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ENHANCING GOVERNANCE, ACCOUNTABILITY AND TRANSPARENCY IN ISLAMIC FINANCIAL INSTITUTIONS: AN EXAMINATION INTO THE AUDIT OF SHARI'A INTERNAL CONTROL SYSTEM

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Abstract

Governance of Islamic Financial Institutions (IFIs) is at the stage of infancy with most of the measures performed internally at the initiative of the management or industry regulated by the means of guidelines. Shari'a compliance reporting at the moment is not corroborated by the external independent parties. For that matter, investors and regulators know little how IFIs' management exercises the measures to comply with the Shari'a. Lack of external corroboration and clear audit also reduces accountability and transparency that starve the decision makers of a better perspective on how to manage the risk of investment. Audit comprises of three elements namely audit of operations, internal control, and financial statement. The industry at the moment has to satisfy only the audit of operations by the way of Shari'a compliance audit or Shari'a review, without much done on the latter two that limits accountability and transparency of information being passed to the users. Without audit on the Internal Control System, the internal risk management is left unchecked. Little research has addressed the internal control measures in IFIs, thus the motivation of the

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authors to fill the gap. In this paper the authors highlighted the importance of external Shari'a audit to be carried out to check on the soundness of the internal control system in IFIs. A Shari'a internal control checklist was designed and adapted in two IFIs, namely Bank Islam Malaysia Berhad (BIMB) and Bahrain Islamic Bank (BIB). In terms of overall score, BIMB scored 97.6% whereas BIB 69.8%. The lower score obtained by BIB did not mean that BIB's internal control system was not effective; instead it was because information was not disclosed in the annual report. BIMB managed to score above 90%, due to its full disclosure in the annual report. Increasing the level of information disclosed in the annual report will uphold the governance, transparency and integrity of the IFIs.

Keywords: *external audit of IFIs, shari'a compliance, internal control system*

Introduction

Malaysia has embraced the practice of Islamic banking and finance for 25 years since its first establishment of Bank Islam Malaysia Berhad (BIMB) and Takaful Malaysia in 1984 and 1985 respectively. Since then, the investors have been relying on the self-reporting Shari'a compliance by the Shari'a Committee (SC) of the relevant institutions. This is the requirement of the Bank Negara Malaysia's (BNM) guidelines of GPS-1 on the role and responsibilities of the Shari'a Supervisory Board of Islamic Financial Institutions (IFIs). The practice is similar to other IFIs in the world, i.e. reporting in IFIs is done at the internal level and only relating to the Shari'a compliance matters and not to the internal control and financial statement audit.

There is an increasing need of external auditors' corroboration or audit on a) the Shari'a compliance of the IFIs b) internal control procedures and c) the financial statements. This is for the following reasons:

1. In the capital market, the Shari'a Advisory Council (SAC) of the Securities Commission of Malaysia, twice yearly announces to the public on the Shari'a Compliant securities listed in Bursa Malaysia including shares, warrants and other securities. The responsibility rests to the SAC team to audit the companies to ensure their Shari'a compliant status. To enhance efficiency, the Shari'a compliant companies could be given the responsibilities to report on their Shari'a compliancy with the help of a Shari'a external auditor.
2. In the banking sector, BNM requires the IFIs to comply with the Shari'a with its announcement of the GPS-1 that states the roles and responsibilities of SAC at the BNM level and SC at the IFIs level. The reporting is done at the internal level with SC reports in the annual reports that IFIs comply with the Shari'a. The value of the report could be enhanced by making the IFIs have their audits performed by the external Shari'a auditors.

In this paper, the need of external Shari'a audit in IFIs will be highlighted. The practice of the Shari'a compliance audit in comparison to the proposed practice of Shari'a external audit will be distinguished. In specific, the authors are proposing one of the Shari'a internal control elements, i.e. the Shari'a internal control list/questionnaire that is useful for external auditors to have a preliminary understanding of the internal control system in IFIs. The Shari'a internal control list/questionnaire is adapted to the two banks, i.e. BIMB and BIB. This Shari'a internal control list/questionnaire can be adopted by the external Shari'a auditors to audit the IFIs.

The Needs of External Shari'a Auditing

In developed economies, auditing is deemed significant because the process of wealth creation and political stability depend heavily upon confidence in processes of accountability, and how well the expected roles are being fulfilled (Sikka *et al.*, 1998). As such, the courts, regulatory agencies and various stakeholder groups have played their parts in demanding that the profession move in an expeditious fashion to meet its responsibilities as perceived by the public.

Grais and Pellegrini (2006) focused on the limitations in relying to the Shari'a compliance assurance to the internal party (i.e. SC). They also proposed in their study an effective framework to monitor and assess Shari'a compliance. This finding is similar with the study conducted by Mansor (2007) who determined that even though the auditors were responsible in auditing the financial statement and gave reasonable assurance that the financial statement was free from material misstatement, somehow the external auditors did not asses or audit whether the transaction made by the Shari'a listed company was free from unlawful transaction outlined by the Qur'an and Sunnah. Mansor (2007)) also proposed in his study that there should be a proper framework for the external auditor to audit the IFIs.

In the Malaysian setting, a study by Shahul and Mulyany (2007) explored the perception of Accounting Academicians, Audit Practitioners and Shari'a Scholars on the practice of Shari'a Audit for IFIs that highlighted the importance of developing a proper governance of the Shari'a compliance issues.

Increased complexity of transactions in the unpredictable economy also increases the requirement of producing Shari'a Audit in the financial reporting. Even though there is discussion on the importance of corporate governance, the impact is still little in ensuring the quality of Shari'a auditing in financial reporting (Adawiah, 2007).

According to Adawiah, (2007)) there are 7 parts of Shari'a Compliance that need to be fulfilled. The 7 parts of Shari'a Compliance Governance can be illustrated through Figure 1 below.

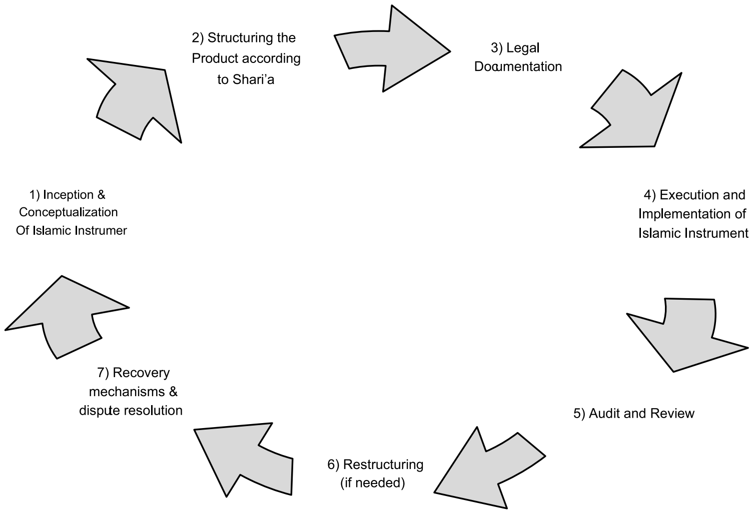

Figure 1: Shari'a Compliance Governance

However, the on-going process of Shari'a audit in Malaysia is currently looking at only 3 aspects, which is inception and conceptualisation of an Islamic product, structuring the rules and principles as according to Shari'a, and the legal documentation procedures. The other four parts are still an on-going process in Malaysia. For the audit review stage, the process is still not yet formulised at the regulatory level. Even though some banks might impose it at the internal department level such as Internal Audit department, there is no independent party being appointed to audit the financial report of the IFIs.

The latest study which is more comprehensive in identifying the issues and challenges of Shari'a audit is conducted by Abdul Rahim (2008). He argued that Shari'a audit is needed to complement the current governance mechanism of the Islamic financial service industry. Abdul Rahim (2008) also discussed paper some challenges which were considered as pre-requisites to effectively undertake Shari'a audit.

The success of any kind of audit depends on the strength of human resources. The critical success factor has the expertise to do the Shari'a audit and has credible people setting the work plan and reviewing the results. Although Shari'a audits have not been made mandatory, hopefully such legislation will be passed since there is a gap between issued fatwas and the respective implementations. Even though there is no legislation requiring an External Shari'a audit, the demand to grow and get more attention from the Central Bank, Securities Commissions and other Islamic Financial Institutions is expected.

Shari'a Compliance Audit vs Shari'a Audit in IFIs

The procedures used in order to achieve audit objective are either stipulated by the law or statute or by those required by non-statutory provisions such as guidelines and circulars. Auditing in IFIs is a statutory requirement in the jurisdictions that use Accounting and Auditing for Islamic Financial Institutions (AAOIFI) as standards when preparing and disclosing information in the annual reports of IFIs.

As the Standard states that the scope of audit should, foremost, include 'appropriate Islamic Rules and Principles', the audit practice in IFIs was termed as Shari'a audit. Specific to the IFIs, Auditing Standard for Islamic Financial Institutions' (ASIFI) AAOIFI mentioned several requirements as the basis of audit scope, which amounts to Shari'a audit.

In Malaysia, the scope of the limited version of Shari'a audit is i.e. Shari'a review or Shari'a compliance audit. It is a non-statutory requirement. The application of AAOIFI standards have never been made mandatory in Malaysia. IFIs operating in Malaysia are required to prepare their accounts according to Financial Reporting Standards (FRS)*)* and International Accounting Standards (IAS)*)* that, by definition do not require a Shari'a audit to be performed on the financial statements prepared.

Non-statutory requirements adopted by IFIs include the BNM guidelines and IFSB-10: Guiding Principles on Shari'a Governance Systems for Institutions offering Islamic Financial services. IFSB-10 requires, among others, an enhanced degree of transparency in terms of issuance, and the audit/review process for compliance with Shari'a rulings. This results in IFIs in Malaysia to report on the face of the annual reports, a Shari'a opinion report, produced by the Shari'a Advisory Council of the IFIs. Shari'a opinion report is the product of Shari'a Review which caters to Shari'a compliance audit on operations and not the examinations into financial statements of IFIs.

According to the AAOIFI Governance Standard for Islamic Financial Institutions (GSIFI) No. 1, an SSB is an independent body of specialised jurists in fiqh muamalat. In terms of its composition, AAOIFI has stated that an SSB shall consist of at least three members (AAOIFI, 2008). In addition to that, GSIFI No. 3 highlights that Shari'a compliance audit or Shari'a review is conducted to examine whether the IFIs comply with Islamic Shari'a rules and principles, fatwa, guidelines and instructions. It is mentioned in GSIFI No. 3 that the responsibility for the Shari'a review is placed on the Shari'a supervisory board and that the internal Shari'a review should be carried out by an independent division/department or part of the internal audit department. Thus, this reflects that Shari'a review is conducted internally without the supervision of external parties in which the accountability and transparency are questionable.

Shari'a auditing can be defined as a systematic process of obtaining sufficient and appropriate evidence to form an opinion as to whether the subject matter (process, personnel, financial and non-financial performance, financial position, systems, marketing, and etc.) corresponds with the criteria (the Shari'a rules and principles) which are broadly accepted by the Islamic community and to report to stakeholder thereon (Shahul, 2009).

In addition to that, according to the Auditing Standard for Islamic Financial Institutions No. 1 (ASIFI 1) "The objective of an audit of financial statements is to enable the auditor to express an opinion as to whether the financial statements are prepared, in all material respects, in accordance to Shari'a rules and principles, the Accounting and Auditing for Islamic Financial Institutions (AAOIFI) and relevant national accounting standards and practices in the country in which the financial institutions operates." The phrase used to express the auditor's opinion is 'to give true and fair view'.

If according to ASIFI 1, from Shari'a perspectives not only should the financial statements need to be audited but the whole institutions including objectives, processes, marketing, personnel, financial and non-financial performance should be subjected to audit from Shari'a perspectives. However, in the Malaysian context, the IFIs only conduct Shari'a review or Shari'a compliant which is done at the internal level. In ASIFI 1 it is also quoted that the audit conducted should adhere to Shari'a principles, AAOIFI and other relevant accounting standards and practices in the country which the IFIs operates. However, Shahul (2009) argues that the necessity to comply with two sets of criteria (AAOIFI and national) might lead to conflict because when national jurisdiction requires banks to follow the International Financial Reporting Standards (IFRS), then IFRS does not allow mutual existence and tolerance of other standards. Since the IFIs in Malaysia do not use AAOIFI as their main standards as reference, thus there is no proper Shari'a audit being conducted because it is not mandatory at the regulatory level.

On the regulatory aspect, in the Malaysian context, the Islamic Banking Act (IBA) 1983 had provided the provision for the establishment of a Shari'a Advisory Board as a requirement of granting license to an IFI. In addition to the IBA 1983, the Malaysian Accounting Standards Board has issued the "Financial Reporting Standards – i" (FRS-i). The purpose of the standard is to provide a guideline which is Shari'a compliant as well as applicable in the Malaysian context in order to address accounting issues and practices in Malaysia (MASB, 2006).

BNM had further issued guidelines on the Governance of Shari'a Committee through the "Garis Panduan Shari'a 1" (GPS-1). The BNM/GPS1 was effective from 1 April 2005, whereby all IFIs regulated and supervised by BNM were required to comply with all the requirements as outlined in the guideline. IFIs comprise of Islamic banks licensed under the IBA 1983, financial institutions licensed under the Banking and Financial Institutions Act 1999 (BAFIA) which participate in the Islamic Banking Scheme, development financial institutions regulated under the Development Financial Institutions Act 2002 which carries on Islamic Banking Scheme and takaful operators registered under the Takaful Act 1984.

Apart from the GPS-1, BNM has also issued another standard known as GP8-i. Unlike the GPS-1 which focuses more on the issue of governance, the GP8-i is more focused on providing the basis for presentation disclosure of reports and financial statements of Islamic Banks in carrying out its banking and finance activities (Guidelines on the Governance of Shari'a Committee for the Islamic Financial Institutions BNM, 2009). One of the requirements stipulated in the GPS-1 guideline is that all IFIs must establish a Shari'a Committee for the purpose of ensuring that the operations of the IFIs are in line with the Shari'a rules. However, the Shari'a Committee is not required to provide a thorough written report of the activities being carried out by the IFIs that would be included in the Annual Report of the IFIs. Its main function is basically to provide advice and guidance to the Board of Directors of the IFIs on Shari'a matters particularly on the new products to be introduced by the IFIs. In terms of reporting, the Shari'a Committee is only required to report to the Board of Directors of the IFIs on their opinions pertaining to the Shari'a matters whereby the final decision on any operation or product to be carried out or introduced will be made by the Board of Directors (Guidelines on the Governance of Shari'a Committee for the Islamic Financial Institutions BNM, 2009).

Framework for Audit process

This section is to satisfy the third objective of this paper that is to propose the IFIs to engage in external Shari'a audit by identifying a suitable framework for the audit process. Even though this research replicates the existing conventional framework for audit process, it can be a starting point to conduct Shari'a audit. In addition to that, this framework inculcates Shari'a aspect to each of the elements involved. Since there is no proper framework issued by any regulatory to conduct Shari'a audit, thus the author feels that an existing audit framework can be used as a reference in developing future Shari'a audit process.

In developing an overall audit plan, auditors have four types of tests that they can use to determine whether the financial statements are fairly stated. It can be divided into 2 major areas. The first part is to satisfy the demand of test of control. During normal audit practice, test of control is conducted during the interim audit whereby it is performed before the company's financial year end. Test of control is done to check on the internal control system of a company as well as if the operational system of the company complies with the laws and regulations.

The second part is to satisfy the substantive test requirement. Substantive test is conducted at the end of each accounting period which is also known as the final audit stage. At this stage the auditor will audit the financial statement of a company based on the samples taken.

This research identifies the framework for audit test as a starting point for audit process by inculcating the Shari'a aspects in each element stipulated. The overall audit process can be illustrated based on the figure below:

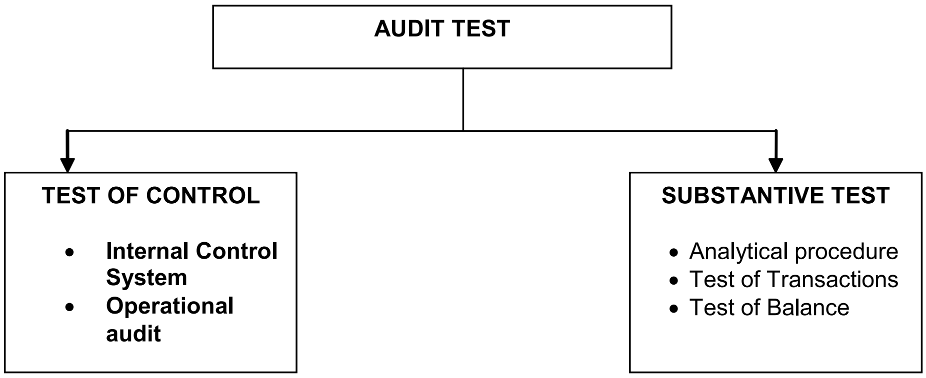

Figure 2: Framework for Audit Process

In this paper, issues related to the first part of the audit test which was on Test of Control were addressed. Test of control is performed to determine the appropriateness of the design and operating effectiveness of the specific internal controls. The Shari'a internal control checklist is developed in order to assess the internal control system of two selected Islamic banks. The internal control checklist will be discussed thoroughly in the next section.

Internal Control

The internal control system is one of the areas that will be audited during the external audit process. However, in IFIs, the internal control system is audited only from the point of the conventional aspect. The elements of Shari'a are not included in the internal control framework. Since the Shari'a reviews current practice in IFIs and only covers the aspect of compliance, it is suggested that the internal control system of IFIs should be included in conducting Shari'a external audit.

Definition of Internal Control

The role of internal control is to manage risk rather than to eliminate it. Internal control is one of the principal means by which risk is managed. Other devices used to manage risk include the transfer of risk to third parties, sharing risks, contingency planning and the withdrawal from unacceptably risky activities.

A system of internal control consists of policies and procedures designed to provide management with reasonable assurance that the company achieves its objectives and goals (Arens, Elder and Beasley, 2008). A sound internal control system reflects the organisation is well managed by the company. An organisation which fails to impose a good internal control system might be facing a higher risk as compared to the organisation which has better control in its working environment. The higher the risk that the company faces might jeopardise the company's objectives. Generally, an organisation has three broad objectives in designing an effective internal control system, which can be concluded as follows:

i. The reliability of financial reporting

Since the preparation of the financial reporting lies in the hands of the management, the management must ensure that the internal control system of the company should be in a good shape, due to the reliance of external parties such as investors, creditors, financial institutions and other users. The management needs to ensure that a good internal control system will prevent financial reporting to be misleading from the facts. The reporting should be prepared in true and fair view.

ii. Efficiency and effectiveness of the operations

The management also holds the responsibility to manage the resources efficiently and effectively. This is to prevent the company from facing huge losses because of failure to manage the resources effectively. Imposing a sound internal control system will minimise the risk of fraud and error among the workers in the organisation. Besides that it will also lead to a better communication between the management and employees of the company.

iii. Compliance with laws and regulations

All public companies are required to issue a report of the internal control system on the effectiveness of the system to the company. The report is available in the annual report of each company.

Thus, with all the objectives mentioned above, management designs a system of internal control to accomplish all three objectives. The auditor's focus in both the audit of financial statements and the audit of internal controls is on those controls related to the reliability of financial reporting plus those controls related to operations and to compliance with the laws and regulations objectives that could materially affect financial reporting.

According to *Internal Control: Guidance for Directors on the Combined Code* (the Turnbull guidance) paragraph 17, in determining a company's policies with regards to internal control, and thereby assessing what constitutes a sound system of internal control in the particular circumstances of the company, the Board's deliberations should include consideration of the following factors:

- the nature and extent of the risks facing the company;
- the extent and categories of risk which is regarded as acceptable for the company to bear;
- the likelihood of the risks concerned materialising;
- the company's ability to reduce the incidence and impact on the business of risks that do materialise; and the costs of operating particular controls relative to the benefit thereby obtained in managing the related risks.

In order to ensure the effectiveness of the internal control system, the operation and monitoring of the system of internal control should be undertaken by individuals who collectively possess the necessary skills, technical knowledge, objectivity, and understanding of the company and the industries and markets in which it operates.

Components of Internal Control

A company's internal control system commonly comprises 5 main components: Control Environment, Identification and Evaluation of Risks and Control Objectives, Information and Communication, Control Procedures and Monitoring, and Corrective Action. The components of internal control can be seen as illustrated using the diagram below:

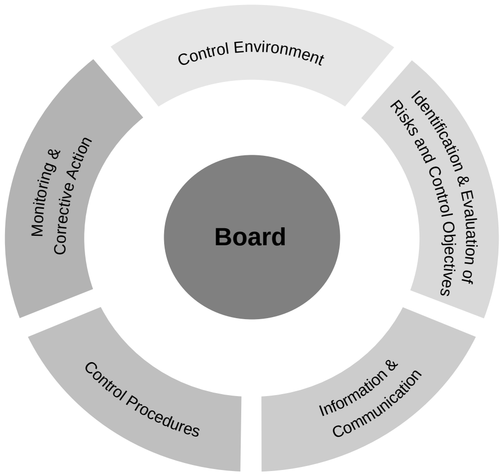

Figure 3
(Sources adapted from The KPMG review - Internal Control, A Practical Guide)

i. Control Environment

The control environment sets the tone of an organisation, influencing the control consciousness of its people. It is the foundation for all other components of internal control, providing discipline and structure. Control environment factors include the integrity, ethical values and competence of the entity's people; management's philosophy and operating style; the way management assigns authority and responsibility, and organises and develops its people; and the attention and direction provided by the Board of directors.

ii. Identification and Evaluation of Risks and Control Objectives (Risk Assessment)

Every entity faces a variety of risks from external and internal sources that must be assessed. A precondition to risk assessment is establishment of objectives, linked at different levels and internally consistent. Risk assessment is the identification and analysis of relevant risks to achievement of objectives, forming a basis for determining how the risks should be managed. Because economic, industry, regulatory and operating conditions will continue to change, mechanisms are needed to identify and deal with the special risks associated with change.

iii. Control Activity

Control activities are the policies and procedures that help ensure that management's directives are carried out. They help ensure that necessary actions are taken to address risks to achieve the entity's objectives. Control activities occur throughout the organisation, at all levels and in all functions. They include a range of activities as diverse as approvals, authorisations, verifications, reconciliations, reviews of operating performance, security of assets and segregation of duties.

iv. Information and communication

Pertinent information must be identified, captured and communicated in a form and timeframe that enables people to carry out their responsibilities. Information systems produce reports, containing operational, financial and compliance-related information, that make it possible to run and control the business. They deal not only with internally generated data, but also information of external events, activities and conditions necessary to inform business decision-making and external reporting. Effective communication must also occur in a broader sense, flowing down, across and up the organisation. All personnel must receive a clear message from top management that control responsibilities must be taken seriously. They must understand their own role in the internal control system, as well as how individual activities relate to the work of others. They must have a means of communicating significant information upstream. There are also needs to effectively communicate with external parties, such as customers, suppliers, regulators and shareholders.

v. Monitoring

Internal control systems need to be monitored - a process that assesses the quality of the system's performance over time. This is accomplished through ongoing monitoring activities, separate evaluations or a combination of the two. On-going monitoring occurs in the course of operations. It includes regular management and supervisory activities, and other actions personnel take in performing their duties. The scope and frequency of separate evaluations will depend primarily on an assessment of risks and the effectiveness of ongoing monitoring procedures. Internal control deficiencies should be reported upstream, with serious matters reported to top management and the Board.

In order to ensure the effectiveness of the internal control system, all 5 common components of internal control and the nature and context of control should fit together.

In addition to that, in order to understand the internal control system of an organisation, few methods can be used as issuance of internal control questionnaires to the employees of the company, interviews to get client feedback, draw flowchart of the system and observation.

Shari'a Internal Control System

Currently, the industry only focuses on the existing internal control system. With the emergence of IFIs, there should be guidelines in measuring the Shari'a internal control system. The definition for Shari'a Internal Control also should be clearly defined. IFIs should include Shari'a elements in designing their internal control system. This is because the nature of the institutions that requires the Islamic elements to be inculcate in the organisations.

A system of internal control of IFIs consists of policies and procedures designed to provide management with reasonable assurance that the company achieves its objectives and goals that are inline with the Al-Qur'an and As-Sunnah. The elements of Shari'a should be inculcated in each of the components in the internal control system. According to Al-Quran Surah An-Nisa' verse 29:

> *"O ye who believe! Eat not up your property among yourselves in vanities: but let there be amongst you traffic and trade by mutual good-will: nor kill (or destroy) yourselves: for verily Allah hath been to you Most Merciful"*

As an overall, the Shari'a internal control system can best be described by a combination of Shari'a compliance (as according to AAOIFI and BNM GPS1) and 5 major components of the internal control system. For example, in the control environment component, in order to ensure higher level of integrity among the employees, the management of IFIs should expose the employees the importance of the five pillars in Islam and the needs to fulfill the requirement. Employees with a high level of integrity will reduce the risk of fraud and error in the organisations. Only qualified, experienced and committed staff are recruited and retained as well as continuously trained and developed. SC involvement in the recruitment will encourage staff with the right aptitude and attitude. Thus, the organisation can rely on its employees to perform other important tasks as well as satisfy other internal control components.

Performing Shari'a Audit on Internal Control System

i. Shari'a Internal Control Questionnaires

Internal Control Questionnaires (ICQs) is a set of questionnaires that is used as one of the tools to measure the effectiveness of the internal control system of an organisation. It is a series of yes or no questions about the organisation's structure. Any no answers will help direct to areas and activities where there is a risk of human error and fraudulent activity. ICQs have been practiced widely by the internal and external auditor during conducting audits. Shari'a ICQs is a set of questionnaires that has been proposed in this research as a tool to measure the effectiveness of the internal control system in IFIs. By using questionnaires, the management or auditors will be able to detect areas that need special attention and thorough investigation.

ii. Shari'a Internal Control checklist

Shari'a Internal Control checklist is a type of informational job aid used to assist in performing audit work. It will reduce failure in detecting the risk by compensating the potential limits of human memory and attention. It helps to ensure consistency and completeness in carrying out a task. It is a list of schedule, which lays out tasks to be done according to areas required. Since this research uses annual reports as the main data thus, Shari'a control checklist is the most suitable tool to measure the effectiveness of the internal control reporting in the annual reports of IFIs.

iii. Interviews

Interviews are often conducted to gather basic data or background knowledge on specific information needed. Interviews basically can be structured in the following criteria:

i. Direction of the information flow: information is given to or requested from the interviewee.
ii. Interview structure: one to one session or in groups.
iii. Form of communication: verbal or written

Through interviews, any deficiency or loopholes in the internal control system can be detected and thus corrective and preventive action can be implemented.

Methodology and Research Design

The research is aimed to highlight the importance of conducting external Shari'a audit in IFIs. To help external auditors to audit the internal control of IFIs, the use of the Shari'a Internal Control Checklist as a preliminary tool to measure the effectiveness of internal control system in IFIs is proposed. Bank Islam Malaysia Berhad (BIMB) and Bahrain *Islamic* Bank (BIB) are chosen as the subject of analysis. The selection of these two banks is basically based on the argument that they are established in two different countries where Islamic banking and finance has been immensely developed. Other researchers such as Shahul and Mulyany (2007*)* also used BIMB and BIB in measuring the Islamicity index in their research. From these two banks, any necessary information for the study will be extracted using the exploratory method.

The practice of the internal control system among these two banks will be measured using the Shari'a internal control checklist (ICC) on the annual report of each bank. Any disclosure of information in the annual report is considered good and it reflects the transparency between the banks and the shareholders. Thus, one point will be given accordingly. The sources of information include AAIOFI standard, relevant accounting standard, bank annual reports and legal standard. Content analysis is the key tool that is employed to extract necessary information. From the findings, some recommendations for the improvement of Shari'a audit practiced in Malaysia are provided.

Shari'a ICC is a set of questionnaires that has been proposed in this research as a tool to preliminarily measure the effectiveness of internal control system in IFIs. All the items chosen are prepared according to GPS1 BNMB: Guidelines on the Governance of Shari'a Committee for the IFIs and GSIFI of AAOIFI (AAOIFI, 2008) that regulates the governance of a Shari'a Committee of an IFI.

This Shari'a ICC can be segregated into two major parts namely Shari'a compliance indicator and 5 main components of internal control system indicator. For each information disclosed, a symbol **'YES'** will be given and subsequently it will be awarded 1 mark. However, if the item is not disclosed in the annual report, a symbol '**ND'** will be assigned and it will be awarded 0 mark. At the end of the marking process, total information available will be divided by the total information that should be reported. Each indicator i.e. Shari'a compliance indicator and 5 main components of internal control system indicator will be assigned weights and each respective weight should reflect their level of importance.

In the research conducted by Shahul and Mulyany (2007) there are 3 major indicators highlighted in order to calculate the Islamicity index for an Islamic bank, namely Shari'a compliance indicator, corporate governance indicator and social responsibility indicator. Since this paper is on enhancing governance, accountability and transparency in IFIs, thus the guidelines as according to GPS1 BNMB: Guidelines on the Governance of Shari'a Committee for the IFIs and GSIFI of AAOIFI are followed (AAOIFI, 2008).

Results and Findings

No.	Question	BIMB	BIB
	PART A : Shari'a Compliance Appointment of Shari'a Committee		
1	The role, scope of duties and responsibilities of a Shari'a Committee clearly defined in the organisation.	YES	ND
2	The appointment and reappointment of a Shari'a Committee member have obtained prior written approval from each country. (The appointment shall be valid for a renewable term of two years.)	YES	YES
	Qualification of Shari'a Committee		
3	A member of a Shari'a Committee shall be an individual. A company, institution or body shall not constitute a Shari'a Committee for the purpose of these Guidelines.	YES	YES
4	The Shari'a Committee in the organisation has the qualification or possess necessary knowledge, expertise or experience in the following areas: (a) Islamic jurisprudence (*Usul al-Fiqh*); or (b) Islamic transaction/commercial law (*Fiqh al-Mu'amalat*). (c) Accounting background	YES	YES
		ND	ND

(*Continued*)

(Con't Table)

5	The composition of the Shari'a Committee shall consist a minimum of three (3) members.	YES	YES
6	In addition to the Shari'a Committee, this organisation hires at least one person with knowledge in Shari'a, who serves as the secretariat to the Shari'a Committee.	YES	ND
	Disqualification of Shari'a Committee		
7	The SC should not act in a manner which may cast doubt on his fitness to hold the position of a Shari'a Committee member.	YES	ND
8	The SC attends at least 75% of meeting on average.	YES	ND
9	SC is not a bankrupt, or a petition under bankruptcy laws is filed against him.	YES	ND
10	SC is not guilty for any serious criminal offence or any other offence punishable with imprisonment of one year or more.	YES	ND
11	SC is not subjected to any order of detention, supervision, restricted residence or banishment.	YES	ND
	Duties and responsibilities of Shari'a Committee.		
12	SC advice the Board on Shari'a matters in order to ensure that the business operations of the organisation comply with Shari'a principles at all times	YES	YES
13	SC endorses Shari'a Compliance Manuals	YES	ND
14	Shari'a Committee endorses the following relevant document:i) the terms and conditions contained in the proposal form, contract, agreement or other legal documentation used in executing the transactions; andii) the product manual, marketing advertisements, sales illustrations and brochures used to describe the product.	YES	YES
		YES	YES
15	SC assists related parties on Shari'a matters for advice upon request. (Legal officer, auditor and etc.)	YES	YES
16	Shari'a Committee prepares written Shari'a opinions (Shari'a Committee Report) in the annual report on matters pertaining Shari'a issues.	YES	YES
17	Shari'a Committee explains the Shari'a issues involved and the recommendations for a decision in the Shari'a Committee report. Is it supported by relevant Shari'a jurisprudential literature from the established sources?	YES	ND
	Policies and Procedures		
18	The organisation refers all Shari'a issues to the Shari'a Committee.	YES	YES
19	The organisation adopts the Shari'a Committee's advice.	YES	YES

(*Continued*)

(Con't Table)

20	The organisation ensures that the product documents are validated.	YES	YES
21	The organisation has a Shari'a Compliance Manual.	YES	ND
22	Shari'a Committee is given access to relevant records, transactions, manuals or other relevant information, as required by them to perform their duties.	YES	YES
23	The organisation remunerates the members of the Shari'a Committee accordingly.	YES	YES
24	The Shari'a Committee reports functionally to the Board of Directors of the organisation.	YES	YES
	Audit & Governance Committee (AGC) for IFIs (known internationally as the Audit Committee)		
25	The AGC are from independent non-executive members of the board of directors.	YES	ND
26	The AGC is knowledgeable in Shari'a rules and principles (at least one)	ND	ND
	Total Part A Score	25/27 **92.5%**	14/27 **51.8%**
	PART B : 5 Major Components of Internal Control		
	Control Environment		
27	Integrity, ethical values and competence of the entity's people;	YES	YES
28	Management's philosophy and operating style;	YES	YES
29	The way management assigns authority and responsibility, and organises and develops its people;	YES	YES
30	The attention and direction provided by the Board of directors	YES	YES
	Identification and evaluation of risks and control objectives (Risk Assessment)		
31	Identification and analysis of relevant risks to achievement of objectives	YES	YES
32	Designing strategies for managing risks	YES	YES
33	Implementing and integrating risk management	YES	YES
34	Measuring, monitoring and reporting the risk area	YES	YES
	Control Activity		
35	Proper authorisations, verifications, and reconciliations of transactions and activities.	YES	YES
36	Reviews of operating performance.	YES	YES

(*Continued*)

(Con't Table)

37	Segregation of Duties	YES	YES
38	Physical control over assets and records	YES	YES
	Information and Communication processes		
39	Internal and External events being highlighted	YES	YES
40	Effective communication with external parties, such as customers, suppliers, regulators and shareholders.	YES	YES
	Monitoring		
41	Ongoing monitoring activities,	YES	YES
42	Separate evaluations from independent party in the organisations (internal audit)	YES	YES
	Part B Score	16/16 **100%**	16/16 **100%**
	Total Score	42/43	30/43
	Overall Score	**97.6%**	**69.8%**

Based on the Internal Control checklist above, the results can be summarised as follows:

	BIMB	**BIB**
Part A : Shari'a Compliance	92.5%	51.8%
Part B : 5 major components of ICS	100%	100%
Overall Score	97.6%	69.8%

Both of the banks are measured using the AAOIFI standards and BNM GPS1 in terms of Shari'a compliance and 5 major components of existing internal control system. By the combination of 2 major elements (Shari'a compliance + 5 major components of Internal Control) it should be best described as Shari'a Internal Control Framework.

Based on the score above, in terms of disclosure in the annual report for the year 2009, BIMB scored at 97.6% as compared to BIB which was only at 69.8%. This might be due to there were certain elements required in the standard but not reported in the annual report of BIB. However, this did not mean that BIB failed to comply with the standard. BIB might have complied at the organisation level but did not report it in the annual report. For example, during the appointment of a Shari'a Committee (SC), the role, scope of duties and responsibilities of a SC should be clearly defined in the organisation. BIB did not mention it clearly in the annual report. The disqualification of SC also was not mentioned at all by BIB. By disclosing such information, the users of the annual report would understand more and have a clear picture of the SC's responsibilities.

During the analysis of the internal control checklist, there were some requirements that were not available in BIB‘s annual report; for example, the qualification of BIB’s SC. It was not mentioned in the annual report. However, this information could be gathered by accessing BIB’s website. It is suggested that the qualification of SC should be reported in the annual report so that the external users who have access to the annual report will not question the qualifications of the SC. This will encourage the IFIs, to be more transparent in terms of appointment, qualifications, disqualification and duties and responsibilities of SC.

In terms of SC report of BIMB, the yearly Shari’a issues and the results were clearly stated in the annual report but were not discussed thoroughly. However, for BIB they still complied with the AAOIFI standard but there was no Shari’a issue shared and discussed with the public for that particular year. If the Shari’a issues were discussed and highlighted in the annual report it would have increased the level of transparency to the shareholders. The shareholders would at least appreciate the information given through the annual report.

In the AAOIFI standard there is a requirement for IFIs to establish an Audit and Governance Committee. After reviewing both of the annual reports, it was found that in BIB, the members of the Audit Committee were not from non-independent non-executive members of the board of directors. It was also mentioned in the standard that, the Audit and Governance Committee of IFIs should be knowledgeable in Shari’a rules. However, both of the banks failed to comply with the standard. Their Audit and Governance Committee were mostly from the Accounting and Business background only.

As an overall, in terms of Shari’a Compliance, BIMB scored at 92.5% whereas BIB at 51.8%. This did not imply that BIB was not Shari’a compliance. BIB might have imposed it at the organisation level but did not disclose it in the annual report. BIMB managed to score above 90%, due to its full disclosure in the annual report. It is proposed in order to increase the level of awareness of the shareholders, IFIs should increase the level of information disclosed in the annual report. This will uphold the governance, transparency and integrity of the IFIs.

For Part B of the internal control checklist, both of the banks managed to score 100% or in other word full disclosure in terms of 5 major components of the internal control system. It is assumed here that the 5 major components of internal control system were commonly practiced by the conventional system. Therefore, the framework of the conventional internal control system has already been established in the existing industry which leads to full compliance by the IFIs. However, as mentioned before, each element of the 5 major components of internal control system should inculcate the Shari’a aspect as well.

Conclusion

This paper aimed to highlight the needs for external Shari'a audit, distinguish the difference between Shari'a review and Shari'a audit and propose the IFIs to engage in external Shari'a audit on voluntary basis. The arrangement in this paper started with the conceptual framework of Shari'a review and Shari'a audit. To demonstrate the concept developed, a simple analysis on the proposed internal control checklist was run in order to test the soundness of internal control system of the IFIs under the analysis. Even though the enforcement of conducting Shari'a audit in Malaysia was still not mandatory, yet this paper proposed the usage of Shari'a ICC as a preliminary tool to measure the effectiveness of internal control system of IFIs. The results showed that for the preliminary findings on the soundness of the internal control system in terms of overall score, BIMB scored at 97.6% whereas BIB at 69.8%. The lower score obtained by BIB did not necessarily mean that BIB internal control system was not effective, but because the information was not disclosed in the annual report. BIMB managed to score above 90%, due to its full disclosure in the annual report. Increasing the level of information disclosed in the annual report would uphold the governance, transparency and integrity of the IFIs.

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