

Shari'ah Audit for Islamic Financial Institutions: Concepts and Mechanisms

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COFFIS
الهيئة الفرنسية المال الإسلامية
Conseil Français de
la Finance Islamique

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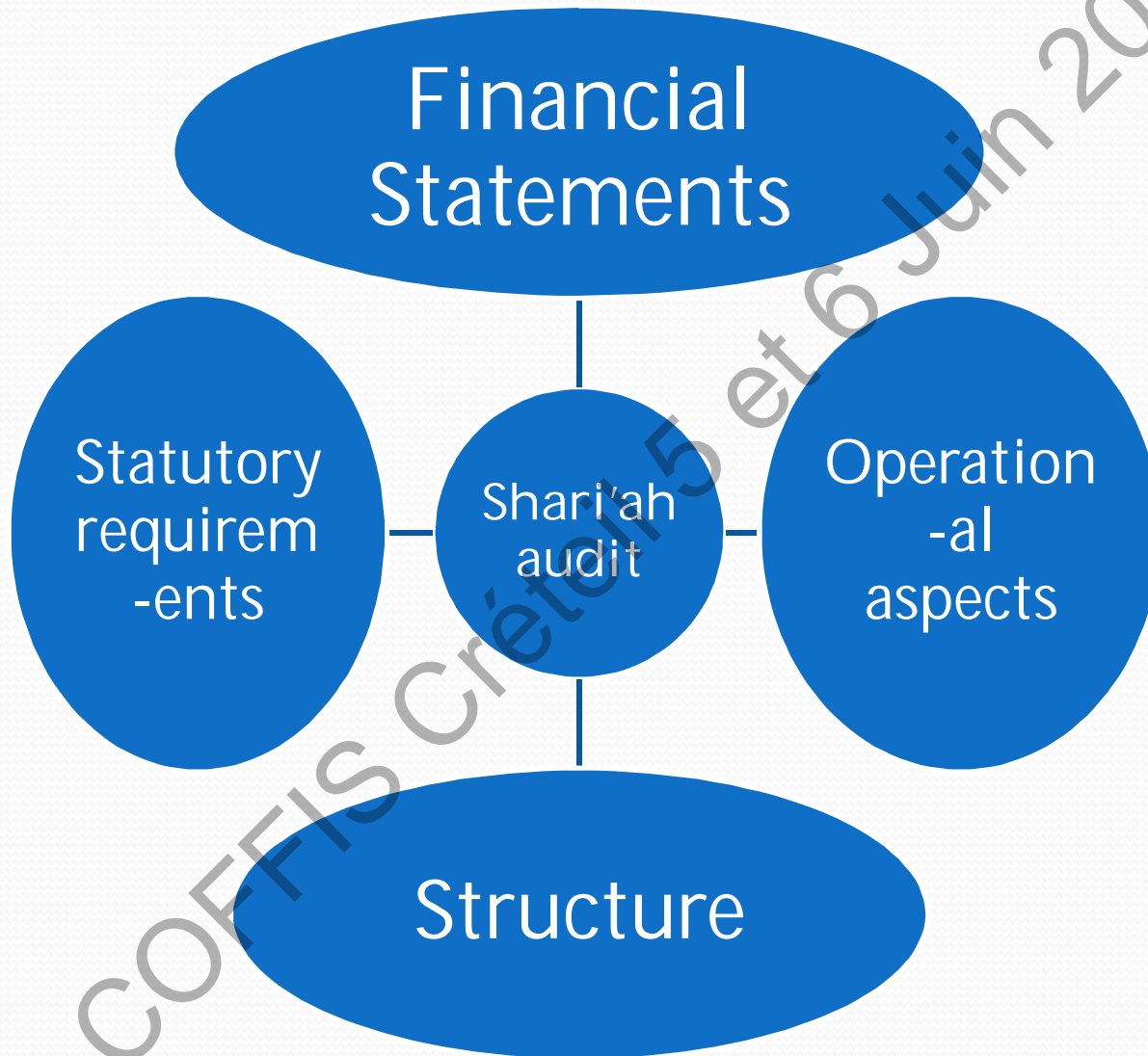
1. Definition.
2. Scope.
3. Shari'ah framework.
4. Techniques and modes of implementation.
5. Case studies.
6. Conclusions.

Definition

Shari'ah audit is the examination of an IFI's compliance with the Shari'ah in all its activities.

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Scope



Shari'ah Framework

Permissibility
of trade.

Profit and
loss sharing

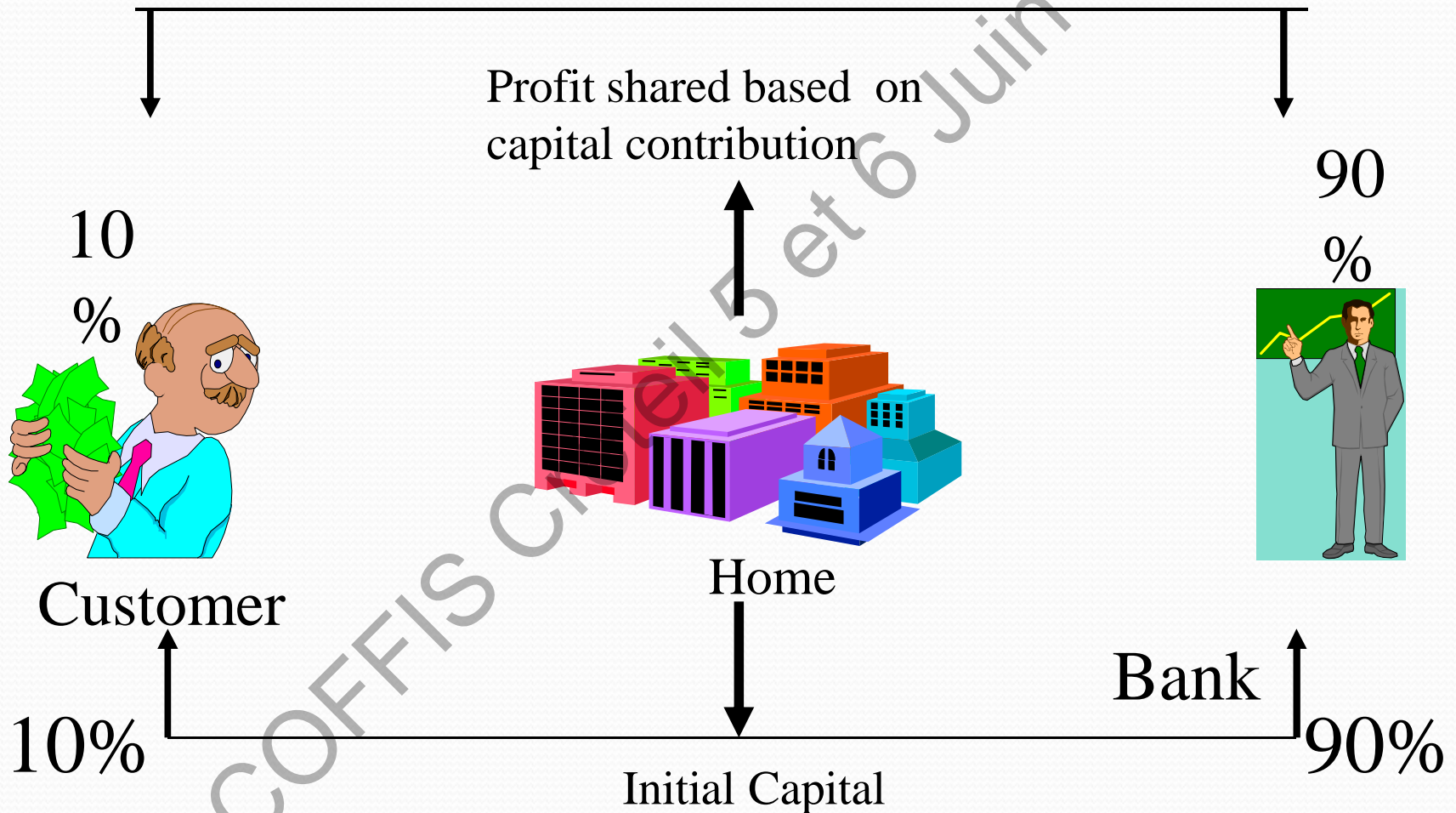
prohibition of
gharar
& maysir.

Trading in
real
commodities

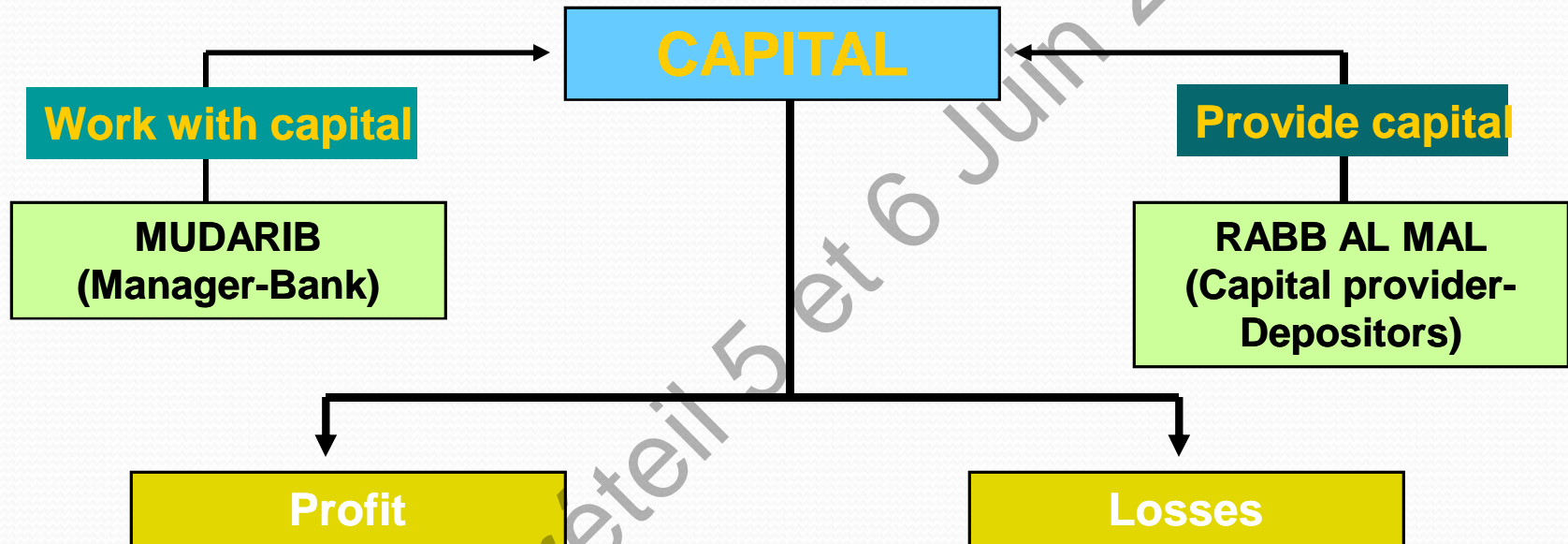
Prohibition of
riba

prohibition of
haram
commodities.

MUSHARAKAH PARTNERSHIP



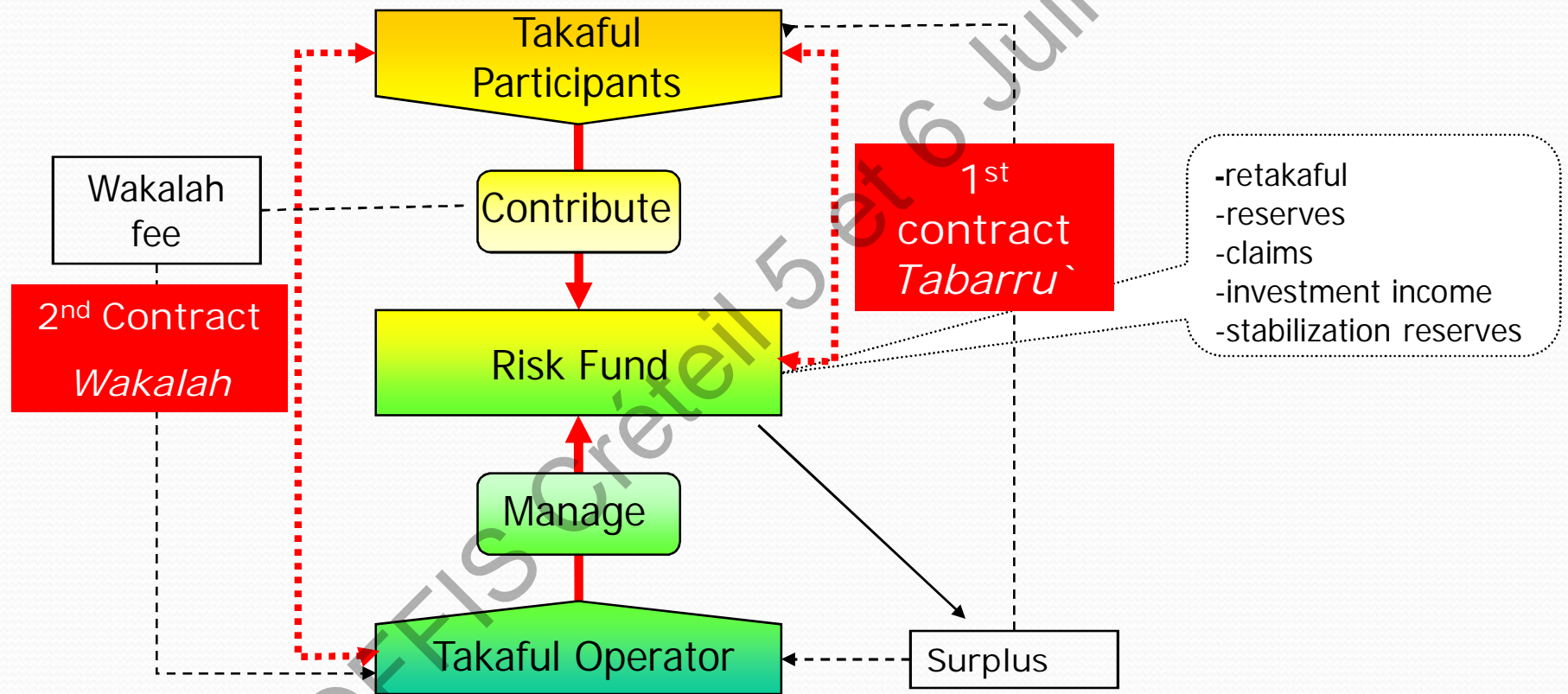
MUDHARABAH (MODUS OPERANDI)



- Shared between mudarib + rabb al mal
- Profit sharing according to a contractually agreed ratio
- Profit sharing cannot be a fixed amount/a fixed percentage of capital contribution

- Born solely by rabb al mal
- Mudarib will only be personally liable if the loss is caused by his negligence

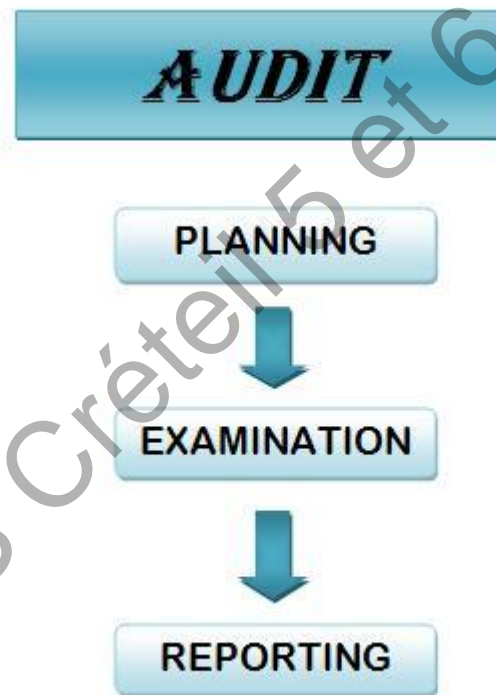
Takaful (WAKALAH MODEL)



IMPLEMENTING SHARI'AH AUDIT:

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PHASES OF THE SHARIAH AUDIT



PLANNING PROCESS

**UNDERSTANDING THE BUSINESS OF
THE IFI**



**IDENTIFYING THE APPROPRIATE
TEHCNIQUES, RESOURCES AND SCOPE**



**DEVELOPING THE AUDIT PLAN AND
PROGRAM**

A) PLANNING PHASE

- I) Understand the business of the IFI.
- II) Identifying the Appropriate Techniques, Resources and Scope.
- III) Developing the Audit Plan and Program.

B) EXAMINATION PHASE

- Actual Fieldwork
- Deploy the right auditing technique
 - To gather the required evidence
 - To enable reasonable conclusions to be reached

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AUDITING TECHNIQUES

- Examination of papers
- Interviewing
- Direct Observation
- Benchmarking
- Surveys

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AUDITING TECHNIQUES

- Case Studies
- Flow Charting
- Statistical analysis
- Walkthrough
- Questionnaires

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C) REPORTING PHASE

- The most important part of the audit cycle.

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AUDIT REPORT FORMAT

1. Title
2. Executive Summary
3. Introduction to Report
4. Objectives and scope of audit
5. Timing
6. Methodology and Approach
7. Summary of Key Findings
8. Recommendations
9. Management Response
10. Conclusions
11. Appendices
12. Glossary

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SAMPLE AUDIT PROGRAM IN FXCFI FII F

C-010 DEBT BASED CONTRACTS (I.e. MURARAHAH, BBA, ISTISNA')			
Ref	Sub-Ref	Document	Detail Checklist
C-010-10	O	To Review the fulfilment of the Essential Elements and the Necessary Conditions in the Purchase Agreement	
	a	Purchase Agreement	Buyer Details (must be the IFI)
	b	Purchase Agreement	Seller name and ID or Business Registration
	c	Purchase Agreement	Seller age exceeds 18 if individual
	d	Purchase Agreement	Description of goods
	e	Purchase Agreement	Location of goods
	f	Purchase Agreement	Unique identification of goods
	g	Purchase Agreement	Good is of pure substance
	h	Purchase Agreement	Price in Currency and absolute amount

Classification of products

Examination of agreements

check for the existence of the essential elements

to satisfy the requirements of Shari'ah and avoid the prohibitions



REVIEW OF OPERATIONAL FRAMEWORK

1.1 Objectives:-

- To examine the extent of an IFIs compliance, in all it's activities, with the Shari'ah.

E.g. : Contracts, Agreements, Policies, Products

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SAMPLE OF SHARI'AH AUDIT FINDINGS

FINDINGS	REFERENCE	RISK INDICATOR
<p>⊖ Trading of mudarabah securities contradict principles of mudarabah contract</p> <p>⊖ This is because the Trade Confirmation sent to the counter party for either a mudarabah placement or deposit, on values date, contains the absolute amount of payment due upon maturity date.</p> <p>⊖ The exposure of this risk to the IFI on mudarabah placements, on average is US\$35million, which forms approximately 30%-40% of the book size</p>	<p>1.1.2</p>	<p>Major</p>

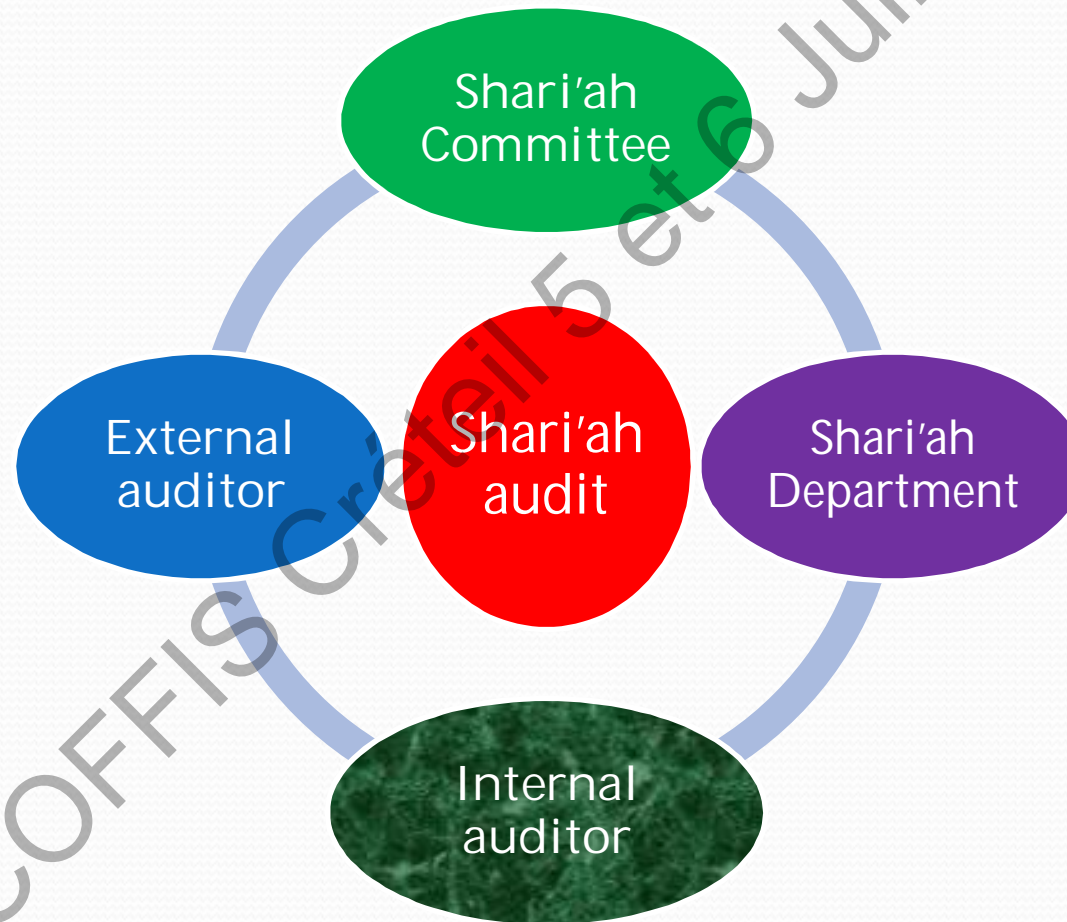
SAMPLE OF SHARI'AH AUDIT FINDINGS

FINDINGS	REFERENCE	RISK INDICATOR
<ul style="list-style-type: none">Term inconsistent with Islamic operations included in statements of account sent to clientsThis affect customers with approximately US\$10million investments in a US\$1billion business i.e. 1% exposure.While the exposure here is considered small, the bigger and more serious risk to the IFI is the impact on IFI's Islamic banking and finance reputation and brand image	2.2.3	Major

INTERNAL ORGANS WITHIN THE ORGANIZATION

- The Shari'ah Supervisory Board (SAB)
 - Independent body of specialized jurists in *Shari'ah*.
- The Internal Shari'ah Review Team
 - Ensures that the decisions of the (SAB) are adhered to.
- The Audit and Governance Committee
 - Oversee the financial reporting and the internal control processes.

Bodies of Shari'ah Audit



SHARI'AH AUDIT IN MALAYSIA AS A CASE POINT

- Started in 1983 with the establishment of Bank Islam Malaysia Berhad (BIMB)
- Dual-banking system was introduced in 1993
- BNM (Central Bank) offer 3 new Islamic Banking licenses to foreign Islamic banks in 2004-2005



NATIONAL LEVEL SHARIAH ADVISORY COUNCIL (SAC)

- Highest Shari'ah authority on Islamic banking in Malaysia
- Streamline and harmonize the Shari'ah interpretations
- Advice BNM on Islamic banking and takaful operation
- Source of reference by the court of arbitrator
- Co-ordinate Shari'ah issues with respect to Islamic banking and finance
- Analyze and evaluate Shari'ah aspects of new products/schemes



SHARI'AH COMMITTEE

- Advise Board of Directors
- Endorse Shari'ah compliance manual
- Endorse and validate pertinent documents
- Assist parties that seek advice on Shari'ah matters
- Advice IFI to seek clarification
- Provide written Shari'ah opinion
- Assist SAC on reference
- Report to the Board of Directors



SHARI'AH AUDIT IN PAKISTAN AS A CASE STUDY

- State Bank of Pakistan (SBP) has adopted a Shari'ah compliance based on international best practices which consist of:
 - a. A central Shari'ah board that advises SBP on issues referred to it by Islamic Banks
 - b. Appointment of a Shari'ah Adviser in Islamic banks
 - c. Periodic internal Shari'ah review by Islamic Banking Institutions (IBI)
 - d. Shari'ah compliance audit of IBIs by SBP as a part of inspection



CONCLUSIONS

- Shari'ah audit must be done vigorously and with accurate disclosure to ensure full compliance to Sha'riah principles.
- Internal auditors, together with shari'ah boards and Shari'ah departments of their respective IFS must complement each other for a better performance in the future.
- External auditors must equip themselves with the necessary knowledge of shari'ah before auditing any particular IFI.
- Some auditing standards such as AAOIFI's can be used as a guidelines in the auditing process.