahrain but not for religious auditors. They also found that financial auditors and religious auditors in Bahrain seem unaware of what each other does. Hood and Bucheery [6] presumed that this finding might be due to respondents' lack of understanding on the subject of religious audit.

In the context of Malaysia, Abdul Rahman *et al.* [7] initiated a preliminary assessment on the responsibility and independence of Shariah Committee of Islamic banks. The sample of the study consists of bank managers of Islamic banks and Islamic banking windows in Malaysia. The result of their study implied a significant need for a proper regulation on the role and function of Shariah advisors. The study also indicates that the bank managers perceived that the Shariah Committee to be more responsible towards external stakeholders. Abdul Rahman *et al.* [7] indicated several factors which can improve the independence of the Shariah Committee like the level of Shariah background, the reputation of Shariah Committees and non-executive role of the Shariah Committees. The findings also suggest the need for a proper regulation by the Bank Negara Malaysia especially in term of the appointment of Shariah Committee. Another important study conducted by Nawal *et al.* [5] found that there are a significant gap between what is actually desired and the actual practise in the institution. The result is based on four issues that are the Shariah auditing framework, the scope of Shariah auditing, the qualification of Shariah auditors and the independence of Shariah auditors. Pursuant to this study, the authors recommended that the regulatory body should implement a comprehensive and integrate the Shariah auditing framework for the benefit of the IFIs as a whole.

Another important area that needs to be highlighted is the study on the area of Shariah Committee. Among the issues related to Shariah Committee are its functions and responsibilities [7], the independence of Shariah Committee [3-5, 8] and other issues like consistency in making pronouncement and competency in term of skills and knowledge [8, 9].

## **MATERIALS AND METHOD**

The objective of the study is to examine the post implementation of the Shariah Governance Framework issued by Bank Negara Malaysia in January 2011, particularly, on the function of Shariah audit, in order to see the impact of this function towards the role of the Shariah Committee. In order to achieve the objectives of this paper, a single case study research on Company HIJR has been conducted. Although the study adopting a single case study method which the findings cannot be statistically generalized to the whole population, it is still believed that this is the appropriate method in order to answer the research objective and research questions. Company HIJR has been chosen as the subject matter of the study because of the easy and fast respond from the organization towards the request for the study to be implemented.

Case study method has been adopted to collect the data as it is believed to be the appropriate approach to answer the research questions [10, 11]. This research is also considered as an exploratory case study as it attempts to explore the impact of the Shariah audit function towards the role of the Shariah Committee. A case study research was conducted in a full-fledged Islamic bank. As such, given the fact that this research is focusing on the specific case and attempting to explain the impact of a new function (Shariah audit) towards the higher authority (Shariah Committee), an exploratory case study was selected.

In this study, a method of collecting data has been used which is the interview. The interview has been selected as the mode of collecting the data as it is believed that the result from this method will be faster and more meaningful as compared to other methods like distributing questionnaires, etc. Two interviews have been held separately with two of the Shariah Committee Members of Company HIJR. The two Shariah Committee Members (out of the total of five) have been chosen as the interviewees of the study because they are the "senior" Shariah Committee Members in Company HIJR. It is because in order to investigate the impact of the Shariah audit function towards the role of the Shariah Committee, the Shariah Committee members needs to be appointed prior and after 2011 (prior and after the implementation of Shariah Governance Framework). The interviews were held in March 2012.

## **RESULTS AND DISCUSSION**

**Prior and Post Implementation of Shariah Governance Framework:** Prior the implementation of Shariah Governance Framework of Bank Negara Malaysia (before the year 2011), the Shariah Committee in Company HIJR does not know much on what is exactly happening at the implementation level. The only detail that the Shariah Committee members will know is when there is any problem or any discrepancy held by the business unit. This is due to the fact that the discussion and approval given by the Shariah Committee members which can be considered at surface and theoretical in nature. The discussion and approval is only given on the structure of the product, the legal documentation and the marketing collaterals related to the product. Hence, prior implementation of Shariah Governance Framework, particularly on Shariah audit function, shows a brief understanding by the Shariah Committee members on the implementation of any product as the discussion and approval is only made at the theoretical level only.

After the implementation of Shariah Governance Framework, particularly on the Shariah audit function, the Shariah Committee members in Company HIJR knows more problems that actually faced at the implementation level. Moreover, the Shariah Committee members can see the impact of the Shariah policy at the implementation level. At this juncture, it requires the Shariah Committee to be more practical rather than being in idealistic approach only. However, this would still not compromise the Shariah principle which should be the main function and focus of the Shariah Committee members. On top of that, a proper internal control system will also be recommended by the Shariah audit function to the Shariah Committee in mitigating any Shariah non compliance instances in the organization from happening in the future. Thus, this will require the Shariah Committee members to acquire more knowledge not just on Shariah but also other areas like risk management, financial management tools, information technology application system and else, in ensuring that the opinion given is accurate.

Post implementation of Shariah audit function shows a significant impact in term of establishing a proper internal control in the organization, indeed through the approval by the Shariah Committee. Prior to the implementation, most of the products are just approved as it is and no proper preventive measures

have been tabled and presented to the Shariah Committee. However, after the implementation, the Shariah Committee needs to also propose and approve certain preventive measures in order to provide proper internal control in the system. One of the common preventive measures is through the establishment of Standard Operating Procedure (SOP). Besides, through the establishment of the Shariah audit function, the Shariah Committee also needs to decide on the corrective measures to rectify any Shariah non compliance event.

#### **The Challenges Towards the Shariah Committee:**

The implementation of Shariah audit function posts a great challenge towards the Shariah Committee in executing its roles. Traditional Shariah Committee is only plays a role in term of giving advice to the organization particularly the Islamic financial institutions. However, the establishment of the new Shariah Governance Framework requires the Shariah Committee to play a greater role, not just in advisory role, but in monitoring role as well. Hence, the establishment of post-Shariah review function and Shariah audit function, respectively. Both functions have their own objectives and characteristics, but the ultimate goal is to help the Shariah Committee in ensuring that the implementation process of any product and transaction is in compliance with the principle of Shariah.

Thus, in executing its 'new' role, in monitoring, the Shariah Committee members face a great challenge especially in term of understanding the procedures, process and system that is used in the implementation part in the organization. Back to the previous system, prior implementation, the approval is only given to the structure of the product and there is no approval given on any system or any deep procedure or process. In other words, the approval is only given at surface. On the other hand, in the new system, all procedures, process and system also need to be approved by the Shariah Committee since this will be part of the 'audit area' as well as the 'internal control measures' to avoid Shariah non compliance instances in the organization. Thus, the understanding of the Shariah Committee is highly important in order to trigger and mitigate any Shariah non compliance before hand. Besides, with the establishment of the Shariah audit function, it is indeed required for the Shariah Committee members to understand the procedures, process and system in the organization. It is for the Shariah Committee members to decide whether the issues highlighted by the Shariah

auditor are complied or not complied with the Shariah principles. Without the understanding, the Shariah Committee members are not able provide accurate decisions on the issues that have been highlighted.

Since most of the Shariah Committees members are having the Shariah background, whilst the Shariah auditor with the accounting background, it is a challenge for Shariah Committee members to understand the issues highlighted by the Shariah auditor. In addition, the language of the report is different in term terminologies and approach. In this situation, the Shariah Committee members will require a longer time in understanding the report and the issues highlighted by the Shariah auditor. The situation may also happen when the Shariah Committee member are to explain certain Shariah principles to the Shariah auditor.

#### **CONCLUSION**

Compliance to Shariah is vital to enhance the confidence of the stakeholders of IFIs. This is one of the reasons for BNM to issue the Shariah Governance Framework for implementation by the IFIs. It is the objective of this paper to examine the impact of the Shariah audit function on the role of the Shariah Committee after the implementation of the SGF. The findings basically reveals that the Shariah audit function has an added value towards the role of the Shariah Committee, particularly on the knowledge of the implementation process of the product in the organization and the internal control that should be imposed. In addition, the function facilitates the Shariah Committee members to identify possible Shariah breach of contracts (if any), prior as well as after the implementation of the product. This is vital for them to provide preventive and corrective measures before greater issues really happen. In addition, it can be concluded that the Shariah Committee members are expected to acquire additional knowledge in finance, risk management, information technology application system and other related area in order for the members to be better off in terms of decision making.

This is an exploratory case study on the post implementation of Shariah Governance Framework particularly on the impact of Shariah audit function in an Islamic bank. Thus it limits itself to the impact of Shariah audit function towards the role of the Shariah Committee and does not address the other purposes of the SGF. Since the study adopts a single case study

methodology, the findings cannot be statistically generalized to the whole population. Furthermore, is conducted for a certain period of time in order to cater for the time constraint.. Small sample size of a limited number of people being interviewed in the study is another limitation. Given more time and opportunities, in-depth interviews with more respondents will perhaps provide a more comprehensive findings concerning the impacts towards the role of the Shariah Committee in the Islamic financial institutions.

As the study only focuses on the post implementation of *Shariah* audit function towards the role of the Shariah Committee, further research can be conducted on the post implementation of Shariah Governance Framework in the context of other functions such as Shariah research and Shariah risk management and perhaps the impact towards the role of the Board of Directors.

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