IFC & ISRA JOINT THOUGHT LEADERSHIP

Enhancing Shari'ah Assurance

Islamic Finance Council

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Contents

Foreword 4

Overview 5

Introduction 7

Audit and Assurance - A professional service 10

Issues:

- Auditing Your Own Work 12
- Use of Shari'ah Audit Opinions 14
- External Shari'ah Auditing - Limited scope audits 16
- Transparency - Enhancing disclosure 18
- Competency and Maintaining Standards 20
- Income Purification - Charitable disbursement 22

Conclusion 24

Appendix 1 - Glossary of Islamic terms 26

Appendix 2 - Glossary of acronyms 27

Foreword

Islamic finance offers a new philosophy, approach and spirit in financial dealings. Inspired by the principles and objectives of shari'ah, Islamic finance presents alternative financial practices that avoid complex derivative instruments which have no real benefit to the public and better aligns the financial sector with the real economy. Islamic finance places a higher commitment to the triumph of ethics and morality in financial transactions.

Compliance with shari'ah provides a distinct value proposition that not only gives a competitive advantage but is also the backbone of the industry.

Non-compliance implicates not only the legal dispute or financial loses, but more importantly questions the credibility and integrity of the industry. Demonstrating comprehensive compliance with shari'ah principles provides necessary assurance to the general public and financial markets.

This report jointly prepared by the IFC and ISRA attempts to address operational concerns that can improve perceptions and practices towards shari'ah assurance. The report is part of our systematic response towards developing a system that will strengthen the integrity, universality and acceptability of Islamic finance.

I express my appreciation to the IFC and ISRA teams for issuing this report. It is a significant initiative that contributes greatly in ensuring the shari'ah integrity remains firmly in place in the tremendous development of the industry.

Assoc. Prof. Dr. Mohamad Akram Laldin
Executive Director, ISRA

As Patron of the Islamic Finance Council UK (IFC), I welcome the findings in this report. The report highlights a set of considerations not for one body to address but for all those involved in the Islamic finance arena, be they shari'ah scholars, shari'ah advisory firms, standard setting bodies, product providers or regulators.

The IFC and ISRA share a key aim - the empowerment of shari'ah scholars. We believe in working collaboratively as an imperative. The UK and Malaysia are two key hubs for Islamic finance and by sharing ideas and experiences we can ensure the industry can continue to flourish globally.

No doubt, the growth and success of the Islamic finance industry has been remarkable. Ensuring customers have continued assurance in the products and associated compliance process is fundamental to maintaining the integrity of the sector.

By adopting a comparative approach with mainstream assurance practices this report provides specific proposals which can serve to strengthen shari'ah assurance frameworks. Finally, I specifically encourage individual scholars to review the considerations within this report and self adopt improved practices and encourage other scholars to do so, as we are aptly reminded in the Quran "help one another in virtue, righteousness and piety, but do not help one another in sin and transgression" (Al Ma'idah 5:2).

Lord Sheikh
IFC Patron

Overview

The continued growth of the Islamic finance industry coupled with recent legal challenges has increased scrutiny of the robustness of shari'ah governance and assurance frameworks. The rapid evolution of the sector has highlighted issues surrounding the role of shari'ah scholars, including their availability, potential conflicts of interest and consultancy versus assurance services amongst others.

Undoubtedly the demand placed on top tier scholars is uniquely challenging as Islamic finance is a horizontal discipline spreading across multiple asset classes, sectors and locations. The Islamic Finance Council UK (IFC) and the International Shari'ah Research Academy for Islamic Finance (ISRA) appreciate the challenges facing scholars and ultimately our work is designed to empower and support scholars in discharging their responsibilities towards preserving the shari'ah authenticity of the Islamic finance industry.

The need to reinforce and enhance shari'ah governance frameworks to keep pace with the rapid growth of the industry is paramount in maintaining stakeholder confidence. Inherently, assurance and governance practices designed for smaller scale emerging sectors valued at a few hundred US$bn may not necessarily be suitable for an industry which has now reportedly surpassed US$1.3 trillion with a continually increasing global footprint. Bank Negara Malaysia's (BNM) revision to its shari'ah guidelines, in Jan 2011, provides one illustration of how leading jurisdictions are evolving their shari'ah governance frameworks.

This report has taken the perspective of examining and drawing upon leading conventional external audit practices to identify select issues that can be suitably cross-fertilised to the shari'ah assurance arena. The issues identified in this report should not be regarded as exhaustive. They are intended to provide a useful basis for further discussion and translation, where appropriate, into specific legislation, exposure drafts, and standards or guidance notes by the appropriate authorities. This report highlights issues on the following specific areas:

1. Avoiding audit impairment by understanding the risk of self auditing.
2. Effective utilisation of Shari'ah Supervisory Board (SSB) audit opinions within annual reports.
3. The opportunity for established audit firms to undertake limited scope audits to provide enhanced external shari'ah audit assurance.
4. Improving transparency by enhancing disclosures by shari'ah scholars.
5. Maintaining and developing competence amongst the current and future body of shari'ah scholars through Continuous Professional Development (CPD).
6. Addressing gaps in the audit and disbursement of mandatory purification amounts by Islamic Financial Institutions (IFIs).

At the end of each section the report includes a list of "Issues for Consideration" for scholars, IFIs, industry bodies and government bodies that can assist in addressing the challenges. These include a number of proposals, such as the segregation of activities by certain members of the SSB, appointment of a SSB member as audit lead, using qualified shari'ah audit opinions, self-certification and disclosure by SSB members including annual declarations of independence.

The IFC has been active in the field of enhancing standards through its global Scholar CPD[1] programme training shari'ah scholars on conventional finance and its involvement in government-level consultancy and the UK Transparency Standard. The IFC team involved in the compilation of this report has among its members decades of audit experience (gained primarily at the "Big Four" global accountancy firms). ISRA with its unique expertise and in-depth knowledge of shari'ah, acts as a repository of knowledge for shari'ah opinions or fatwas and undertakes studies on contemporary issues in the Islamic financial industry.

Collectively the IFC and ISRA partnership provides a distinctive and expert view on the shari'ah assurance challenges facing the industry.

The objective of this report is not only to highlight problematic issues, but also to provide relevant and practical solutions. The IFC and ISRA encourage individual scholars to reflect on these issues and demonstrate leadership by taking a self-adoption approach and thereby encouraging other scholars to do likewise. In addition regulators, AAOIFI, IFSB and other relevant authorities are encouraged to consider the questions raised within and to take proactive steps in response, such as issuing consultation papers, exposure drafts, etc.

Working collaboratively towards the shared objective of enhancing the shari'ah assurance framework is paramount to maintaining the credibility of the industry, which will ultimately drive the future growth of the sector. We are happy to share our detailed findings and welcome further discussion with individual scholars, Central Banks, AAOIFI, IFSB and other relevant bodies on the issues identified in this report.

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1 The IFC (supported by CISI) has successfully developed and delivered the only global Continuous Professional Development (CPD) programme designed exclusively for those involved in shariah assurance. The programme has been successfully delivered in the UK, Bahrain, Malaysia and Dubai through partnerships and endorsements by the Central Bank of Bahrain, UK Government body UKTI, Bank Negara body ISRA and DIFC based body Hawkamah.

Introduction

From modest beginnings in the mid 1970's, the Islamic finance industry has grown to a current estimated global value of USD 1.3 trillion. Despite the global financial crisis, the expansion of Islamic Finance looks set to continue with the industry forecasting growth of between USD 3 and 5 trillion by 2016.

The fundamental requirement for any Islamic finance product is simply for it to be in compliance with shari'ah (Islamic law). Shari'ah compliance of financial products is assessed and certified by shari'ah scholars either in their individual capacity or more typically by the collective decision making of Shari'ah Supervisory Boards (SSB) within Islamic Financial Institutions (IFI). Ongoing assurance of shari'ah compliance is provided to stakeholders through the Shari'ah Compliance Certificates included in the annual audit report of an IFI.

Demystifying Shari'ah

Shari'ah is the sum of Islam's teaching and system, which was revealed to Prophet Muhammad, peace be upon him (p.b.u.h.), recorded in the Qur'an as well as deducible from the record of the Prophet's divinely-guided life called the *Sunnah* (i.e. words, actions and tacit approval of the Prophet). Some scholars take the view that all commandments of Allah to mankind are part of shari'ah. Each one of such commandments is called *hukm* (pl. *ahkam*).

Fiqh, (Islamic jurisprudence) is the product of a deeper understanding of shari'ah and allows interpretations based on the relevant context. The study of the bases of fiqh is referred to as *usool-ul- fiqh* (principles of Islamic jurisprudence) and utilises elements such as scholarly consensus (*ijmaa*), analogy (*qiyas*) and scholars' reasoning *(ijtihad*). These principles and guidelines are applied by a scholar (*faqhi*) to formulate a legal ruling (*fatwa*). Shari'ah scholars determine that a financial product or structure is shari'ah compliant by issuing their opinion as a legal ruling.

Scholars have often viewed shari'ah as a pyramid with the *Maqasid* (purpose of the shari'ah) at the top, followed by usool-ul-fiqh (principles which derive rulings from shari'ah), thereafter *qawaid fiqhiyyah* (legal maxims) and finally the fatwa (specific rulings issued by scholars) as illustrated in the diagram below. The maqasid is seen as the pinnacle

of the system and in this regard certain current Islamic financing structures have received criticism for their apparent dearth in applicability or focus on maqasid. A key challenge to the continued growth of the Islamic finance industry is the need to provide confidence to customers that Islamic finance products are in both substance and form shari'ah compliant.

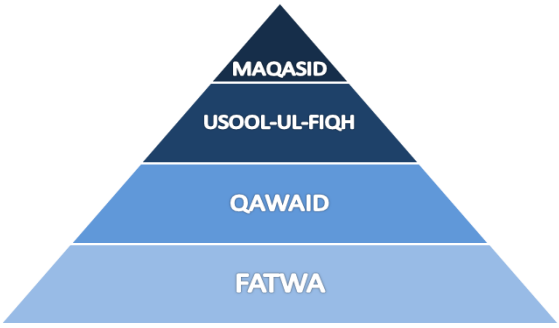

Diagram 1: Shari'ah Pyramid, Utrujj Foundation, London.

The law of Allah and its inner meaning is not easy to interpret and shari'ah regulates all human actions. This is why it is not "law" in the narrower modern sense as it contains a comprehensive set of principles and legal and ethical doctrines. It is basically a doctrine of duties, a code of obligations. For this reason, although legal considerations and individual rights have a place in it, these are only aspects of the broader role of shari'ah in providing a religious perspective and evaluation of the affairs of life as a whole.

Historical Role of Assurance Frameworks in Islam

Assurance and governance is by no means alien to Islamic practice. The principle itself is deeply rooted in the established concept of Islamic governance also known as the institution of hisbah (ombudsman/ market regulator). Historically, hisbah was initiated by the Prophet Muhammad (p.b.u.h) as an institution to govern and supervise commercial transactions in the market. The Prophet appointed a number of officers to supervise and monitor market operations and other trading activities. These officers were given special titles such as *Sahib al-Suq* (market supervisor) or *Al-Amil fi al-Suq* (market officer). Their roles and responsibilities included ensuring the market was free from any element of exploitation, deception and unfairness. They were also responsible for ensuring that traders complied with all the principles, values and ethical codes outlined by the Islamic law.

The practice of hisbah continued to be implemented throughout Islamic history from the time of the Prophet until the end of 19th century. In fact the word Sahib al-Suq was replaced during the Ummayyah period by the term *Muhtasib (*an officer in-charge of monitoring and supervising the market operation).

The institution of hisbah highlights the importance of market regulation and governance in Islamic jurisprudence. It provided two-tier filtration of economic and commercial activities. The first level of filtration involves creating consciousness and awareness among the market participants of the importance of abiding by the moral and legal rules prescribed by shari'ah. The second level of filtration is evidenced by the presence of a muhtasib who will continuously monitor and promote good market practices and prevent negative ones.

Current Assurance Frameworks in Islamic Finance

The development of contemporary shari'ah governance frameworks in Islamic finance has been primarily led by select central banks and two international organisations: the Accounting and Auditing Organisation for Financial Institutions (AAOIFI) and the Islamic Financial Services Board (IFSB). The International Islamic Fiqh Academy, established by the Organisation of Islamic Countries (OIC), has also played an important role historically in the issuance of fatwa regarding certain financial structures.

On the basis of recently completed research conducted by ISRA, there are broadly three different models of shari'ah governance adopted by various jurisdictions. The first is centralized shari'ah governance, which applies to jurisdictions having their own centralized bodies governing Islamic finance such as Malaysia, Indonesia and Pakistan. Second is an exclusive shari'ah body, which applies to jurisdictions having their own central body governing Islamic finance but which is restricted to its Central Banks alone such as the UAE and Bahrain. The third category is self-regulatory shari'ah governance, applying to jurisdictions where shari'ah decisions are made at the institution level with very little, or no, government intervention, such as the UK and France.

AAOIFI issues standards and guidance on accounting, auditing, governance, ethics and shari'ah standards for Islamic financial institutions and the Islamic finance industry. Other areas covered by IFSB include standards and guidance on capital adequacy, corporate governance, risk management and transparency. Shari'ah governance standards published by both AAOIFI and IFSB include guidance on areas such as Shari'ah Supervisory Boards, Central Shari'ah Boards, Shari'ah Compliance Manual, Fit and Proper Criteria, Conflict of Interest rules, Disclosure requirements and Shari'ah Review Units.

IFSB	AAOIFI
11 published standards	26 Accounting Standards
5 guidance notes	5 Auditing Standards
1 technical note	7 Governance Standards
	2 Ethics Standards
	45 Shari'ah standards
189 Members	187 Members

[as at July 2012]

Report Methodology

The approach taken by this report has been to consider existing shari'ah assurance practices in light of current market norms within the conventional assurance arena.

The report has been based on the collective insights and experience of the IFC and ISRA teams, including their professional interactions with IFIs in Malaysia, GCC and the UK.

In addition the Annual Reports of seven large Islamic banks across multiple jurisdictions for the most recent three years available were reviewed to specifically evaluate their level of disclosure relating to the shari'ah assurance process. An analysis of AAOIFI, IFSB and BNM shari'ah guidelines along with a limited literature review was also undertaken.

The remainder of this report analyses six distinct areas and provides specific practical proposals towards improving assurance practices related to shari'ah compliance.

Audit and Assurance
A professional service

Islamic financial institutions employ shari'ah scholars as consultants on their Shari'ah Supervisory Boards (SSB). The role of the shari'ah scholar as part of the SSB typically includes advising on the design of Islamic financial products (ex-ante) and attesting on the ongoing compliance and execution of the products (ex-post).

With both design and compliance activity being performed by the same shari'ah scholar, a dual role is formed. Each role has its own professional requirements, however, the compliance element in particular gives rise to a number of issues which the SSB members must consider throughout their involvement in the design and execution of the products.

A parallel can be drawn between the requirement for assurance on shari'ah compliance in the Islamic finance industry and the requirements for external audit assurance over financial statements. Independent external audit provides assurance over financial statements for which a key requirement is that the external auditors ensure that there is no actual or perceived impairment to their independence.

An examination of current market practice for providers of audit and assurance services highlights a number of regulations and guidelines which act as safeguards and must be adhered to for individuals or firms to qualify to provide such services. Similarly, in performing compliance activities shari'ah scholars should be unbiased and avoid scenarios that could lead to questions over the objectivity of their review activities. The integrity of the SSB is paramount and where appropriate existing conventional market best practices as employed by audit firms should equally be applied to enhance the robustness of the shari'ah assurance process.

Examples of guidelines, professional standards and legal requirements, which act as a safeguard to independence and self-review for audit practice firms are listed in the table below.

MITIGATION	ILLUSTRATIVE EXAMPLE
Audit Guidelines	International Standards of Auditing (ISA) ISA 220 requires that for each audit engagement, the engagement partner forms a conclusion on compliance with independence requirements.
Professional Standards	Institute of Chartered Accountants in Scotland (ICAS) Code of Ethics sets out that: *"In the case of audit engagements, it is in the public interest and, therefore, required by this Code of Ethics, that members of audit teams, firms and network firms shall be independent of audit clients." (Section 290.4)*
Regulatory Requirements	US Sarbanes Oxley Act set out: - Restrictions on non audit services that can be provided by an auditor - Audit Committee approval on services being provided by the auditor - Disclosures on services provided by auditor and fees paid to auditor - Partner rotation requirements - Auditor reporting to Audit Committee on specific issues
Internal Firm Procedures	Audit firms will have processes and policies in place to consider the independence implications of each audit engagement. This will include reviews of audit staff connections to clients and the audit and non audit services provision to clients.

The breadth and depth of the guidance continues to grow as regulators and practitioners enhance safeguards for improved independence and objectivity. The continuous evolution of safeguards has become increasingly important following major audit scandals such as WorldCom, Enron, Parmalat and the collapse of Arthur Andersen.

The Islamic finance arena has also recently witnessed an increasing number of operational concerns. These have included conflicting shari'ah opinions, multiple SSB roles held by a small number of scholars, confidentiality concerns, sukuk (Islamic bonds) defaults and associated legal actions challenging agreements on grounds of their lack of Islamic validity in the first place and public disagreements among scholars on issues such as the Goldman Sachs sukuk.

In light of these issues, the need to apply a professional approach to the shari'ah assurance arena has become increasingly urgent. Accordingly the importance of the following topics should not be underestimated.

Auditing Your Own Work

SSB members are involved in the design of financial products and frequently will perform the subsequent compliance activity in relation to these same products.

Involvement in both activities gives rise to a real possibility that the shari'ah scholar will undertake compliance reviews of their own design work. This likelihood of self-review (i.e. evaluating one's own work) contains an inherent risk of the shari'ah scholar's independence being impaired in practice or in perception.

Large multinational audit firms often provide a range of services which include audit and assurance services and non-audit services (e.g. advisory, tax). Where firms provide audit services, they are however restricted by various professional regulations, auditing standards, ethical standards and local regulations which act as safeguards as to the non audit services (if any) that they can provide. Each service provided by the audit firm must be considered on a case by case basis to assess any perceived threats to independence and the safeguards needed to reduce such threats to an acceptable level.

In certain instances firms will forego audit engagements so that they can provide non-audit advisory services. This has a twofold advantage, firstly there will be less restriction on the number and nature of services that the audit firm can provide (e.g. tax, transaction advisory, restructuring, operational improvements etc.), and secondly the fees generated from non-audit services are likely to be significantly higher. Often providing non-audit services is considered to be more lucrative.

Established audit firms have built safeguards into their client/engagement acceptance process to ensure their independence. The acceptance process will include a reference to ethical standards which require the auditor to conduct the audit of the financial statements of an entity with integrity, objectivity and independence (Auditing Practice Board (APB) Ethical Standard 1.6). Examples of perceived threats to independence include: acting in a management role, participations involving self interest (i.e. marketing products/services with the client) and agreeing contingent fees.

Scholars extensively involved in providing consultancy advice on the design and development of select products may give rise to independence and objectivity concerns. Ascertaining the depth of advice provided is important to determine if there is a risk of independence impairment; for example if a SSB member is asked whether a particular structure is compliant and the answer is no with an explanation as to why, then this can be deemed as clarification but not a design role. However if the SSB Board Member is then asked to restructure the product to make it compliant then this is likely to be deemed a significant design activity.

ISSUES FOR CONSIDERATION

The threat of SSB Members performing self-review needs to be examined in detail with a view to develop mitigating strategies. The issue is further accentuated by the limited number of scholars in the market place which must be considered in addressing the challenge proportionately.

Potential solutions could explore requiring segregation between those shari'ah scholars who undertake the design of a product and those scholars that are involved in the compliance activity for the product. Practical considerations in implementing this segregation of duties can include:

- **Clarity and Guidance for SSB Members**
  Provision of guidelines explaining when an SSB member is performing a role that is significant enough to be deemed as contributing to the design of a product to an extent that would impair them from being involved in the audit (due to self-review risk).

- **Appointing a Lead Audit SSB Member**
  In light of the limited number of recognised scholars, SSB members can consider implementing ethical barriers to promote separate design and compliance activities by nominating one of the SSB members to be the exclusive lead on audit and compliance. Typically there tends to be a minimum of 3 persons involved (AAOIFI Governance Standard 1) thus appointing one to be audit lead (potentially on a rotating basis) should in practice be possible. For example at an SSB meeting, where the client desires to discuss details on product development and design the lead audit SSB member can withdraw from that part of the meeting.

Use of Shari'ah Audit Opinions

In the annual report of an IFI, the SSB will provide a Shari'ah Supervisory Board Report which will include an opinion on compliance with Islamic Shari'ah rules and principles.

This provides stakeholders with the assurance that the IFI's activities and products sold during the specified period have been in compliance with shari'ah. The SSB provides this opinion based on the audit work it has performed during the year.

The SSB Opinion may be compared to the Auditor's report included in conventional annual accounts. The output of a conventional financial statements audit includes the production of an Auditor's Report incorporating an Auditor's Opinion which can, in certain situations, include an 'emphasis of matter' paragraph. External audit reports are based on the relevant Auditing Standards (e.g. ISAs) and local regulations (e.g. UK Companies Act 2006). In conventional audit the types of audit opinions found within the annual financial statements include:

- Unqualified opinion – that the financial statements give a true and fair view and are prepared in accordance with the applicable financial reporting framework.
- Qualified opinion – where an unqualified opinion cannot be given but disagreement or scope limitation is not material or pervasive to the extent an adverse opinion or disclaimer needs to be issued.
- Adverse opinion – where disagreement is material and/or pervasive and requires disclosure.
- Disclaimer – where scope limitation is so material and pervasive that sufficient appropriate evidence could not be obtained and an opinion on the financial statements cannot be expressed.

An Emphasis of Matter paragraph is normally placed after the opinion paragraph and is defined in the International Standard on Auditing 706 as "a paragraph included in the auditor's report that refers to a matter appropriately presented or disclosed in the financial statements that, in the auditor's judgment, is of such importance that it is fundamental to users' understanding of the financial statements."

Limited guidance on the format of the shar'iah audit report that is to be included in the financial statements of IFIs is issued by AAOIFI (Governance Std 1). There is no detailed guidance on categories of opinion comparable to those noted above and there is no mention of the possibility of including other paragraphs (such as Emphasis of Matter or Other Matter). The current BNM Shari'ah Governance Framework and the IFSB Standard on Shar'iah Governance (Dec 2009) are relatively silent on the issue of qualified audit opinions and do not provide guidance on the content structure of the annual shari'ah audit report.

In our review, no instances of qualified opinions, in any manner, were found.

ISSUES FOR CONSIDERATION

The Annual Report of the Shari'ah Supervisory Board is a mechanism that can empower a SSB. AAOIFI, IFSB and other bodies should consider developing Guidance Notes on incorporating additional categories into the Report, such as qualifying statements (opinions) on compliance and Matters of Shari'ah Emphasis.

Qualified Compliance

For cases of qualified compliance a range of opinions could be developed to reflect different levels of qualified compliance. For example a 'qualified' shari'ah opinion might be issued when there are one or two instances of a breach in shari'ah compliance. The Report could state that the areas being audited are shari'ah-compliant but with certain exceptions. These exceptions might sometimes be the result of regulatory requirements when operating within secular environments (for e.g. the compulsory utilisation of government deposit insurance which is not based on takaful principles).

A qualified opinion might also be issued when there is a limitation of scope, for example when access to certain documentation is not possible or restricted. An explanatory paragraph could explain the reasons for qualification.

A qualified opinion could further be used to highlight the use of a particular structure which may raise a known difference in opinion between jurisdictions. For example certain structures accepted in Malaysia may not be accepted by scholars within the GCC. As a case in point, in Malaysia bai-al-inah or sale and buy back involving two parties is generally accepted and used to structure various cash-line and personal financing products. On the other hand within the GCC this structure is broadly disallowed. Another example is the utilisation of the tawaruq structure which has come increasingly under scrutiny and forms of which have recently been deemed not shari'ah compliant by the OIC International Fiqh Academy and other bodies. Reporting on such enhances transparency for international investors on such sensitivities.

Matters of Shari'ah Emphasis

Other factors that the SSB has identified as of concern could be disclosed in a paragraph similar to an emphasis of matter paragraph in the Report. The SSB might incorporate within the Report areas that the SSB considers the management of an IFI has not sufficiently addressed. For example there may be concerns that management has failed to improve product design and is over-reliant on contentious structures that may not be aligned with the maqasid.

On occasion the SSB could allow, by exemption, certain 'grace' periods to utilise certain less favourable structures on an assurance from management that they will be converted within an agreed period of time. Reporting where these exceptions lie and detailing where the 'grace' periods are close to expiry could be made as an emphasis of matter. Such issues could apply both to banks and asset managers acting in the private equity arena. Further, there may be certain issues of concern arising from qualitative analysis of listed screened stocks where SSB members have strong reservations.

The ability to include such issues with the annual SSB Report empowers the SSB to exert pressure on management and also enables the individual scholars to discharge their duty of care to key stakeholders (e.g. shareholders, customers, etc.) in a transparent manner which also protects their personal integrity.

Illustrative examples of qualified shari'ah compliance opinions with suggested wording should be developed by Islamic finance industry regulators such as AAOIFI and IFSB.

External Shari'ah Auditing
Limited scope audits

A common practice adopted by IFI's to provide assurance over shari'ah compliance is the use of an Internal Shari'ah Compliance Unit (ISCU). The ISCU teams are historically a unit independent from the traditional internal audit department, exclusively involved in the review of shari'ah compliance.

Debate within the Islamic finance industry is ongoing as to the potential for ISCUs to be integrated within internal audit departments, as this appears to be the most efficient and appropriate place for them.

Separately from the internal audit work, the key source of assurance over financial reporting and internal control for stakeholders is the work performed by external auditors, as required by local regulation. In the case of Malaysia, the BNM Shari'ah Governance Framework prescribes that the function of shari'ah audit is to be carried out by the internal auditors, who must have acquired adequate shari'ah-related knowledge and training. However, utilising internal audit staff as part of the external audit team raises concerns on the level of reliance that can be placed (APB ES2). The Guidelines also indicate that the IFI may alternatively engage an external audit party to conduct an annual shari'ah audit as long as the scope is sufficient to cover the shari'ah audit requirements.

As the Islamic finance market evolves and increases in range and sophistication, the requirement for external shari'ah auditors will naturally increase. Currently top tier accountancy firms, such as the "Big 4", have no or only limited external shari'ah audit offerings; however they all clearly have the necessary skills to undertake a robust risk and controls based audits.

Ultimately it is the SSB which is opining on the shari'ah authenticity of the IFI, although they are relying on the work undertaken by the ISCUs. Since many of the ISCU members are not adequately trained auditors or qualified accountants this gives rise to a potential systemic limitation which is a natural challenge posed to a young industry experiencing rapid growth. The up-skilling of the junior scholars within the ISCU and the increased integration of the ISCU with the internal audit teams will address some of the issues over time. However there remains, in practice, a large gap in the performance of external shari'ah audits by suitably qualified firms.

ISSUES FOR CONSIDERATION

An IFI could consider appointing established external audit firms to perform audits which address the accounting and governance standards set by AAOIFI, IFSB and local regulatory bodies such as BNM and the State Bank of Pakistan (SBP), where relevant.

The SSB could appoint the existing external auditors or alternatively an independent audit firm to perform a 'limited scope shari'ah audit' to encompass selected shari'ah compliance work, reporting their findings directly to the SSB (Shari'ah Committee, per BNM) and Audit Committee. Limited scope audit findings can provide higher assurance to a SSB given it has been performed by an independent, external auditor with the specific required skills and experience.

The limited scope audit work would not interfere with the statutory external audit requirement, where relevant, but reliance could be placed on the work undertaken where the limited scope shari'ah audit work was undertaken by the incumbent external auditor. This would align shari'ah audit practice with existing market practices where both internal and external auditors are utilised.

The limited scope could be set by the SSB to cover select sensitive balances and gain additional assurance where SSB and the company management feel they have limited reliance on the ISCU work.

Issues to be considered by external auditors when creating relevant audit programmes to undertake a limited scope shari'ah audit can include:

- Identification of areas of high sensitivity, regardless of materiality. For example if IFI staff are from a diverse background, expense reimbursements should be checked specifically to ensure they do not include purchase of alcohol, pork, etc. Service contracts with third parties (e.g. company car leases, leases for photocopiers, rent, etc.) might be examined to identify any possibility of contractual interest charges. Where possible these could be renegotiated to remove such non-compliant elements.

- Audit test plans can incorporate certain sensitive balances or specific testing thereby providing additional assurance on shari'ah compliance.

- Purification payments and disbursements of late payment fees can be deemed to be a sensitive area over which specific additional audit procedures can be performed. This issue is considered in further detail later.

- Results would be reported to the SSB in the form of an "Additional Audit Findings for SSB and Management" report.

Transparency

Enhancing disclosure

In professional services such as accountancy and law, service providers are required to be objective. Any perception of the impairment of a professional's independence will lead to concern that adequate due diligence and professionalism has not been applied in the performance of their work.

Applying the same professional attitude to shari'ah scholars providing shari'ah audit services, it is equally important that they are objective and diligent in performing their roles and apply suitable best practice market disciplines in the course of discharging their responsibilities.

Alongside the challenge to independence from self-review, SSB members' impartiality can be impacted by the threats of self interest and familiarity. Where SSB members have financial interests (e.g. shareholding) in an IFI or are connected to individuals that benefit from the success of an IFI that they are appointed to, then there is inherent risk to the independence of the SSB member. Appropriate disclosures are critical in dealing with such risks.

For example, International Accounting Standard (IAS) 24 issued by the International Financial Services Board sets out disclosures required in respect of an entity's transactions with related parties. Under IAS 24 the definition of related parties include members of key management personnel of the entity and close members of their families. Financial interest, non-financial interest or ability to influence outcome amongst other factors would all exclude a person from involvement in an audit. An example might be a where a key member of the audit team or SSB has an Islamic mortgage or deposit account with the IFI, which could be deemed to constitute financial interest.

Bodies regulating professional services typically set out within the code of conduct for their members' requirements and restrictions designed to mitigate any threat to independence. For example, the Association of Chartered Certified Accountants (ACCA) code of conduct sets out areas of risk to independence and certain restrictions on members. For example:

- Family and other personal relationships: Statute prohibits any officer/employee of the company from accepting appointment as an auditor of the company. A member should likewise not accept appointment if he has been an officer/employee of the company in last 3 years.

- Beneficial interest in shares and other investments: A member should not have an Individual Savings Account or similar which has among its investments an audit client. Shares acquired by a partner in the relevant firm should be disposed of at the earliest practicable date, or the firm disengage from the assignment.

Shar'iah consultancy firms

Where shari'ah audit is provided, disclosures relating to the audit firm itself are relevant in evaluating audit quality or the availability and delivery of audit services amongst shari'ah consultancy firms. Such disclosures can be grouped as follows: 1) network, governance and management of audit firms; 2) quality and control systems; 3) human resource policies and procedures, including training; and 4) independence and ethics. Such information can be provided on a voluntary basis, usually either on the company's website or as part of a Transparency Report.

In addition to the above, most local regulation (e.g. US SEC Nov 2000) requires transparency over the fees audit firms charge their clients. This is usually notified by a disclosure in the notes to the annual financial statements where fees levied for both audit and non audit services must be detailed. This requirement arose as a result of the concern that non-audit services were increasing in magnitude and consequently could compromise auditor independence. The disclosure was designed to give investors an "insight into the relationship between a company and its auditor". Shari'ah scholars similarly often provide both a consultancy service (related to product design) and an annual audit service.

ISSUES FOR CONSIDERATION

The Islamic finance industry should look to adopt best practice from conventional market practices where appropriate. As part of the SSB role is similar to that of an external auditor, disclosure requirements for external audit firms should be examined with select elements being incorporated within the Annual Report and/or the annual SSB Report.

Enhanced disclosure improves transparency and can be undertaken on a voluntary basis in a manner that encourages self-regulation. Alternatively regulators and/or standard setting bodies such as AAOIFI or IFSB could consider setting minimum disclosure requirements for the SSB (or shari'ah consultancy firm where it is providing the shari'ah assurance service).

Potential examples of disclosure requirements for the SSB include:

- Disclosure of fees paid to SSB members within IFI annual reports (split by audit and non-audit), similar to disclosures of fees paid to external auditors.

- An annual declaration of independence by SSB members to a suitable professional body or regulator.

- Specific confirmation to the IFI by shari'ah scholars before accepting an SSB position that working for the IFI does not create a conflict of interest and that there are no other matters such as personal bankruptcy or criminal convictions that the IFI should be aware of.

- Disclosure by all personnel involved in the audit (SSB, ISCU members, etc.) of any interests such as shareholdings, a relative/related party working in a senior role in the IFI, commercial relationships as a customer or supplier (either with the individual or with a related/linked company of which the SSB or any relative may be a director), etc. Currently AAOIFI, IFSB and BNM have guidelines on independence applying to the SSB and a limited 'negative list' of exclusionary situations. Enhanced advice through a Guidance Note including issues such as holding bank accounts, loan facilities, etc. could be beneficial for those involved in the shari'ah audit process.

Competency and Maintaining Standards

The audit profession recognising the criticality of meeting stakeholders' needs has developed mechanisms that ensure audits of appropriate quality are performed.

Auditors are required to be suitably qualified with accountancy or audit qualifications and experience relevant to the role of an auditor. Qualifications and standards on internal auditing are available from the Institute of Internal Auditors. The qualifications of external auditors are generally set out in legislation in each jurisdiction. For example in the United Kingdom only Recognised Supervisory Bodies such as the Institute of Chartered Accountants in Wales and England can register and supervise auditors. These bodies in turn set out minimum qualifications and criteria for individuals to be able to perform the role of an auditor. The external auditor will also be required to comply with appropriate audit regulations such as the International Standards on Auditing.

Similarly, the performance of shari'ah compliance activity should be performed by appropriately qualified and competent individuals, who are both versed in suitable audit techniques and the shari'ah subject matter.

Professional training and Continuous Professional Development (CPD)

Being suitably qualified requires both a minimum level of knowledge and skill as an entry criterion, and also the need to have ongoing training. With a fluid and developing financial market and complex products constantly being developed, if compliance staff do not maintain their knowledge and skills there is a risk they will not be able to perform compliance work to a professional standard. Shari'ah scholars working as advisors to an IFI need also to consider the risks of litigation over the advice they provide as increasing litigation activity related to Islamic finance is being seen in courts. Initiatives in the Islamic finance industry specifically addressing the issue of competence include "fit and proper" criteria set by industry regulators and the Islamic Finance Council UK's Scholar Professional Development Programme developed exclusively for shari'ah scholars.

The *IFC Scholar Professional Development Programme* is an international conventional markets training programme designed specifically for shari'ah scholars and those associated with the shari'ah assurance process. Developed by the IFC and assisted by the

Chartered Institute of Securities and Investment (CISI) the programme takes a CPD (Continuous Professional Development) approach to empowering shari'ah scholars by providing them with a comprehensive and up to date understanding of conventional financial markets, covering both key fundamental mechanics and contemporary issues. Elements of Islamic finance are also covered.

The programme began in London in 2008 and is endorsed by the UKTI. It has run in partnership with ISRA in Malaysia, with the Central Bank of Bahrain in Manama and with Hawkamah Institute for Corporate Governance in DIFC. Both IFSB 2009 shari'ah standards (Principle 2.2) and BNM guidelines (Principle 4) have highlighted the need for regular training of scholars.

Fit and proper criteria

Leading professional associations impose requirements for their members to continue to meet "fit and proper" criteria. For example the Institute of Chartered Accountants in England and Wales (ICAEW) requires that new members are confirmed as fit and proper persons and provides guidance on the relevant criteria:

Fit – competence to fulfil responsibilities as a member considering qualifications, knowledge, skills, experience and reliability.

Proper – character and suitability for membership adhering to ethical standards, professional standards, behaviour and financial integrity.

In the Islamic finance industry regulatory bodies such as BNM and SBP state that shari'ah scholars must match the 'fit and proper' criteria prior to their appointment to the board. In BNM's shari'ah Governance Framework, it is stated that the majority of shari'ah board members should hold at least a bachelor's degree in shari'ah, including study in Usul ul Fiqh or Fiqh Muamalat, from a recognised university. SBP has similar criteria requiring board members to hold a shari'ah degree and have had exposure to banking and finance.

The BNM and SBP requirements for qualifications and experience are similar to the "Fit" requirements as set by ICAEW; the gap there appears to be in Islamic finance is the lack of guidance for individuals to be "Proper".

ISSUES FOR CONSIDERATION

Fit and proper criteria

IFSB, BNM, AAOIFI should have guidelines further addressing "fit and proper" criteria covering in detail elements of character and shari'ah background. Specific consideration should be given to including an explicit requirement of undertaking a basic auditing course (or other such relevant certification or qualification), as undertaking the annual shari'ah audit is one of the core activities of the SSB. As suggested earlier, if a lead audit member of the SSB is appointed this requirement could be placed on that individual as opposed to the whole SSB. IFI's should make available and provide the necessary training for the SSB lead audit member (for say a 1 or 2 week course to gain the AAOIFI CSAA certification).

Continuous Professional Development (CPD)

A CPD programme similar to that described above for shari'ah scholars would assist scholars in keeping up-to-date with new product features and contemporary issues. Governing bodies should consider setting a minimum number of CPD hours required on an annual basis and IFI's should issue a declaration that their SSB members have met the necessary requirements.

A professional body for shari'ah scholars should be established to which scholars can annually self-certify their CPD requirements as having been met through an annual return. Individual scholars should maintain a record of their personal learning plan and development roadmap.

Income Purification

Charitable disbursement

IFIs are expected to conduct their business activities within shari'ah rulings from which they generate lawful income. However, haram (impermissible) income may arise when a non-shari'ah compliant business activity is inadvertently undertaken.

This commonly occurs with Islamic asset managers investing in listed stocks where the companies may generate a portion of their income from non-permissible means (e.g. bank interest income). This requires the IFI to undertake a periodic purification of dividends.

Late payment fees

In addition Islamic banks may charge penalty fees to customers for late or defaulted payments. From a shari'ah perspective the penalty charge is acceptable within a context, however so as not to constitute riba (interest) the bank is not allowed to have a net financial benefit from this income, thus it is required to be disposed of to charitable causes. The IFI cannot have any direct or indirect benefit from this source, for example they cannot openly sponsor events using such income as this could lead to positive publicity and consequent commercial benefit.

Existing disclosure practices

AAOIFI guidelines state that disclosure of purifications amounts should be made within the annual Shari'ah Report. AAOIFI guidelines further note that the disclosure should state that all non-permissible income sources 'have been disposed of' whereas BNM guidelines note the disclosure should state 'have been considered for disposal'.

BNM Guidelines also prescribe the need for the establishment of a Shari'ah Risk Management function as one of the important organs of governance. Amongst its main functions is 'measuring the potential impact of such risks to the IFI, based on the historical and actual de-recognition of income derived from shari'ah non-compliant activities'.

As income purification is a key requirement for shari'ah compliance and can be perceived as an area of sensitivity and accordingly a more robust reporting and audit requirement should be considered for income purification and disbursements to charity.

Our review of IFIs indicated the disclosure of purifications and charitable disbursements is limited. Only one IFI has disclosed the distribution of non-shari'ah compliant income. The review disclosed a lack of evidence as to whether any of the other IFIs had indeed received any non-permissible income, and if they had, the amount involved and whether it had been disbursed.

ISSUES FOR CONSIDERATION

Disclosure

AAOIFI, IFSB and national regulators should set additional requirements for disclosures in IFI Annual Reports relating to income purification and disbursement to charities, due to the inherent sensitivities associated with these funds. Additional disclosures can include:

- Value of impermissible income and late payment fees relating to the period, including any contingent amounts.
- Purification amounts that have been disbursed during the period with explanations for any non-disbursed amounts.
- Reporting on the nature of the charities supported and their social impact.
- Confirmation from management that the IFI has not benefited from the disbursement of purification amounts.
- Related party transactions where IFI's have close connections with any of the receiving charitable organisations.

Compliance audit

Shari'ah compliance activity should include testing on purifications and charitable disbursements. Testing should confirm whether management have appropriately identified, calculated and disbursed non-permissible income. Substantive testing can include the recalculating and tracing of disbursements to third parties, including reviewing the documentation and confirming the beneficiaries.

Conclusion

Although shari'ah assurance is an issue unique to the Islamic finance industry, the mainstream audit and assurance industry has over time developed and embedded practices and mechanisms that address what are in essence similar underlying challenges.

The comparative approach adopted in compiling this report provides a distinctive perspective which has highlighted a number of issues for shari'ah scholars, shari'ah advisory firms, multilateral standard setting bodies and local regulators to consider.

A number of proposals have been presented in this report. We believe these could play a significant role in enhancing shari'ah assurance robustness while at the same time empowering individual shari'ah scholars to ensure the direction of the industry remains aligned with the highest principles of shari'ah.

We would strongly encourage a process of self regulation by scholars and advisory firms by voluntarily adopting certain of the solutions presented in this report. Regardless of legal requirements scholars have the individual choice to adopt better practices, which indeed is encouraged and reflected in the Islamic philosophy of the constant striving for ihsaan (excellence). Due to the limited number of top tier scholars, adoption by even one can have an immense impact in shaping the industry and encouraging other scholars to adopt similar improved practices.

An evident gap in Islamic finance is the presence of a professional services body for shari'ah scholars. In most professions (medicine, law, accountancy, banking etc.) a common feature is the existence of a professional body that accredits, regulates and supports its individual members. In mainstream accounting and auditing a number of bodies have been established, such as ICAEW or ICAS, which are recognised by law with external audit requirements typically stipulating that external auditors are required to be members of such recognised professional bodies.

A number of the considerations noted in this report could be effectively addressed by the establishment of a global professional body for shari'ah scholars in Islamic finance, which AAOIFI and other bodies should strongly consider. We believe that affording the same professional regard to shari'ah scholars as their mainstream equivalents and establishing a truly global professional body for scholars could play a significant role in the future development of the Islamic finance sector.

The Islamic finance sector has undergone an exciting journey over the past decade, demonstrating positive growth and attracting global interest. As the next phase of the journey begins, the need to maintain shari'ah integrity has increasingly become a central issue. Against a backdrop of seismic collapse in the conventional banking system and the unveiling of the moral bankruptcy inherent within the prevailing unchecked capitalistic model, Islamic finance has the opportunity to present an alternative approach. The principles underlying Islamic finance if properly applied can lead to a more equitable distribution of wealth, systemic stability and a higher regard to social impact. These are solutions that many in society are currently seeking.

Ensuring that the highest principles of shari'ah are embedded in the structures of the Islamic finance industry is the responsibility with which today's shari'ah scholars are charged. The IFC and ISRA are committed to empowering and assisting scholars by encouraging best practice. We believe by working together and providing positive mutual support the Islamic finance industry can continue its stellar growth with the principles of shari'ah firmly embedded at its heart.

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Appendix 1 - Glossary of Islamic terms

Al-Amil fi al-Suq	Market officer
Bai-al-inah	Sale and buy-back agreement
Fatwa	A ruling on a point of Islamic law given by a recognised authority
Fiqh	Islamic jurisprudence
Fiqh Muamalat	Islamic rulings on commercial or trading transactions
Ihsaan	Striving to reach perfection in any circumstances or situations particularly in the worship of Allah
Haram	Unlawful, illegal and impermissible
Hisbah	The enjoining of a good that has been evidently abandoned and the forbidding of an evil that is openly practised. In Islamic economics, it is a system of state inspection to ensure fair practices in markets
Hukm/Ahkam	Islamic commandments or orders
Ijmaa	Consensus of Islamic scholars
Ijtihad	Independent or original interpretation by Islamic scholar(s)
Maqasid	Objectives, purposes, goals, intents and underlying principles
Muhtasib	Officer in-charge of monitoring and supervising market operation
Qawaid	Legal maxims
Qiyas	Analogical reasoning as applied to the deduction of juridical principles from the Qur'an and the Sunnah
Riba	Usury or specifically any excess paid/given or received/taken over and above the principal in a debt contract (Riba Nasi'ah) or in a barter transaction (Riba al-Fadl)
Sahib al-Suq	Market supervisor
Shari'ah	Islamic code of law derived from the teachings of the Qur'an and the Sunnah
Sunnah	Words, actions and tacit approval of Prophet Muhammad (p.b.u.h) that have become models to be followed by all Muslims
Tawarruq	Buying an item on credit and selling the item on spot to get cash

Appendix 2 - Glossary of acronyms

AAOIFI	Accounting and Auditing Organisation for Islamic Financial Institutions
ACCA	Association of Chartered Certified Accountants
APB	Auditing Practices Board
BNM	Bank Negara Malaysia (Central Bank of Malaysia)
CISI	Chartered Institute for Securities & Investment
CPD	Continuous Professional Development
CSAA	Certified Shari'a Adviser and Auditor
DIFC	Dubai International Financial Centre
GCC	Gulf Cooperation Council
IAS	International Accounting Standards
ICAEW	Institute of Chartered Accountants in England and Wales
ICAS	Institute of Chartered Accountants of Scotland
IFC	Islamic Finance Council UK
IFI	Islamic Financial Institution
IFSB	Islamic Financial Services Board
IOSCO	International Organization of Securities Commissions
ISA	International Standards on Auditing
ISCU	Internal Shari'ah Compliance Unit
ISRA	International Shari'ah Research Academy for Islamic Finance
OIC	Organisation of Islamic Countries
PEP	Personal Equity Plan
SAMA	Saudi Arabian Monetary Agency
SBP	State Bank of Pakistan
SEC	Securities and Exchange Commission
SSB	Shari'ah Supervisory Board
UKTI	UK Trade & Investment

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Islamic Finance Council

The Islamic Finance Council UK (IFC) is a not-for-profit body established to promote and develop the Islamic finance industry. The IFC has been appointed to advise a number of governments and pioneered the development of a global educational programme for shariah scholars the only one of its kind. The programme has received endorsement from government agencies in UK, Bahrain, Dubai and Malaysia. The Board Members of the IFC represent a unique group of highly qualified professionals spanning the banking, legal and financial advisory sectors.

The IFC has developed expertise in four key areas:

1. Government Advisory: policy development, technical capacity building and drafting regulatory frameworks for government agencies (tax, regulatory authorities, etc.)

2. Shari'ah Governance: running the only global CPD training programme for shariah scholars and developing shari'ah audit frameworks

3. Thought leadership and education & awareness campaigns

4. Ethical finance: promoting better co-ordination and an enhanced understanding of the shared values amongst operators in Islamic finance and the broader ethical finance arena

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The International Shari'ah Research Academy (ISRA) was established to promote applied research in the area of Shari'ah and Islamic finance. Based in Malaysia and as part of the International Centre for Education in Islamic Finance (INCEIF), ISRA is able to leverage on the existing infrastructure and facilities as well as to tap on the knowledge, expertise and resources of the academic faculty and post graduate students in INCEIF

ISRA also acts as a repository of knowledge for Shari'ah views or fatwas and undertake studies on contemporary issues in Islamic financial industry and contribute towards strengthening human capital development in the areas of Shari'ah. Through pioneering research and rigorous intellectual dialogue, ISRA aims to promote innovation and dynamism into new boundaries of Islamic finance.

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