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The Development of Shariah Audit Scope in Malaysian Takaful Industry: A Preliminary Analysis

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Abstract

Shariah auditing strengthens Shariah compliance while also enhancing the Islamic Financial Institutions' (IFIs) integrity. They arose as a response to the different natures and characteristics of IFIs including Takaful Operators. Failure to comply with shariah to the letter can have an impact on the legality and enforceability of Islamic finance transactions, as well as increasing financial and non-financial risks to IFIs. Due to that, it is critical for IFIs to have a thorough internal control system for Shariah compliant in order to effectively manage all Shariah issues. The focus of this study is to ensure that Shariah-compliance issues are adequately addressed, as Shariah non-compliance is a threat to all IFIs. Prior research reveals that there was a restrictive focus in the development of the audit scope as currently, the scope cover does not specifically cover financial statements nor the internal control systems relating to Shariah objectives. Thus, the aim of this study is to examine the scope of shariah audit developed by the auditors when conducting shariah audit. To achieve audit objective, semi-structured interviews were conducted involving selected committee members and shariah auditors of Takaful Operators. The study discovered that Takaful Operator addressed the requirement in the existing guidelines when developing their shariah audit scope. This study may provide relevant suggestions especially for the Takaful industry player in enhancing their shariah audit practice towards robust practice.

Keywords: Shariah Audit, Takaful, Scope

Introduction

Shariah auditing is a systematic process of gathering sufficient and relevant evidence to form an opinion on whether the subject matter, such as personnel, processes, financial and non-financial performance, is consistent with Shariah rules and principles that are widely accepted by the Islamic community, and to report to stakeholders. The role of Shariah auditing is far more complex and vital from an Islamic perspective, since it demonstrates the auditors' accountability not only to the stakeholders, but also to the Creator, Allah S.W.T.

Since the function of shariah audit have become mandatory in 2011, the function has evolved from providing shariah compliance services to providing an independent assessment

of internal control for any Shariah non-compliance risk in Islamic Financial Institutions. Shariah Governance Framework (SGF) introduced by BNM in 2010 has defined Shariah audit in para 7.7 as :“periodic assessment conducted from time to time, to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IFI’s business operations, with the main objective of ensuring a sound and effective internal control system for Shariah compliance” (BNM, 2011).

In 2019, Bank Negara Malaysia proposed a new definition of Shariah audit in a new policy document on shariah governance as following: “function that provides an independent assessment on the quality and effectiveness of the IFI’s internal control, risk management systems, governance processes as well as the overall compliance of the IFI’s operations, business, affairs and activities with Shariah” (BNM, 2019). AAOIFI’s Governance Standard for IFIs no. 3 elaborates the objective of Shariah audit as :“The primary objective of the internal Shariah review (carried out by an independent division or part of the internal audit department) is to ensure that the management of an IFI discharges their responsibilities in relation to the implementation of the Shariah rules and principles as determined by the IFI’s Shariah Supervisory Board (SSB)”.

Understanding the meaning of Shariah audit is critical because it can influence how Shariah audit should be carried out. By merging the definitions of AAOIFI and SGF, an extensive description of Shariah audit may be presented. Apart from that, Shariah audit should take into consideration the components of Maqasid Al-Shariah in order to improve the function of Shariah audit. The preservation of wealth, which will result in the fulfilment of stakeholders' requirements, including the society as a whole, is an important part of Maqasid Al-Shariah in Islamic finance.

Therefore, the practice of shariah audit is expected to be comprehensive especially on the scope of shariah audit. However, it have been revealed in the past studies that there was a restrictive focus in the development of the audit scope as currently, the scope cover does not specifically cover financial statements nor the internal control systems relating to Shariah objectives (Alahmadi et al., 2017; Ginena, 2014; Shafii et al., 2013). There are two main objectives of the study:

RO1.To examine the scope of shariah audit developed by the auditors when conducting shariah audit.

RO2.To propose the relevant scope of shariah audit based on the perceptions of the Takaful industry player

To this end, the main research question would be as following:

RQ1. To what extent does the development of shariah audit scope by Malaysian Takaful operators cover all the requirements in SGF and TOF?

RQ2. What should be included in the scope based on the perceptions of the Takaful industry player?

Literature Review

Takaful and the Development of Takaful Industry

Takaful derives from the root word *kafala*, which means "guaranteeing each other." It is based on the mutual insurance paradigm. Takaful was created to spread risk and help people who have suffered a financial loss. Members or participants in a group agree to jointly guarantee themselves against loss or damage under this scheme(Dikko, 2014). The entire

group would work with the incumbent to compensate him for his loss and offer him with financial assistance (Swartz & Quartzner, 2010).

Basically, Takaful mechanism is based on the concepts of *tabarru'* (donation) and the intention (*niah*) to participate in the mechanism of pooling aid (AlNemer, 2015). This *tabarru'* concept is the main distinguisher between conventional insurance and Takaful. From the Shariah perspective, *tabarru'* is a charitable contract which is normally unilateral in nature as opposed to contract of exchange; and that in the unilateral contract, the application of the rule of uncertainty is more flexible (Hassan, 2019). *Tabarru'* contract involves all forms of contract which are carried out with the aim of kindness and mutual help with the hope of obtaining a reward from Allah (S.W.T).

In general, the funds submitted for *tabarru'* should not be recovered (Irkhami, 2017). *Tabarru'* is also the core of the Takaful system, which allows the element of uncertainty under the Takaful concept (Ab. Rahim & Amin, 2011). There is also a concept of risk distribution in Takaful. The conceptual difference between Takaful and conventional insurance is that risk is not exchanged in Takaful through contribution payments made to the operator, which means that the operator does not sell and the participant does not buy any risk cover (Hussain & Pasha, 2011). Risk management also is encouraged by Islam and without a doubt Takaful ought to fall inside its ambit.

A study by Kasim et al (2015) proved that Takaful is a risk-sharing tool. In addition to that, Takaful depends on the idea of hazard sharing, not founded on the two-sided contract utilized in protection. The respective contract utilized purchasing and selling exchanges. The protected pays the premium in return for remuneration. As for Takaful, it depends on a one-sided contract. Among the members, they are tied with the agreement of *Tabarru'* (donation) since the members commonly add to the Takaful hazard reserve with the expectation that the hazard reserve will be utilized to pay the cases. While between the members and Takaful Operators, the legally binding relationship is typically based on *wakalah* and *mudarabah* contract.

Takaful industry, particularly in the financial sector, plays a critical role in reducing risks and boosting global basic economic growth. The Malaysian Takaful industry, which began in 1984, was developed in three phases based on the Central Bank of Malaysia's master plan (Bank Negara Malaysia, 2005). The first phase, from 1982 to 1992, saw the establishment of the Takaful industry's infrastructure in Malaysia. The regional cooperation between Takaful operators was strengthened in the second phase (1993-2000). The third and final stage of the Financial Sector Master Plan (FSMP) (2001-current) aims to strengthen the legal, Shariah, and regulatory framework, as well as improve the competency of Takaful operators.

Malaysia's Takaful business has grown into a critical primary hub in the Malaysian economy, supporting Malaysia's status as a global Islamic financial centre. The main objective of developing Takaful plan in Malaysia was to comply to Islamic law and standards while also avoiding the three prohibited components (*Riba*, *Maysir*, and *Gharar*). The aim is to create and invent an Islamic alternative to conventional, which Muslims in Malaysia prefer. Presently, there are fifteen (15) Takaful Operators which get the license from Bank Negara Malaysia to operate.

Empirical studies on Shariah Audit

Given the Islamic financial sector's rapid growth, it is critical that it has an adequate 'check and balance' mechanism in the form of Shariah auditing adapted to its establishment's

aims and functions, Maqasid Al-Shariah, which literally means Shariah 'objectives of Islamic law' (Yaacob & Donglah, 2012). Razak and Omar (2008) addressed the application of Shariah auditing in Malaysian IFIs and proposed that the Shariah audit function be implemented to improve Shariah assurance, as well as Kasim et al. (2009), who highlighted the gap between "the desired" and "the actual" practice of Shariah auditing in Malaysian IFIs. This is one of the first studies in Malaysia to look into practitioners' perspectives of what Shariah audit is and how the notion of Shariah audit works from an Islamic perspective.

These two studies were among those conducted prior to the issuance of SGF 2011, which made Shariah auditing mandatory. It's worth noting that the study conducted before to the publication of SGF 2011 focused on the idea for a single Shariah compliance component in any IFI. Prior to the issuance of the SGF, the focus of the research is on shariah audit practise, shariah audit human resources, issues and challenges and shariah audit awareness (Kassim & Sanusi, 2013; Yaacob et al., 2013; Mohd Ali & Shafii, 2014; Kassim & Zuraidah, 2013; Ab. Ghani & Abdul Rahman, 2015; Yazkhiruni et al., 2018).

Yazkhiruni et al., (2018) conducted the most recent study on Shariah audit practise, which used semi-structured interviews to investigate current Shariah auditing processes among IFIs (IFIs) in Malaysia. The study's findings revealed that the procedures are still being developed and improved, with a special focus on the standardization of the Shariah audit framework and guidelines for the design of the Shariah auditing audit programme. Recent studies on shariah audit have focused on determining the effectiveness of shariah audit while taking into consideration the drivers of effectiveness (Ab. Ghani et al., 2019; Zakaria et al., 2019; Al-Gabry et al., 2020; Al-Gabry et al., 2021)

Among the identified drivers include of the structure of shariah audit, the process of shariah audit, the requirements of shariah audit, management support, independency and objectivity, ecosystem, competency of the auditor and shariah audit charter. Recognizing the major drivers can help institutions improve their auditing practices by concentrating on the important aspects. On the same ground, it have been identified that majority of institutions are using risk based approach in conducting their shariah audit function (Ab. Rahman et al., 2019; Puad et al., 2020). Presently, the ideal decision for any Islamic Financial Institution is to implement risk-based auditing in the shariah audit function. By using risk-based approach, focus is placed more on higher risk areas as every institutions would have different risk appetite.

Regulatory Framework on scope of shariah audit

Shariah Governance Framework (SGF) and Policy Document of Shariah Governance (2019)

The policy document on Shariah governance was introduced on 20th September 2019 and shall be effective starting 1st April 2020. In relation to the Takaful industry, this new policy will supersede a few other policy documents known as Shariah Governance Framework for IFIs issued on 22 October 2010 and Paragraph 13.5 of Financial Reporting for Takaful Operators issued on 2 February 2018. This policy document aims to further enhance the effectiveness of the implementation of Shariah governance and reinforce a closer integration of Shariah considerations into IFIs' business and risk strategies.

Before the introduction of these policy documents, IFIs have to comply with the Shariah Governance Framework (SGF) which was introduced back in 2010. Commonly, there is not so much differences on the description for Shariah audit between the new policy document and SGF 2011. The new description for Shariah audit function is simpler and clearer which highlighted on the objective of having effective and quality internal control, risk assessment, governance and Shariah compliance. This is the same for the description of Shariah audit process, which emphasized on the need for establishing suitable audit methodology, audit plan, audit program and finally audit report communication to the board and Shariah committee.

Under SGF(2011), the scope of Shariah audit in SGF shall cover all aspects of IFI's business operations and activities as follows:

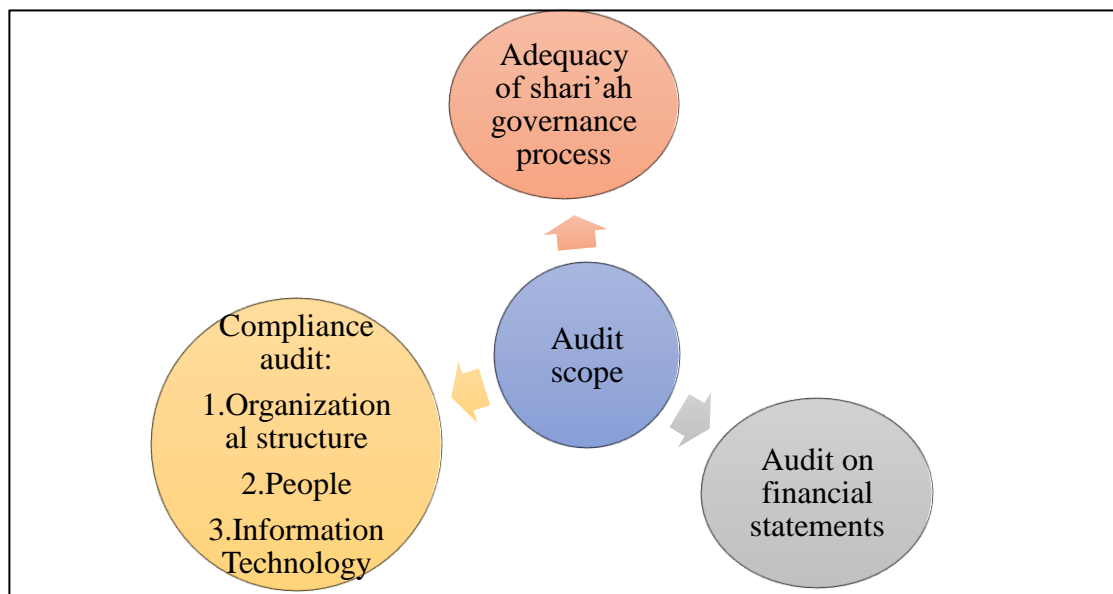


Figure 1.0 Audit Scope based on SGF

Sources: (SGF,2011)

It is very crucial to explore to what extent is the scope of Shariah audit covered by Takaful Operators as it will determine whether these institutions have already followed the available requirements or they have gone beyond that. A study done by Ab. Ghani and Rahman (2015) revealed that only 5% of Islamic banks conducted a Shariah audit on their financial statements. Most of them just rely on external auditors to review their financial systems which are focusing more on operational issues rather than Shariah issues.

Takaful Operational Framework(TOF)

Bank Negara Malaysia has introduced the Takaful Operational Framework (TOF) for the orderly growth of Takaful business, which provides certain parameters for the management of Takaful business. Among the objectives of this guidelines are to enhance operational efficiency of Takaful business; to build healthy Takaful funds which are sustainable; to safeguard the interests of participants; and to promote uniformity in Takaful business practices.

The Guidelines cover operational processes relating to Takaful and shareholders' funds. The requirement in TOF includes of setting up of funds, management of Takaful operations, management of operating costs and income of the Takaful operators, management of assets,

liabilities and surplus, and, rectification of deficiencies of the Takaful funds and disclosure and transparency.

Takaful operators shall establish an operational model that outlines the key policies, procedures and management's responsibilities in carrying out the Takaful operations. The operational model shall be based on contracts preferred by the Takaful operator and approved by the Shariah Committee. In setting out the policies and procedures, Takaful operators must ensure that the principles outlined in the contracts are appropriately operationalized.

In terms of segregation of funds, Takaful operators are required to establish and maintain separate Takaful funds in respect of family Takaful business and general Takaful business. Each Takaful operator shall establish and maintain a separate Takaful fund for its Malaysian Takaful certificates and for its foreign Takaful certificates. The Takaful funds for the family Takaful business shall be segregated into two further funds, namely Takaful protection fund and Takaful annuity fund.

Within the family Takaful funds, Takaful operators shall separately establish Participants Risk Fund (PRF) and Participants Investment Fund (PIF). Takaful operators shall maintain records of and properly allocate the assets, liabilities, revenues and expenses of the Takaful operations to the relevant funds. The method of allocation and the proportion of contribution allocated to the Takaful funds must be made transparent in the Takaful contracts.

In 2019, the revised version of TOF has been issued by BNM which aims to provide clarification in the use of various Shariah standards for Takaful models and structures namely: Tabarru', Wakalah, Mudarabah, Qard and Hibah. The new TOF also lays out criteria for enhancing internal controls over the development of additional Takaful funds. Under the revised standard, Takaful operators need to create a process for assessing the efficiency of additional resources and their long-term sustainability, ascertaining distinct pricing methodologies specific to distinct products, and considering, among others, distinct techniques of surplus distribution. This new TOF is hoped to enhance the governance of Takaful operators, including how Takaful funds are managed, to further protect the interests of Takaful participants.

In conclusions, this TOF is a regulatory framework which focuses on the operational part of Takaful to ensure uniformity in the practice of Takaful Operation. For auditors, this TOF is the main reference for them to perform the compliance audit and to ensure the operations of Takaful comply with all the requirements.

Research Methodology

A qualitative research approach was applied in this study to allow for the application of clarification, insight, discovery, and interpretation of the phenomena under inquiry. Qualitative research uses open-ended and flexible methodologies to assist researchers understand how individuals perceive the events under investigation and examine them from various perspectives (Merriam, 2009). This approach was utilized for the present study because it allows for a more holistic understanding of the nature, context, and processes of shariah auditing procedures from the perspective of the participants. As a result, rather than "proving" or "disproving" allegations concerning the breadth of the shariah audit activity, the study's goal is to perform an in-depth analysis.

A structured interview was undertaken to acquire complete information and an understanding of the respondent's IFI's internal control and Shariah issues. According to

Weischedel et al. (2005), even if the interviewer is able to provide a quick explanation, in-depth information cannot be obtained. A list of potential respondents was prepared based on their knowledge and experience of conducting Shariah audit in the Malaysian takaful industries. The data were collected from a total of 22 respondents. In the meantime, each respondent received a formal interview request by e-mail. Below is the table which illustrate on the details of the respondents involved in the interview sessions:

Table 1.0: Details of Respondents

Respondents	Gender	Highest Qualification	Positions	Years of experience in industry
R1	Male	Bachelor	Principal Auditor	16-20 years
R2	Female	Master degree	Senior Manager, Shariah Department	11-15 years
R3	Male	Bachelor	Senior Manager, Internal Audit	6-10 years
R4	Male	Bachelor	Assistant Manager, Internal Audit	6-10 years
R5	Female	Bachelor	Audit Associate	16-20 years
R6	Male	Bachelor	Manager, Internal Audit	6-10 years
R7	Male	Bachelor	Head of Internal Audit	21-25 years
R8	Male	Bachelor	Senior Manager Shariah, Legal and Secretarial, Governance & Strategy	6-10 years
R9	Female	Bachelor	Manager, Internal Audit	11-15 years
R10	Male	Master degree	Manager, Internal Audit	15-20 years
R11	Male	Master degree	Head, Shariah Advisory, Research and Training	11-15 years
R12	Female	Ph.D. in Business Law	Shariah Committee	11-15 years
R13	Male	Ph.D. in Islamic Finance	Shariah Committee	11-15 years
R14	Male	Ph.D. in Islamic Finance	Shariah Committee	11-15 years
R15	Male	Ph.D. in Islamic Finance	Shariah Committee	11-15 years
R16	Female	Ph.D. in Islamic banking and Finance	Shariah Committee	11-15 years

R17	Male	Master's degree in Islamic Management Banking and Finance	Shariah Committee	11-15 years
R18	Male	Ph.D. in Islamic Banking and Finance	Shariah Committee	11-15 years
R19	Female	Ph.D. in Law	Shariah Committee	11-15 years
R20	Female	Ph.D. in Islamic Finance	Shariah Committee	11-15 years
R21	Male	Ph.D. in Islamic Studies	Shariah Committee	11-15 years
R22	Male	Ph.D. in Syariah (Muamalat)	Shariah Committee	11-15 years

Sources: (Researcher,2020)

Structured interviews were conducted using a smartphone and a digital recorder. The interviews lasted between 1 and 1.5 hours. The respondents were assured at the start of the interviews that their identity and all information provided would be kept totally confidential. The recordings of the interviews were then transcribed in order to retrieve the data needed for the study. Regardless of the analytical methodologies and tools utilised, transcribing, according to McLellan et al. (2003), assists researchers in systematically organising and analysing textual data.

The data was then analysed using a phenomenological technique, which included interpreting and reflecting on the data transcribed. As a result, in order to gain a holistic comprehension of the significance of the interviewees' impressions of the study's ongoing occurrences (Alexis & Vydelingum, 2007)

Findings and Analysis

This section will answer two main research questions followed by the analysis of discussions. The research questions are as following:

RQ1. To what extent does the development of shariah audit scope by Malaysian Takaful operators cover all the requirements in SGF and TOF?

Shariah Governance Framework (Audit of financial statements of the IFI)

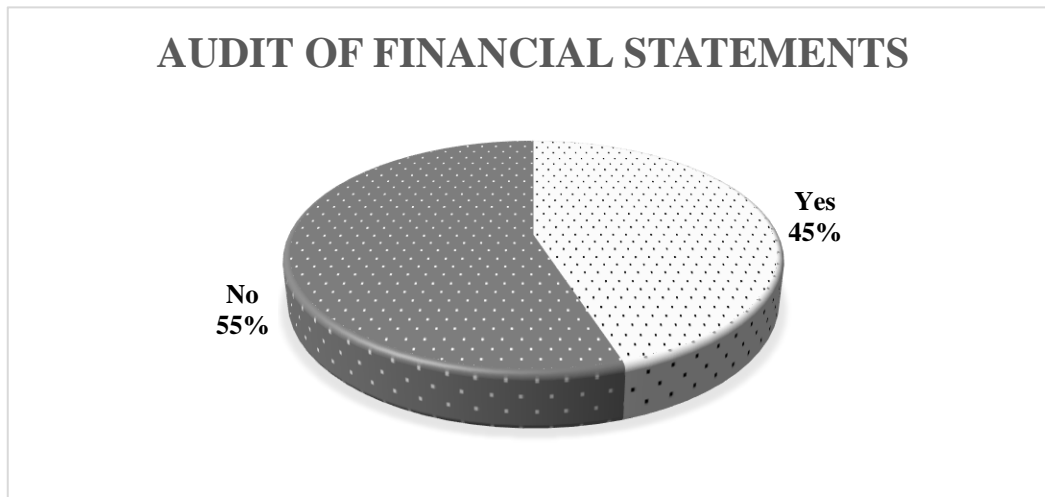


Figure 2.0 Percentage of Takaful Operators Which Developed Scope for Audit of FS Sources: (Researcher,2020)

Majority of Takaful Operators which is approximately about 55% of Takaful Operators do not include the review of financial statements in their Shariah audit scope. This is because they rely on external auditors to check on their financial statements which is allowed in SGF. On the other hand, 45% of the operators perform audit on their financial statements and look into certain elements which can lead to potential Shariah non-compliance risk.

Normally, the auditors will look into areas which have Shariah concerns. Among the elements include Takaful surplus distribution, claim expenses and entertainment and investment. In some cases, the auditors will only review their financial statements if there are any issues raised by SC or BAC in the meeting during the planning stage. On the same ground, one of the Takaful Operators audit their financial statements because it is part of their audit universe of finance. Figure 3.0 below summarizes the elements of Shariah that have been audited by auditors based on their financial statements.

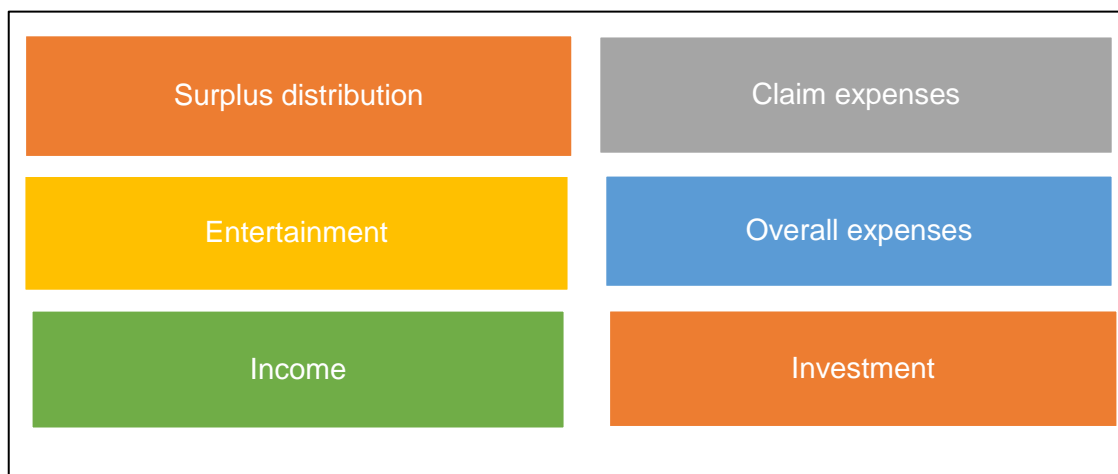


Figure 3.0 Elements of Shariah Issues in Financial Statements Highlighted by Auditors Sources: (Researcher, 2020)

The word surplus in Takaful is the excess contribution to claims payments in the risk pool (Saha, 2010). According to Noordin (2013), currently there are at least three rulings issued by Shariah scholars on this issue. The first ruling is that both of the participants and the shareholders (or operators) may not have a legitimate claim to the Takaful's surplus. Secondly, participants are the only legitimate proprietor of the surplus and finally the other opinion validates the sharing, depending on ratios that vary according to the product line offered. Takaful Operators must implement their surplus distribution based on these three rulings and therefore these elements should be included in their audit scope.

The second element is claim expenses which is further defined as a formal request to the Takaful operator by the Takaful participant (policyholder) detailing the disaster that impacted him; and requested compensation as agreed in the Takaful Policy (Muhamat et al., 2017). On the other hand, fraud on Takaful claims occurs when the specific accident results in a formal claim procedure with additional economic implications for the non-existent damages. Fraud is one of the risks faced by the Takaful Operators. A study by Mohd Fauzi and Rashid (2016) revealed that there is a need for the Takaful industry in Malaysia to expedite action on claims to give stakeholders and the public more confidence with higher ownership by both Takaful operators and operators of the claims processing process and decision-making. Thus, Takaful claim procedures and techniques developed should be in accordance with the Shariah laws and regulations.

The third element is entertainment which includes the expenses for entertainment incurred by Takaful Operators. Among the examples for entertainment expenses include dinners for award achievement or family day or holiday rewards. Normally, these entertainment expenses would be for the agent of Takaful Operators. It is very important to ensure that these entertainment expenses are used for halal and Shariah compliant subject matters. The same goes for the overall expenses of Takaful Operators. The expenses of Family Takaful Operators and General Takaful Operators consist of refund contribution, Re-Takaful, depreciation, death claims, maturity of certificate, certificate surrender and part withdrawal (Billah & Basodan, 2017). The distribution of expenses must be done in accordance with Shariah.

The next element is sources of income. All income for Takaful Operators must come from halal sources such as from wakalah fees or profit sharing from mudharabah contract or profit from investment. Takaful Operators should also maintain three types of accounts namely the Family Takaful Fund, General Takaful Fund and shareholder fund (Billah & Basodara, 2017). An investment-related Takaful is generally a Family Takaful plan that combines investment with full coverage (Noor, 2009). In this investment-linked Takaful, Participants' contributions will be split into two portions. One part is to serve protection where the fund will be treated as a gift for a specific portion of the contribution. This part, as in the event of death or disability, is used to assist participants who need it most. The other part of the contribution concerns the purchase of investment-linked units. Thus, Takaful Operators must ensure that the investing is included as an option into the Shariah-compliant investment with a valid Shariah contract which at the same time could eliminate the issues of riba'.

Based on the elements described by the interviewees, there is still a gap between the

No.	Issues
1	Distribution of profit and loss is made in accordance to Shariah principles
2	Accuracy of accounting transactions Income from general Takaful and family Takaful is accounted for on cash basis and any receipts in advance are treated as liabilities Expenses accounted for on accrual basis Calculation of reserve is based on 1/365th Cost of Retakaful is considered as a liability until contribution is fully paid
3	Zakat payment
No.	Issues
1	Distribution of profit and loss is made in accordance to Shariah principles
2	Accuracy of accounting transactions Income from general Takaful and family Takaful is accounted for on cash basis and any receipts in advance are treated as liabilities Expenses accounted for on accrual basis Calculation of reserve is based on 1/365th Cost of Retakaful is considered as a liability until contribution is fully paid
3	Zakat payment

actual practices in the scope of financial statements with the elements discussed in the previous literature which should be addressed properly. Table 2.0 illustrates the gap of Shariah issues which have been highlighted by previous literature and should be included as a part of the elements in auditing of financial statements.

Table 2.0 Elements in Financial Statements that should be Addressed by Auditor
Sources: (Abu Kasim, 2012; Bilah & Basodan, 2017; Nahar, 2015)

The table above illustrates the gap between the actual practice as described by the interviewee and the scope proposed for this study on financial statements. Based on the table, it can be concluded that it would be better if Shariah auditors can conduct the Shariah audit scope on financial statements rather than just relying on the external auditors. The reason is because normally external auditors would be focusing on the operational part rather than the Shariah issues. Not all external auditors have expertise on Shariah and therefore auditing on financial statements should be considered to be put under the obligation of Shariah auditors.

4.2 Shariah Governance Framework (Compliance Audit on Organizational Structure, People, Process and Information Technology (IT) Application Systems)



Figure 4.0 Percentage of Takaful Operators which Developed the Scope for Audit on Organizational Structure, People, Process and Information Technology (IT)
Sources: (Researcher, 2020)

In terms of compliance audit on organizational structure, people, process and information technology application systems, based on interview, all operators did perform audit on these elements. One of the respondents mentioned that they cover all the scope in their audit, but the auditor did not agree with the term of compliance in front of the elements as for him, compliance is more like a checklist approach, which does not portray the objective of Shariah audit.

Normally, Information Technology is the system which reflects the implementation of the contract. For example, the percentage of wakalah fees. If it has been stated in the contract or proposal form that the percentage of wakalah fees is 40%, then it must be reflected in the system as well. This is the example given by the auditor when they perform the audit on information technology.

For organizational structure, normally the auditors will check on the job descriptions and the functions for each of the departments. Sometimes, it happens that there is a confusion between the job function of compliance and risk management. The segregation of duties and the job scope for each function must be clarified from the start. In terms of staffing, normally the auditors will check whether they have the appropriate skills or not. The table

below summarizes the elements that will be reviewed by the auditors when performing this audit scope:

Table 3.0 Audit Elements for Organizational Structure, People, Process and IT

No.	Scope	Elements
1	Organizational structure	Reporting line, Job descriptions, Functions, Authority, Responsibility
2	People	Background, experience, skills, awareness, training
3	Process	SOP, manual
4	IT	System (Integrate with IT auditor)

Sources: (Researcher, 2020)

Usually, the compliance audit process is performed to ensure that an organization complies with legislative laws and guidelines for the provision of valid and reliable audit reports to all stakeholders especially on any Shariah issues. Based on the analysis of the respondents' answers, the majority of Takaful operators cover these four elements, but the practices adopted are different based on each Takaful operator's interpretation. Some might be more detailed, which means that the auditors look beyond the compliance aspect as what has been practised by Takaful Operator A. Since this second proposed scope has the word "compliance", it can be observed that Takaful operators have established this scope when conducting Shariah audit.

The findings reveal that normally Takaful Operators which adapt embed all auditors for their Shariah audit function model usually will cover this scope of audit in detail only if there is any Shariah issues raised by Shariah committee or by Shariah officers. For example, if there are any issues on the IT systems which miscalculate the rate of wakalah fees, then the scope would be established for this area. Otherwise, they will just follow the minimum requirement which is checking on the compliance. Some Takaful Operators also would apply a risk-based approach when deciding on the details of the scope that they plan to cover for the financial year.

Shariah Governance Framework (Review of Adequacy of the Shariah Governance Process)

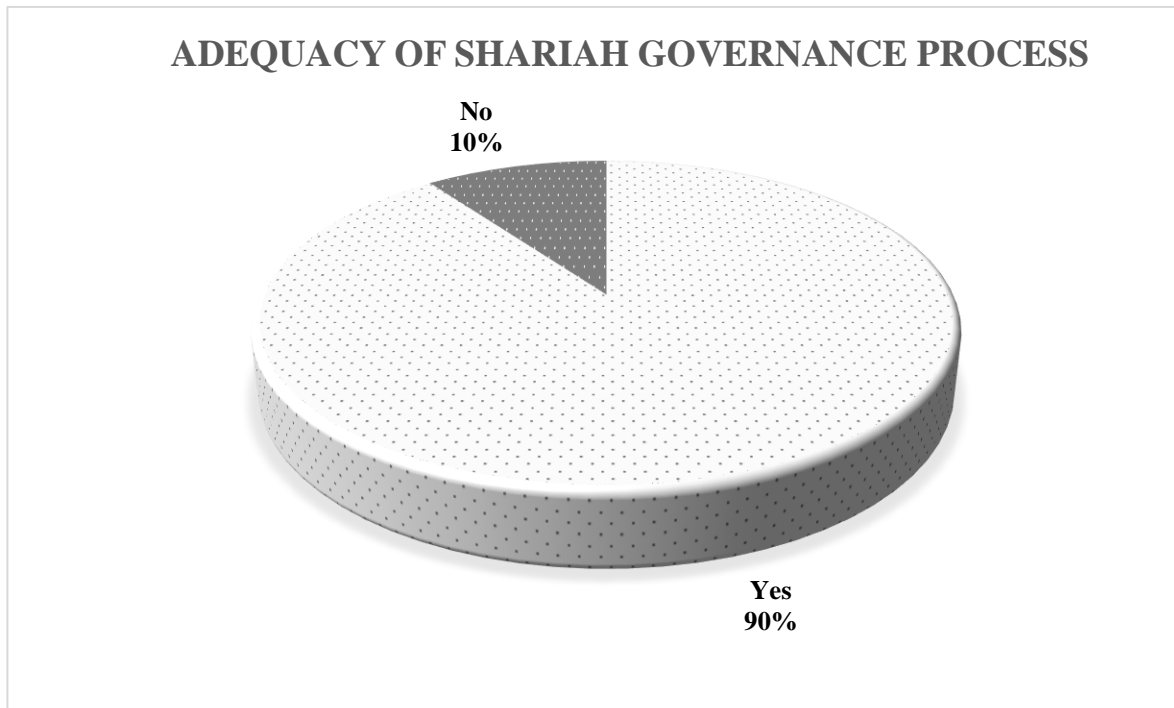


Figure 5.0 Percentage of Takaful Operators Audit on Adequacy of Shariah Governance Process
Sources: (Researcher, 2020)

In terms of reviewing the Shariah governance process, normally auditors will refer to the requirement in Shariah governance framework, for example the duties of Shariah committee, Shariah review and other Shariah governance organs. Analysis shows that all operators perform audit on the adequacy of Shariah governance processes. However, one operator did not perform this audit. One of the respondents admitted that she did not know about this and asked the researcher to refer to the Board regarding this matter.

By checking the adequacy of Shariah governance process, it actually could give a very big impact because of the broad definition of Shariah governance. However, the minimum requirement that must be taken into consideration by the auditors is the existence of the four main functions as required in SGF; Shariah review, Shariah risk and management, Shariah research and development and Shariah function. Since there is no detailed explanation on this scope, majority of Takaful Operators just respond that they do check on the adequacy of Shariah governance process based on the requirements in SGF. Using the requirement in SGF as the benchmark to check on the Shariah governance process may be sufficient as this is the main guidelines for IFIs in Malaysia.

There are a few studies that have been conducted to examine on Shariah governance practice of Malaysian IFIs. This serves as a guide for the researcher to propose in detail the scope for Shariah governance that should be established by Takaful Operators. Table 4.0 provides the details of the scope that could be added up by the auditors in the future.

Table 4.0 Proposed Scope for Adequacy of Shariah Governance Process

No.	Issues
1	Role of Shariah Committee, Shariah review and Shariah auditor Establish governance structure A written policy that sets out the SC members' appointment, composition, selection and dismissal. Supervisory and advisory roles of SC Independency of SC A written policy on Shariah review procedures, quality assurance and the report Access to all records, transactions and information Charter that specifies the purpose, authority, and responsibility of the Shariah audit
2	Effectiveness of Shariah governance Notifications of Shariah committee meetings to board Sufficient Shariah research conducted Shariah risk management performed by risk officer Findings of Shariah review must be communicated to SC The officers conducting each Shariah compliance function are qualified and capable Exercise full disclosure and transparency on all issues deliberated in SC meeting
3	Role of management Being responsible for providing training and learning programs to internal stakeholders notifying the BNM and SC on any potential and actual Shariah non-compliance events or activities and ensuring the correct rectification measures can be taken into action immediately Providing sufficient staff Being transparent by providing accurate information to the SC

Sources: (Hidayat & Khalifa, 2018; Yussof et al., 2014; Harun & Abdullah, 2017)

It is very important for auditors to include those elements in their audit scope as it portrays the overall Shariah governance of the Takaful Operators. Having good Shariah governance would help in boosting the integrity of Takaful Operators, enhancing stakeholders' confidence, and reducing Shariah non-compliance risk which indirectly can contribute towards maintaining financial stability.

Takaful Operational Framework (TOF)

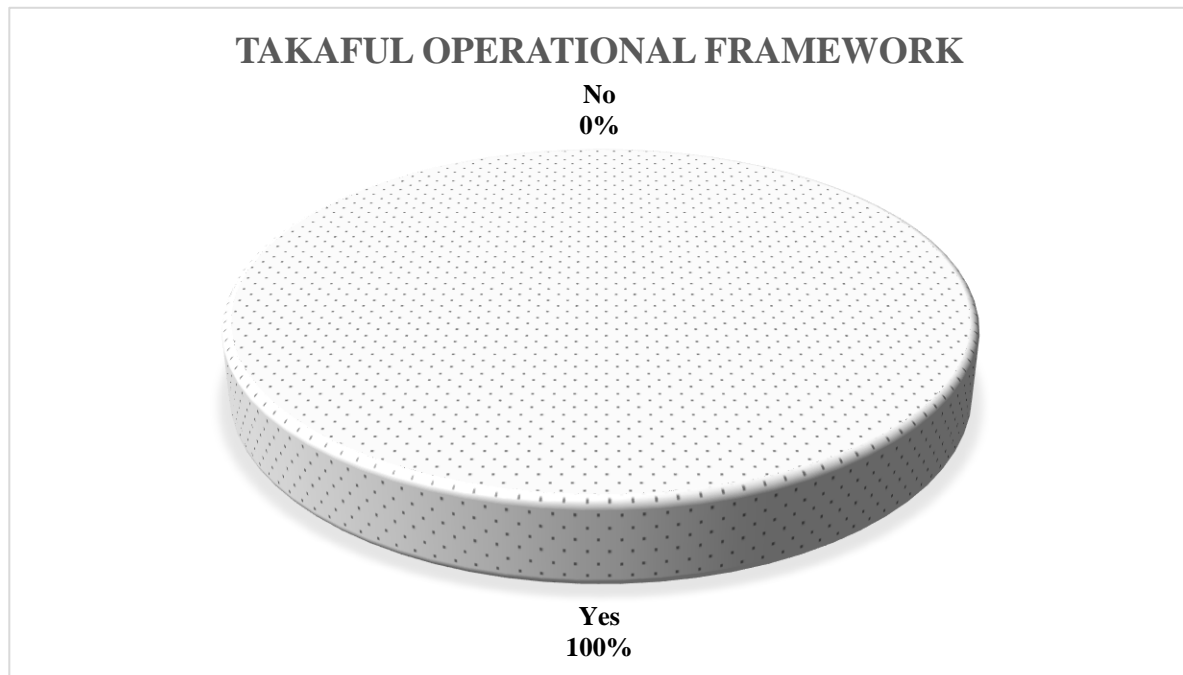


Figure 6.0 Percentage of Takaful Operators which Developed Their Audit Scope based on TOF Sources: (Researcher,2020)

Based on the analysis from the chart, all operators cover the requirement in TOF when performing Shariah audit exercise. But, it will be covered based on the audit cycle which means it is not covered during every financial year. This is the response from R11:

“Of course all of these cannot be covered in one year. We have an audit cycle. So of course, when we talk about audit cycle, we have to look at the risk. For every two years. All these depends on our yearly assessment”. (R11)

On the other hand, R14 response was as follows:

“For every audit that we would like to perform, let’s say we want to do audit on claims management because we have claims as one of our audit universe. We need to cover it once in three years’ time. Thus, during the audit, we need to refer to this TOF and see what is the requirement related to claims. Another example is Retakaful. So, we will refer to TOF and see all the requirements. However, I remember last time, we did a comprehensive review on the requirement by TOF. So actually, it depends on our audit universe. Based on the audit universe, we need to identify the relevant guidelines.” (R14)

On the same ground, R8 mentioned that they don’t have any pending issues pertaining to all the requirement in TOF and SGF. Hence, they consider themselves to be on track and have fulfilled all the regulators’ requirements. The auditor also emphasized that the audit scope will be based on their audit cycle and audit universe.

For Takaful Operator F, their auditor's response was as follows:

"When referring to the requirement in TOF, it is more towards operations and very general in terms of Shariah. There are a few things that were not covered and mentioned in TOF. For example, claims management. In claims management, TOF did not mention on the issues of ex-gratia payment. So, in this case, the organization, or we as Shariah auditors have to come out with one control for ex-gratia...or limitation. To whom can we pay? In what situation do we have to approve? These matters were not discussed in TOF and also the control. Another example is Retakaful commission. Let's say, a Takaful operator cannot cover a huge risk, and the operator gets the capital from their parent company which also provides conventional products. So, the commission came from a non-Takaful company and it should be a non-compliance risk issue from the income received. This is also not discussed in TOF". (R10)

Based on the above interview result, it is found that all operators always refer to TOF and the auditors always check on the level of compliance of operators to this TOF. Although, the level of compliance will not be checked every year because of time constraints and limited of resources, they have audit cycle which can help to ensure the comprehensiveness of the audit scope covered. Audit cycle also is related to risk-based approach. For example, for consecutive years, if there is a potential of risk on claims management, then the auditors would go for that scope in detail.

This TOF is the main reference for the operational part of Takaful Operators and failing to comply with those stipulated requirements would give a big impact to the Takaful Operators. Takaful Operators might be facing Shariah non-compliance risk, reputational risk and regulatory risk if they are not able to comply with requirements in the TOF. Thus, it can be concluded that the auditors did establish the requirement in TOF as the scope in conducting Shariah audit.

RQ2. What should be included in the scope based on the perceptions of the Takaful players?

In order to enhance the current practice, majority of Shariah committee agreed that the scope of Shariah audit should be widened. Among the suggested areas of scope that must be included when conducting Shariah audit besides the items suggested in SGF includes audit on the agent which can be considered as a marketing strategy, Shariah governance and so on. Although majority of Takaful Operators have successfully followed the suggested requirements of the scope that should be covered when performing Shariah audit function, some of them still did not include auditing financial statements as their audit scope because the financial statement part has been covered by the external auditor. The issue here is to what extent an external auditor could cover on Shariah issues in financial statements as we know that normally external auditors would just touch on the operation part when performing audit on financial statements.

A study done by Ab Ghani and Abdul Rahman (2015) indicates that only 55.5% of the respondents have established audit of financial statements as part of their internal Shariah audit and this practice mostly comes from full-fledged Islamic banking. This result is quite similar with this study which found that only several Takaful Operators cover financial statements when performing Shariah audit function. The others would just let the external auditor audit their financial statements without bothering on what is the Shariah element that should be checked out in their financial statements.

Other than widening the scope, the function of Shariah audit also should be broadened up rather than just monitoring the compliance. As stated by Dr Daud Bakar during INTAC Seminar series II on the topic of “Comply or face consequences” that IFIs as a whole should move beyond compliance to be more visible and transparent in providing information to the public. He then added:

“It is not just meeting the requirement to ensure Shariah compliance in products, people, system and environment. What’s more is the IFIs must be seen as ‘whiter than white’ and be able to articulate the reason behind Shariah compliance and non-compliance”.

The above statement shows that Takaful Operators should think out of the box to improve their practices and at the same time enhancing their transparency to increase public confidence. Figure 7.0 below illustrates the scope that should be included in the shariah audit based on the perceptions of the industry.

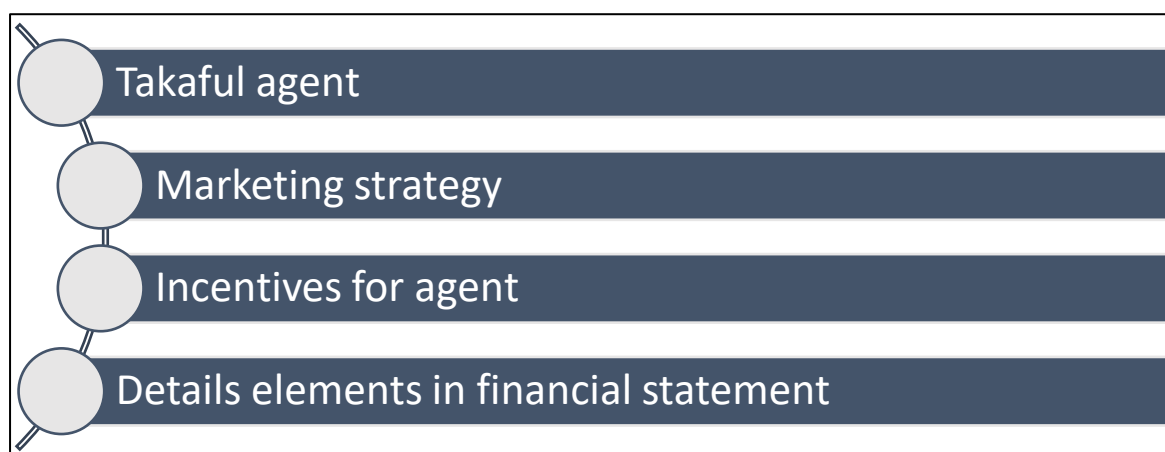


Figure 7.0 Expectation of the scope for shariah audit
Sources: (Researcher,2020)

Conclusions and Recommendations

Based on the findings, mostly all Takaful Operators manage to cover the proposed Shariah audit scope except for the area of financial statements. The main reason why some Takaful Operators include financial statements as the Shariah audit scope is because they rely on external auditors to audit their financial statements. SGF has also mentioned that the auditor can exclude financial statements from their Shariah audit scope provided that it has been audited by external auditors. Relying only on external auditors might lead to the failure to see any potential Shariah non-compliance risk in the financial statements.

This is because external auditors have different objectives when auditing financial statements. Normally, the external audit process ensures that the internal controls, procedures, protocols, and policies of an organization are sufficient, efficient, and in compliance with government requirements, industry standards, and corporate policies. External auditors are not focusing on the Shariah risk as their objectives are associated with the operational aspect only whereas in financial statements, there are also certain areas that are considered as Shariah key risk. For example, in reporting for claims and surplus. Thus, in order to enhance the effectiveness of the Shariah audit, the scope of financial statements should be developed by Shariah auditors.

This study has several limitations, much like most other empirical research. First, since this study only provides insightful knowledge from auditors and shariah committee, it is limited in generalizing the perspectives of all Takaful Operators' main stakeholders. As a result, more perspectives and viewpoints are needed in a comprehensive debate on Shariah audit practices of Takaful Operators. Secondly, the scope of the study is limited to Malaysian Takaful Industry only. Due to that, the practice of other types of Islamic Financial Institutions would not be discussed in this study. Third, this study does not take into account the viewpoints of policymakers such as Bank Negara Malaysia, which leaves potential for further research. Future research could look into policymakers' views on the issue. Future research could also evaluate the effectiveness of present audit processes using standards from the finance industry, particularly the Takaful industry. Despite its limitations, the study's findings are critical for Takaful players in enhancing present Shariah auditing practices.

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