Malaysia continues to strive towards Best Practices in the global Islamic financial services industry.

In this issue, we look into Malaysia’s stage of development in Shariah audit, a key pillar underpinning Shariah Governance.
**Malaysia as an international Islamic Financial centre, continually seeks to pursue Best Practices in Shariah Governance (including Shariah audit)**

**Contents**

04 Foreword

06 Shariah regulatory environment
   Malaysia: Key milestones
   New Shariah Governance Framework
   Shariah audit approach

12 Shariah audit survey
   Survey background
   Survey insights
   • Organisational readiness
   • Talent pool and competencies
   • Working practices
   • Communication
   • Technology

22 Moving forward

24 How PwC can help

25 Contact us

26 Useful references
When it was implemented in January this year, we ran a Shariah audit survey to better understand current Shariah audit practices and to identify areas where our IFIs can improve. The survey results indicate that there is a strong need to expand the talent pool of Shariah auditors, to enhance the comprehensiveness of Shariah audit coverage and to improve Shariah audit methodologies, including risk management.

We hope this publication will offer good insights on IFIs current Shariah audit practices, challenges and what Shariah governance best practices can be effectively implemented.

Mohammad Faiz Azmi
Islamic Finance Leader
PwC Malaysia
Globally, Islamic finance has fast developed into a significant alternative financial services industry with over 300 Islamic financial institutions (IFIs) and an industry asset size of more than USD1 trillion.

Within this fast growing global Islamic finance (IF) community, Malaysia has emerged as a leading hub. Benchmarked against other IF centres in the world, Malaysia has the:

- largest Islamic capital market for both sukuk and Islamic equity
- second largest Islamic unit trust (mutual fund) and takaful market
- second largest IF education provider, and
- third largest Islamic banking market.

Malaysia has successfully embarked on a number of strategies and initiatives to develop its IF industry, including its continued development of market players, infrastructure and expertise to reinforce its position as a leading international IF centre.
Shariah regulatory environment

Malaysia: Key milestones
1983
Islamic Banking Act (IBA) 1983 was enacted in Malaysia. The first full-fledged Islamic bank was established in Malaysia.

1984
Takaful Act 1984 was enacted to provide regulation for Takaful business in Malaysia.

1996
Amendment to Section 124 of Banking and Financial Institution Act (BAFIA) allowing conventional banks in Malaysia to offer Islamic banking products through Islamic windows.

1998
Interest-free Banking Scheme (SPTF) was upgraded to Islamic Banking Scheme allowing conventional banks to open full-fledged Islamic banking subsidiaries.

2001
Malaysia’s Financial Sector Masterplan sets target for Islamic Finance to make up 20% of the finance sector by 2010.

2002
Islamic Financial Services Board (IFSB) was established in Malaysia.

2003
Bank Negara Malaysia (BNM) guidelines on Outsourcing of Islamic Banking Operations. (23rd June 2003)

2004
BNM guidelines on Directorship for Takaful Operators. (8th November 2004)

2005
BNM guidelines on the Governance of Shariah Committee for Islamic Financial Institutions. (1st April 2005)


2007
BNM guidelines on Corporate Governance for Licensed Islamic Banks. (24th January 2007)

2008
BNM guidelines on Outsourcing for Takaful Operators. (22nd July 2008)

2009
Amendment of section 51 of Central Bank Act (CBA) to position the Shariah Advisory Council of BNM as the apex authority for the determination of Islamic laws for the purpose of Islamic financial business.

2011
By 30 June 2011, IFIs are to comply with the Shariah Governance Framework.

June: Launch of Phase 2 of the Financial Services Masterplan (FSMP)

BNM guidelines on Introduction of New Products. (18th May 2009)

BNM guidelines on Introduction of New Products for Insurance Companies and Takaful Operators. (1st July 2009)

2010
Launch of the new Shariah Governance Framework by BNM. (effective 1st January 2011)

BNM guidelines on Internal Audit Function of Licensed Institutions. (1st July 2010)

New Shariah Governance Framework

Shariah audit, a key pillar of governance

The foundation of Islamic banking and finance is based on Shariah principles and guidelines. Malaysia’s newly launched Shariah Governance Framework (SGF) is aimed at further developing a Shariah-based operating environment. It is also designed to enhance the role of the Board, the Shariah Committee and management in relation to Shariah matters, and the role of key players in undertaking Shariah compliance and research functions.

The SGF is focused in the following areas:

**Shariah governance structure**
Sets out IFIs’ Shariah governance structures, processes and arrangements to make sure all operations and business activities are in accordance with Shariah.

**Shariah governance attributes**
Provides comprehensive guidance to the Board, Shariah Committee and management of IFIs in discharging their duties in matters relating to Shariah.

**Shariah compliance and research functions**
Outlines the functions relating to Shariah review, Shariah audit, Shariah risk management and Shariah research.
Compared to the previous Guidelines on the Governance of Shariah Committee for the Islamic Financial Institutions (2005), there are a number of changes and clarification in the new SGF. Among them:

1. Number of Shariah committee members has increased from three to five.
2. Minimum qualification of Shariah committee members - a bachelor’s degree in Shariah.
3. Details of the process of Shariah review, Shariah risk management, Shariah research and Shariah audit are clarified and expanded.

Source: Shariah Governance Framework for Islamic Financial Institutions, 26 October 2010 (www.bnm.gov.my)
A key pillar of the Shariah Governance Framework is the Shariah audit function. It provides assurance to stakeholders independently by ensuring conformance with Shariah, including the products and services offered by Islamic financial institutions and Takaful operators.

The Shariah Audit approach is set out in the SGF, as described in Chart 2.

The Shariah Audit function is to be performed by internal auditors who have adequate Shariah-related knowledge and skills. Their ultimate goal is to ensure a sound and effective internal controls system for Shariah compliance.

Internal auditors may also engage the expertise of IFIs’ Shariah officers in performing the audit so long as the objectivity of the audit is not compromised.

IFIs may also appoint an external party to conduct a Shariah audit on their banking operations.
1. **Audit of IFIs’ financial statements**

Independent assessment and objective assurance to ensure a sound and effective internal control system for Shariah Compliance.

2. **Compliance audit on organisational structure, people and processes**

Scope of Shariah audit to cover all aspects of business operations and activities.

3. **Review on adequacy of the Shariah governance process**

Provide recommendations and communicate results to Audit Committee and Shariah Committee.

Source: Shariah Governance Framework for Islamic Financial Institutions, 26 October 2010 (www.bnm.gov.my)
Shariah Audit Survey

Survey background

After the announcement of Malaysia’s new Shariah Governance Framework in October 2010, PwC ran a survey of 15 Malaysian-based IFIs (including foreign financial institutions) on current Shariah audit practices.

The survey, conducted over November to December 2010, was segmented into five areas:

- Organisational readiness
- Talent pool and competencies
- Working practices
- Communication
- Technology
Survey objective
To review, analyse and provide insights on current and future practices of Shariah Governance by IFIs in response to the new SGF.

Survey methodology and sample
Semi-structured questionnaires were forwarded to Chief Internal Auditors or Heads of internal audit (including Shariah audit) units/departments of the Malaysian-based IFIs.

Survey timings
12 November to 31 December 2010.

Respondents profile
10 of the 15 IFIs representing 67% of Malaysian-based FIs responded:
- Three full-fledged Islamic banking institutions (standalone)
- Six full-fledged Islamic banking subsidiaries
- One bank with license to operate Islamic windows

Target respondents were Chief Internal Auditors of the IFIs.

Chart 3: Profile of survey respondents

Source: PwC Shariah Audit Survey, December 2010
Note: *IB = Islamic bank
Organisational readiness

Independence and authority

All of the FI respondents agree that the Shariah audit team has adequate independence and authority to perform Shariah audits without any restriction from the management and business units.

Chart 4: Shariah audit team – independence and authority

The Shariah audit team has adequate independence to perform Shariah audits

- Strongly Agree: 40%
- Agree: 60%
- 0% Disagree, Strongly Disagree and Not Applicable

The Shariah audit team has adequate authority to perform Shariah audits without any restrictions from the management and business units

- 40%
- 50%
- 50%

Unanimous agreement on the independence and authority of Shariah audit teams

Source: PwC Shariah Audit Survey, December 2010
**Strategy, roles and responsibilities**

The majority or 80% of respondents agree that the Shariah audit strategy is designed to fulfill a Shariah compliance role. But only 60% agree that the Shariah audit strategy is designed to fulfill a Shariah consultative role. As Shariah auditors have a unique role and position in the operational assessment of banks, their role in providing feedback on strategy can be enhanced. Shariah auditors can add more value to the organisation by providing consultative recommendations which enhance the Shariah audit processes.

Chart 5: Shariah audit strategy – compliance vs consultative

The Shariah audit strategy is designed to fulfill a Shariah compliance role

<table>
<thead>
<tr>
<th></th>
<th>Strongly Agree</th>
<th>Agree</th>
<th>Disagree</th>
<th>Strongly disagree</th>
<th>Not Applicable</th>
</tr>
</thead>
<tbody>
<tr>
<td>Strongly Agree</td>
<td>20%</td>
<td>60%</td>
<td>20%</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>Agree</td>
<td>20%</td>
<td>40%</td>
<td>20%</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>Disagree</td>
<td></td>
<td></td>
<td>20%</td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>Strongly disagree</td>
<td></td>
<td></td>
<td></td>
<td>10%</td>
<td>10%</td>
</tr>
<tr>
<td>Not Applicable</td>
<td></td>
<td></td>
<td></td>
<td>10%</td>
<td>10%</td>
</tr>
</tbody>
</table>

Shariah audit strategy can be better designed to fulfill a consultative role

Source: PwC Shariah Audit Survey, December 2010
Talent pool and competencies

While 70% of FI respondents agree that they have enough staff to perform Shariah audits effectively, a significant one-third or 30% disagree. These results reflect the lack of talent available to the banking industry for Shariah audit in Malaysia. To keep an effective talent pipeline to perform Shariah audits, relevant and adequate training is critical.

Need to expand talent pool with Shariah audit knowledge competencies

In terms of professional development and training, there appears to be a need to enhance knowledge of Shariah-related audit risk and issues.
Working practices

Scope

While 60% of respondents indicated that the scope of Shariah audits are comprehensive enough to cover all the relevant processes in their financial services, a significant 30% of respondents disagreed.

Survey responses also indicate a number of areas which lack coverage in Shariah audits. A particular area of concern is risk management.

The scope of Shariah audits needs to expand to cover all aspects of business operations.

Chart 8: The scope of Shariah audits are comprehensive enough to cover all the relevant processes in the bank

- 30% Disagree
- 20% Strongly Agree
- 10% Not Applicable
- 40% Agree

Source: PwC Shariah Audit Survey, December 2010

Chart 9: Areas that are covered in the scope of the Shariah audit

<table>
<thead>
<tr>
<th>Which areas are covered in the scope of the Shariah audit?</th>
<th>Percentage of Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Financing</td>
<td>90% 0% 10%</td>
</tr>
<tr>
<td>Credit admin</td>
<td></td>
</tr>
<tr>
<td>Treasury</td>
<td></td>
</tr>
<tr>
<td>Treasury operation</td>
<td></td>
</tr>
<tr>
<td>Settlements/disbursements</td>
<td></td>
</tr>
<tr>
<td>Finance</td>
<td>60% 30% 10%</td>
</tr>
<tr>
<td>Shariah fatwa process</td>
<td></td>
</tr>
<tr>
<td>Human Resources</td>
<td>50% 40% 10%</td>
</tr>
<tr>
<td>Recovery</td>
<td>80% 10% 10%</td>
</tr>
<tr>
<td>Legal</td>
<td>70% 20% 10%</td>
</tr>
<tr>
<td>Risk management</td>
<td>50% 40% 10%</td>
</tr>
</tbody>
</table>

Source: PwC Shariah Audit Survey, December 2010
Risk Assessment

The majority or 80% of respondents indicated that Shariah audit risks are comprehensively and accurately assessed during the audit cycle.

When presented with a list of events which may lead to Shariah non-compliance risk, most IFI respondents agree that these events have been adequately addressed in the Shariah audit process. However, the role of Shariah risk in the risk management framework can be improved.

**Shariah audit coverage in the area of risk management can be expanded**

Chart 10: Shariah audit risks are comprehensively and accurately assessed during the audit cycle

Source: PwC Shariah Audit Survey, December 2010

Chart 11: Specific type of Shariah risk events which the audit is designed to address

<table>
<thead>
<tr>
<th>Please describe the specific type of Shariah risk events which the audit is designed to address</th>
<th>Percentage of Respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shariah approval of financing products</td>
<td>YES</td>
</tr>
<tr>
<td>Trade sequencing</td>
<td>90%</td>
</tr>
<tr>
<td>Legal agreements and product documentation</td>
<td>90%</td>
</tr>
<tr>
<td>Valid commodity vendors</td>
<td>80%</td>
</tr>
<tr>
<td>Staff awareness on Islamic Finance</td>
<td>70%</td>
</tr>
<tr>
<td>Communication between Shariah committee and management</td>
<td>80%</td>
</tr>
<tr>
<td>Marketing materials</td>
<td>70%</td>
</tr>
<tr>
<td>Role of Shariah risk in the risk management framework</td>
<td>70%</td>
</tr>
</tbody>
</table>

Source: PwC Shariah Audit Survey, December 2010
Shariah audit methodology

Majority of respondents or 80% agree that current Shariah audit methodology and tools are adequate to perform the audit.

The majority of respondents do not perceive that the Shariah scholars have significant involvement in the Shariah audit process – this is an interesting point as Shariah committee members are expected to sign the Shariah audit opinion and it is reasonable to expect that they have significant involvement in this area.

**Shariah scholars’ involvement in the Shariah audit process can be enhanced**
Communication

Dispute resolution process

About half or 50\% of respondents said that a dispute resolution process is not in place in their bank’s existing Shariah Governance Framework.

A dispute resolution process is important to allow the bank’s management to resolve any potential conflicts between the Shariah scholars and the management in a structured manner.

Chart 14: Is there a dispute resolution process in the bank’s existing Shariah Governance Framework?

Source: PwC Shariah Audit Survey, December 2010

For an effective Shariah Governance process, the Shariah dispute resolution process should be further developed
Technology

IT system

While 70% of respondents agree the bank’s IT systems are sufficient to assist them in assessing data and information to complete the audit process, some 20% disagree.

Chart 15: Shariah audit – adequacy of IT systems
The bank’s IT systems are sufficient to provide Shariah auditors with the necessary data and information to complete the audit

Source: PwC Shariah Audit Survey, December 2010
Moving forward
Survey - current state of Shariah audits, and next steps

The result of this survey indicates the need to expand the talent pool and roles of Shariah auditors, and having a structured Shariah audit methodology.

Expanding talent and roles
• Need to expand the talent pool of Shariah auditors.
• Need to enhance the role of Shariah auditors in adopting a consultative approach and add value to Shariah audit processes.

Enhancing Shariah audit methodology
• Need for a structured and methodical approach to Shariah audit.
• Improve coverage of risk management and legal aspects.

Moving forward, senior management need to ensure sufficient investments are made in increasing the talent pool and knowledge base for Shariah audits to be performed effectively.

With the rapid expansion of Islamic finance, it is integral for the IFI industry to maintain its distinctiveness.

A robust Shariah Governance Audit framework will help make this possible.
# How PwC can help

## Shariah audit framework and training

A Shariah audit framework is essential to ensure a consistent and effective approach to performing Shariah audits. We can assist with the set-up of Shariah audit framework based on our in-house methodology.

We can train your staff to help complete Shariah audit successfully. In addition, we can also equip them with specialist knowledge in the areas of financial risk management and accounting.

## Shariah risk management framework

Shariah risk considerations should be embedded into the risk management framework to help you manage and address Shariah non-compliance risk effectively.

A major aspect of operational risk in Islamic financial institutions is Shariah non-compliance, which may affect the voiding of contracts, loss of income, withdrawals, diminished reputation and decline in business. By having a comprehensive Shariah risk management framework, you will be able to better manage your financial risks.

## Shariah audit co-source

We can provide manpower support to perform Shariah audits. We can either work with your firm’s Shariah scholars or with our own panel of scholars.
Contact us

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**Investor guide**

- International Islamic Bank
- International Takaful Operator
- Islamic Fund Management Company

As part of our Government’s continuous efforts to establish and promote Malaysia as the forerunner in global Islamic Finance, special schemes and incentives have been accorded to investors.

In supporting the development of the Malaysian International Islamic Financial Centre (MIFC), PwC Malaysia has prepared investor guides for its potential investors.

**Islamic Finance in Malaysia**

This three-edition series provides useful insights on the progress and road ahead for Malaysia’s Islamic finance Industry.

The latest edition, released on May 2010 is “Gateway to Asia: Malaysia, International Islamic Finance Hub”. It discusses Malaysia’s position as an Islamic Finance hub, Shariah developments, tax neutrality and incentives offered to the industry.

**Global Islamic finance**

Shariah-compliant funds: A whole new world of investment

Takaful: Growth opportunities in a dynamic market

Growing pains: Managing Islamic banking risks
Today’s challenging economic times have many businesses scrutinising their operations in search of cost-cutting opportunities. But indiscriminate cost cutting may damage companies in the long run. Short-term savings will leak away, leaving in their wake a compromised business struggling to overcome a battered corporate infrastructure, a tainted culture, and a bruised reputation—well after the economy itself has bounced back.

The attached white paper describes 14 practical strategies for internal audit functions to consider, including: New Governance-related Reforms, Requirements, Standards and Proposals; Governance Environment: The Culture, Structure and Policies Providing the Foundation for Good Governance; Governance Processes: Specific Activities that support the Governance Environment; Governance Procedures: Specific Procedures and Practices Critical to the Implementation and Operation of Governance Activities.

This thought leadership has been developed to provide PwC’s insight on the state of internal audit and how it needs to respond to new growth areas (e.g. emerging markets and technologies) and new risks. The discussion concludes that “the curtain is rising, are you ready?” with a summary of actions, most often practised by internal audit functions facing challenging times.