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# Unravelling Shariah Audit Practice in Saudi Islamic Banks

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***Abstract:*** This paper critically reviews the limited literature on the practice of Shariah audit and expounds on its meaning and scope and explores issues on contemporary practice in Islamic banks. The study focusses on Saudi Arabia as it is the largest global player in the Islamic finance industry.

The authors construct a measure for Shariah audit comparison using guidelines issued by regulators of Malaysian Islamic banks – a country with the most developed governance framework for Islamic financial institutions. Using these guidelines, we critically review comparatively the current role of internal audit and Shariah Boards (SBs) of Saudi Islamic banks in ensuring religious compliance.

The study identifies a lack of consistency in the Shariah audit framework to mitigate ambiguity and risk between banks internal audit function and their respective SBs. A discernable gap exists in banks operating Islamic windows which are found to be more susceptible to religious non-compliance risk compared to their fully-fledged counterparts.

Our review finds that the Shariah audit function amongst Islamic banks in Saudi still remains vague without any guidelines issued. Islamic banks in Saudi Arabia are required to develop their own internal policies to be applied by SBs and internal auditors. The paper further highlights that Saudi authorities, regulators and practitioners should ensure uniformity in Shariah audit practice for its Islamic banking industry by moving from a self-serving regulatory model and to urgently consider implementing robust Shariah audit practice and governance framework.

***Keywords:*** *Internal audit; Islamic banking; governance; Shariah audit; Saudi Arabia.*

## I. INTRODUCTION

Islamic banking emerged in the late 1970s with only a limited number of institutions and a negligible amount of capital but has grown significantly over the past few decades, with total assets reaching almost USD2 trillion at the end of 2014 (Hussain, Shahmoradi & Turk, 2015). Islamic banking has also experienced far greater growth than conventional banking since the 2008 financial crisis (Hasan & Dridi, 2011; Rahman *et al.*, 2014) and expanded operations outside the Muslim world to developed economies including Europe and the United States (Abedifar, Molyneux & Tarazi, 2013). While strong ûnancial performance is important for stakeholders, the primary aim of Islamic banks (IBs) is to fulûll stakeholders' needs for operations to conform to Shariah precepts. Recent empirical studies have, indeed, confirmed that the most attractive feature for customers in Islamic banks is religious compliance (see Abdul Rahman & Abdullah, 2013; Abedifar *et al.*, 2013; Amin, Isa, & Fontaine, 2013; Berg & Kim, 2014; Bizri, 2014).

Due to its accelerated development and expansion, the industry has amplified the need for regulation and governance of IBs to be more comprehensive and integrated in providing absolute assurance of religious compliance to stakeholders over the whole range of its activities and operations. In this context, Shariah audit becomes pivotal as it involves participation of individual Shariah Boards (SBs) and internal auditors. Both these governance mechanisms are central for ensuring compliance in IBs operations to instill stakeholder confidence (AAOIFI, 2012; BNM, 2010b; Haqqi, 2014). However, despite its importance, IBs are still struggling to establish an effective auditing framework (Kasim *et al.*, 2013; Yaacob *et al.*, 2014; Yahya & Mahzan, 2012) which is partly attributed to lack of qualified and experienced auditors equipped with specialist Shariah knowledge, particularly in commercial jurisprudence. In addition, although the audit scope in IBs is similar to that of conventional banks, it remains a moot point that the scope of audit in IBs should be much wider given the more rigorous religious requirements (Kasim & Ibrahim, 2009; Sarea *et al.*, 2013; Yahya & Mahzan, 2012) and based on the modus operandi of IBs, a question remains as to who should have ultimate responsibility for undertaking the all-important function of the Shariah audit itself? Should this task be conducted by SBs and internal auditors of IBs or should this be entirely outsourced to external auditors or is there a further need for a new type of hybrid professional auditor to emerge to undertake this important task? Based on this, the objective of our study is to explore the current practice of Shariah audit through a critical review of the extant literature to gain a fuller understanding of the meaning, scope, function and the main attributes of Shariah audit. We focus on Saudi Arabia as it is the largest player in the Islamic finance industry[2] and is viewed as the most influential Muslim country by virtue of its importance as the custodian of the two Holy Mosques. Therefore, the main research question for this study is what is the current practice of Shariah audit in Saudi Islamic banks?

We believe our study contributes to the literature in the following ways. First, although corporate governance mechanisms play a critical role in religious compliance, this paper sheds important light on the main disparities in the existing governance framework of IBs operating in different jurisdictions. For example, in the Gulf Cooperation Countries (GCC) region, Shariah responsibility and authority is assigned to government bodies such as the Ministry of Endowment (known as Awqaf) and Religious Affairs (as in Kuwait), and to the Ministry of Justice and Islamic affairs (as in the UAE and Qatar). In relation to Saudi Arabia, legislation regulating the operation of IBs is non-existent as the Saudi Arabian Monetary Agency (otherwise known as SAMA) has, to date, not granted individual Islamic banking licenses. Furthermore, given that ultimate Shariah responsibility is vested in SBs of each IB, the governance role of SBs is actually inûuenced by the market, with voluntary initiatives taken by individual banks to develop their own internal Shariah supervisory system (Grassa, 2013b; Hasan, 2011). Also, cross membership and interlocking behavior among Shariah experts may further affect SBs independence and hence decrease effectiveness of those members (Grassa, 2013b; Richter, 2010).

Second, since we undertake a comparative examination of the existing Saudi Arabian regulatory and Shariah governance practice with that of Malaysia, our study further adds to the literature. This is because we report the presence of a discernible Shariah audit gap to exist and thus, we make a call for Saudi authorities to consider introducing uniformity in its Islamic banking framework by adjusting itself from a self-styled form of governance to a more standardized system of centralized governance to minimize risk and regulatory conflict in its Islamic banking industry. After all, Baydoun *et al.* (2013) highlighted that corporate governance in the Gulf countries need to be more consistent and robust. They also asserted that the best way for the GCC countries to be competitive is by supporting new initiatives in corporate governance with collaborative effort between regulators, corporate managers and professional accounting bodies. Our study therefore lends support to Baydoun *et al* (2013) and potentially paves the way for the consideration and development of an effective corporate governance ecosystem not only for the Islamic finance industry but also for the financial and capital markets. Finally, since recent studies have pointed to the deficiency in the quality of religious compliance assurance provided by SBs and internal auditors (see for example Hassan *et al.*, 2016; Ullah, Harwood and Jamali, 2016), our study points to some policy recommendations highlighting the need for establishing a more robust governance framework that would enhance confidence amongst stakeholders and improve the credibility of Saudi IBs not only within the GCC but also more internationally.

The remainder of the paper is structured as follows. In Section 2, we discuss Shariah audit and describe the major distinction between internal audit function and Shariah audit from IBs perspective. We also present our thoughts on the current scope and practice of this form of religious audit and critically review issues concerning overall responsibility for performing this audit based on different governance regimes. Whist, section 3 presents a background of the banking sector in Saudi Arabia, in section 4, we address the main problems and challenges relating to Shariah audit in Saudi Arabia. Finally, Section 5 presents the conclusion and highlights some policy implications and recommendations.

## II. SHARIAH AUDIT

To enable a greater understanding of the concept of Shariah audit, it is important to explain the meaning of the word "Shariah" in Islam. This literally means the path to follow and denotes the all-embracing legal system that regulates the lives of Muslims[3]. The Shariah also outlines both the social contract and the scientific groundwork for a global order that is premised on the episteme of Divine unity (Choudhury, 1997). This explains that Islam offers comprehensive guidance for human life and specifies the principles that aim to protect the interest of the human being. Therefore, the objectives of Shariah or otherwise known as 'maqasid al-Shariah' has been used in various dimensions in Islamic economic system such as allowing for growth and justice (Siddiqi, 2004; Kahf, 2006). Meanwhile, Ahmed (2011) used the concept of maqasid al-Shariah to develop a framework that classifies Islamic financial products into three components which are survival[4], security[5] and growth[6], which are meant to describe the different societal needs of the financial product.

Focusing on audit, its broad definition is provided by the American Accounting Association (AAA) as: "a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users" (Anderson *et al.*, 1972, p. 24). However, in general, auditing in Islam means to observe and inspect the operations that include the process of controlling, reviewing and reporting about dealings and transactions according to Islamic law to deliver valuable, accurate, timely, confidence and fair reports for decision makers (Uddin, Ullah and Hossain, 2013). Sultan (2007) asserted that Shariah audit in IFIs include examination of the compliance with the Islamic requirements in all products, the technology used, the people engaged in key areas of risk, the contracts and documentations of IB activities. Meanwhile, Bank Negara Malaysia (BNM), i.e. the Central Bank of Malaysia, outlines Shariah audit being a "periodical 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 IB's business operations, with the main objective of ensuring a sound and effective internal control system for Shariah compliance" (BNM, 2010a, p. 23). Being a relatively new audit perspective, Shariah audit in IBs could be referred as a periodical systematic process conducted to confirm that all operations are consistent and legitimate within the confines of the Islamic religion. Shariah audit is both different and much broader than conventional audit because Shariah auditors should be qualified in both the Islamic religious knowledge and finance related disciplines, whilst the requirement for conventional audit only depends on an accounting and finance background.

### 2.1. Shariah Audit vs Internal Audit

An effective internal audit activity is a precious resource for management and all business related stakeholders due its crucial insight and understanding of an organization, its culture, operations and risk profile. Essentially, whether it is Shariah audit or conventional internal audit, the objectives are similar. Both types of audit serve as a control function by reviewing and assessing the adequacy, effectiveness and legitimacy of all other controls. The Institute of Internal Auditors has explained internal auditing being "an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. The internal audit activity helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control, and governance processes" (IIA, 2012, p. 21). It highlights the valuable contribution of internal auditing designed to add value and improve organizational operations. Such a perspective expands internal auditing's working domain to include risk management and control and governance processes. Nagy and Cenker (2002) investigated whether the new internal audit definition really reflects the day-to-day activities of the internal audit function (IAF) and found that the new definition describes the current practice. However, according to BNM (2010b), the Shariah audit function is an independent assessment that is conducted on a periodical basis in order to improve the degree of compliance to ensure a sound and effective control system for religious compliance in the institution. Moreover, this religious audit function, is not concerned only with communicating the result of assessment directly to the Board Audit Committee, as is the case in conventional banks, but at the same time it may communicate its findings to the SBs. Therefore, the Shariah audit function provides an added value to the role of the SBs, particularly regarding the knowledge of the implementation process of the product in the organization.

The Shariah audit function in Malaysia is currently performed by the internal auditors of the IBs with no specific guidelines on the desired qualifications for a professional to be appointed as a Shariah auditor of an IB as the religious audit function would become more valuable if it were conducted by Shariah auditors. However, currently, the responsibility for carrying out this audit function is only implied on the SBs (Kasim, Sanusi, Mutamimah & Handoyo, 2013). Therefore, it could be concluded that the Shariah audit is a part of the internal audit function, which involves both internal auditors and the SBs. However, the lack of mandatory standards pertaining to the responsibility for conducting the religious audit adversely affects these functions. With regard to the IBs in Saudi Arabia, the relationship between the internal audit and the SBs is weak, especially in full-fledged IBs. The reason for this is that all products and activities in these banks are deemed Shariah compliant and the SBs are expected to have sufficient authority and experience to deal with any issue regarding compliance to the Islamic religion. In contrast, the relationship between the two audit functions in banks with Islamic windows is stronger since the management of those banks provides courses in Shariah for internal auditors who are interested in activities relating to Islamic windows and thus engage in religious supervision.

## 2.2. Shariah Audit

A distinct feature of Shariah audit when compared to conventional audit is its scope. Although the scope of internal audit has, in general, expanded to cover internal control, risk management and governance systems and processes (BCBS, 2012), conventional auditing is unable to cater for the values enshrined in Islamic faith. In this regard, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), an international regulatory body established in 1991, issues standards on accounting, auditing, Shariah, ethics and governance for IFIs has shed important light on what constitutes Shariah audit. AAOIFI's Auditing Standards emphasizes that the objective of a Shariah audit is "to enable the auditors to express an opinion as to whether the financial statements are prepared, in all material aspects, in accordance with the Shariah rulings and guidelines issued by the SBs of Islamic financial institutions, the accounting standards of AAOIFI, international and national accounting standards and practices, and relevant legislation and regulations applied in the country where the Islamic financial institution operates" (AAOIFI, 2010). Similarly, the Central Bank (BNM) in its 2013 newly implemented Shariah Governance Framework (SGF) clearly states that: "the scope of Shariah audit shall cover all aspects of the IFI's business operations and activities, including: financial statements, compliance audit on organizational structure, people, process and information technology application systems; and review of adequacy of the Shariah governance process, which means that the scope should encompass financial statement and internal control system" (BNM, 2010b, p. 24).

The above statements by AAOIFI and BNM clearly illustrate that a Shariah audit has broader rules and guidelines. While this religious audit is perceived to be wider than its conventional counterpart, at present there appears to be no specific framework for the former audit needs (Ginena, 2014; Shafii *et al.*, 2014). Kasim *et al.* (2013) examined the scope of the current practice of auditing in IBs in both Malaysia and Indonesia using a questionnaire survey. Their findings indicate that in both Malaysia and Indonesia gaps exist between the expectations of the ideal religious auditing and the current practice of religious auditing in IBs. Meanwhile, Shafii *et al.* (2014) used a questionnaire survey to identify the content and scope of religious audit certification. This questionnaire survey was distributed to regulators, SBs members, and internal Shariah reviewers in Malaysian IBs. A vast majority of the respondents believed that the religious audit should encompass the internal control system of an IB. Current practice suggests that religious audit does not cover internal control systems, and there exists issues in internal control systems with regards to religious compliance. In addition, in the same study, more than fifty percent of the interviewees strongly agreed that internal auditors who act as religious auditors should attest the financial statements of IBs for religious compliance. This means, at present, the scope does not specifically cover financial statements nor the internal control systems relating to Shariah objectives. Despite the fact that Malaysia is advanced in the regulation of Islamic finance, there appears to be a discernible gap in the scope of the religious audit in respect of both financial statements and internal control systems. Perhaps Malaysia is not alone in this; a similar situation can be found in other parts of the Islamic finance world, where similar issues may arise. In the Saudi context, however, each IB determines its own regulation on its religious audit, which ultimately creates differences in the level of compliance. For this reason, Khokhar and Bukhari (2014) emphasize that there is no clear distinction between conventional banks and IBs in Saudi Arabia. Moreover, Saudi consumers perceived that their banking operations were just marginally religious compliant and they overwhelmingly disapproved of the use of Islamic windows by conventional banks.

### 2.3. Shariah Audit Responsibilities

On the current practice of religious audit in IBs, the critical question that arises is who should be responsible for undertaking the all-important function of the Shariah audit? Should it be the responsibility of the SBs, the internal auditor or external auditors? The difficulty in answering this question is due to the lack of talent of qualified SBs members, internal auditors and external auditors with sufficient knowledge and experience in both Shariah and finance. This shortage of qualified human capital and unclear religious audit responsibilities may affect negatively on IB's religious compliance resulting in financial and reputational risk leading towards loss of confidence and trust from depositors and investors. In a recent study by Mollah and Zaman (2015) using a sample of eighty six IBs and conventional banks from twenty five countries for the period 2005–2011, they found that eighty two percent of respondents reported that their bank had an independent SB; however, other IBs tended to rely either on external Shariah advisory firms or on in-house Shariah officers. Moreover, in most banks (seventy three percent), the internal review was found to be conducted by an internal reviewer but twenty seven percent of the respondents reported that this is primarily the responsibility of audit committees to conduct internal reviews. The survey results highlight that IBs still substantially differ in the manner in which they conduct religious supervisory and auditing function between the SBs, Shariah advisory firms, internal auditors, internal reviewer and audit committee.

AAOIFI's Auditing Standard for IFIs No. 1 explicitly states that external auditors are responsible for investigating and confirming that financial statements of IBs are prepared according to Shariah principles (AAOIFI, 2002). In addition, AAOIFI emphasized that the external Shariah auditor shall be knowledgeable about Shariah rules and principles (AAOIFI, 2010). However, when attention is turned to the Malaysian practice, the SGF of BNM states that Shariah audit functions shall be performed by internal auditors who have adequate religious-related knowledge and training. Furthermore, the SGF also encourages cooperation between internal auditors and Shariah officers. Consequently, Shariah audit functions could be conducted by internal auditors or Shariah officers, but what is deemed vital is that they should have sufficient knowledge and training to undertake such crucial responsibilities. Because of apparent lack of people having both religious knowledge coupled with accounting and finance experience or auditor with special qualifications, the important role of internal auditors in Islamic financial institutions cannot be ignored, especially since internal audit is considered to be a cornerstone mechanism of corporate governance. However, this means that internal auditors would have to go through suitable training programs, establishing and facilitating formal or informal interaction between them and the SBs.

## III. REGULATION AND GOVERNANCE IN THE SAUDI BANKING SECTOR

Saudi Arabian banks are regulated by the Saudi Arabian Monetary Agency (SAMA), which commenced operations in 1952. SAMA, as the Central Bank of the Kingdom of Saudi Arabia, has a number of important functions, including: (1) minting and issuing the national currency; (2) strengthening the currency's cover; supervising commercial banks and exchange dealers including IFIs; (3) supervising cooperative insurance companies and self-employed professions relating to insurance activity; (4) supervising finance companies; supervising credit information companies; managing the Kingdom's foreign exchange reserves; promoting the growth of the financial system and ensuring its soundness; and (5) operating a number of cross-bank electronic financial systems such as tadawul (Saudi Stock Exchange), SPAN, SARIE, MAQASA and SADAD[7]. SAMA has also implemented electronic management and granted permission for the operation of banks from the Gulf Cooperation Council (GCC) countries[8] and issued seven international foreign banks licenses between 2000 to date. Article 1 of the Charter of SAMA stipulates that one of the objectives of SAMA is to regulate commercial banks and exchange dealers, however, without any mention on the operation of IBs or IFIs.[9] Constitutionally, the responsibilities for religious supervision of Saudi IBs have not been identified by SAMA leaving the level of adherence of and the governance functions for religious compliance being at the discretion of banks (Asaad, 2007). Currently, SAMA regulates and supervises Islamic financial institutions (IFIs) that conduct banking and financial activities side-by-side with conventional commercial banking businesses under the Banking Control Law (BCL) of 1966. Despite the IBs not being affected by the 2008 global financial crisis SAMA insists on not permitting Saudi banks to operate under an Islamic banking license for Islamic financing operators (Ramady, 2009). However, there are presently twelve local banks with four banks operating as a fully-fledged IBs and another eight conventional banks operating with Islamic windows. Interestingly, SAMA does not recognize the concept of Islamic banking, the logical reason would be, if SAMA recognized some banks as an Islamic institutions that means others are non-Islamic (Warde, 2000). SAMA also regulates and supervises the cooperative insurance companies sector under the Law of Supervision of Cooperative Insurance Companies of 2003 and the recently enacted Mortgage Law of 2013.

The Capital Market Authority (CMA) was established under Article 4 of the Capital Market Law in 2003, for regulating and developing activities in Saudi Arabia. The CMA is considered as an independent authority because it links directly to the king of Saudi Arabia, and it has an autonomy financial and administrative. The CMA is managed by a board of five full-time members appointed by the King (Al-Shamrani, 2014). The main role of CMA is to issue the regulation related to Securities, monitoring Securities and dealing Securities containing issuance of Sukuk (Islamic bond). The main objective of the CMA is to create an appropriate environment for investment, growth of investment activities and reinforcing disclosure standards and transparency for all listed companies to protect the right of investors and dealers[10]. Moreover, that CMA has implemented three main corporate governance initiatives in three main phases (ROSC, 2009) to improve the practice of corporate governance in Saudi Arabia. The first phase has been completed by releasing the Saudi corporate governance code (SCGC) in 2006. The code, considered to be the main guide for implementing good corporate governance practice, consists of four parts: (i) preliminary provisions with essential definitions and the relationship between the codes and other sections of legislation; (ii) shareholders' right and the general assembly; (iii) enhancing disclosure and transparency; and (iv) issues relating to the functioning of board of directors. Meanwhile, the second phase is to increase the appreciation and the awareness of good governance practices, however this phase is still on-going. The third phase encompass the revision of the code aimed at enhancing the effectiveness of the Saudi corporate governance to ensure that the Saudi governance practice is at par with the requirement of international corporate governance standards.

### 3.1. Shariah Audit Challenges

Saudi consumers have raised confusion arising from the large number of Shariah edicts (fatwas) issued as to what a religious compliant financial product was, and what it was not and there was no central Shariah advice, monitoring or professional standards available (see Khan, 2011) . Such revelation came as no surprise as there has been a claim that IBs in Saudi Arabia based their portfolio decisions mainly on the advice of internal Shariah advisory boards (Wilson, 2005). In a recent study, Khokhar and Bukhari (2014) reported that Saudi IB customers were generally satisfied with the practice of Islamic banking, but their perception was that the operations in IBs are only marginally Shariah compliant and that consumer also disapproved operations of Islamic banking windows provided by conventional banks. Interestingly, these results emanated when two different and conflicting edicts (fatwa) were issued regarding subscription in shares of the National Commercial Bank or NCB (which was operating as an Islamic window). First, an edict was issued by the bank's SBs approving the subscription, whilst, a second edict issued by the permanent National Fatwa Committee which had disapproved the subscription in the NCB leading to confusion between religious scholars, SBs members and investors in the country. However, a study by Ismail (2014) on boards' involvement in risk management practices (RMPs) of banks incorporated in Saudi Arabia indicated otherwise. Respondents to his study from twelve local banks (four fully-fledged IBs and eight banks with Islamic windows) and eleven foreign banks asserted that they were committed to implementing religious compliance RMPs. Nonetheless, this claim cannot be verified as the annual reports to these banks did not disclosed this important information in their annual reports hence customers find it hard to remove their doubt on the level of religious compliance in the IB operations in Saudi Arabia.

Financial statements for IBs are now deemed more important to religious scholars, researchers and users of financial statements. The Saudi Organization for Certified Public Accountants (SOCPA) is a professional organization established under Royal Decree No. M12 in 1991. It operates under the supervision of the Ministry of Commerce in order to promote the accounting and auditing profession and all matters that might lead to the development of the profession and upgrading its status. Currently SAMA requires banks and insurance companies in Saudi Arabia to report under International Financial Report Standards (IFRS), however; SOCPA standards apply to all other companies, listed and unlisted. An interesting development is that from 2017, all companies in Saudi Arabia will be required to adopt IFRS though with some modifications. One of the modified standards relates to disclosure in IBs aimed at enhancing the level of transparency on IB products. SOCPA identified that, among others, modifications to the conceptual framework for financial reporting with emphasis, such as the following, to be made:

"*In an investment environment where special consideration is directed towards the kind of the entity's operations and the nature of its financial instruments, the investment decision is largely dependent on the availability of information about the nature and kinds of such transactions and financial instruments. For example, from the bank's perspective both bonds and Sukuk accomplish the same purpose, i.e. an investment opportunity or a financing medium. However, investors' decisions in an environment such as that in Saudi Arabia are directly affected by the availability of detailed information about the different kinds of financial instruments and their periodic returns or costs. Such investors may refrain from investing in particular entities because of the types of financial instrument they are dealing in, no matter how high their return or how low their risk*" (SOCPA, 2016, P 5).

There was also a lack of consensus on what qualifications and experience were needed for religious scholars in Saudi Arabia. Currently, the majority of scholars have specialized academically in Islamic jurisprudence (i.e., fiqh) with only a limited number having a background in law or economics. About 90 percent of SBs members were found to be graduates of religious institutions in which a command of foreign languages and banking experience was not required (Asaad, 2007). Furthermore, banks operating Islamic windows need to exert greater effort to comply with the Shariah compared to fully-fledged banks in Saudi Arabia as fully-fledged IBs tend to have a greater number of SB members. Ginena (2014) argues that Islamic windows are more exposed to religious non-compliance risk due to many reasons, especially, for example, the need to segregate the funds of a conventional bank from those of its Islamic windows, and also to distribute corresponding returns to Islamic investment account holders. Therefore, Islamic windows in Saudi Arabia need enhanced care and control, especially since the value of Islamic banking assets belonging to IB windows in Saudi Arabia amount to approximately US$80 billion (Song and Oosthuizen, 2014). In a recent study, Ramady (2015) evaluated the effects of the global financial crisis on regulation in GCC banks, the impact on the region and the policies adopted by the regulators to avoid financial panic and contagion. Regarding Islamic banking in the GCC, we find that there is no uniform interpretation of religious principles, and criteria for verification even differ within the GCC. Thus, there is an urgent need to establish uniform accounting, auditing and governance guidelines for Islamic financial institutions. Even though AAOIFI has uniform accounting, auditing and governance, it is still very much limited in its scope.

## IV. SHARIAH AUDIT COMPARISON BETWEEN SAUDI ARABIA AND MALAYSIA

Although the purpose of this present study is to investigate Shariah audit practice in Saudi Arabia, we felt it is necessary to compare practice with the Malaysian guidelines of Shariah audit since the latter is acknowledged to have the most developed governance framework in the Islamic world. Table 1 highlights the major differences between the guidelines on this religious audit issued by the Central bank of Malaysia (BNM) with the existing practice in Saudi IBs. Analysis on the objective of Shariah audit of the two countries reveals that Malaysia has a clear specified objective, however, it is ambiguous for Saudi IBs as our preliminary investigation indicates that there are no guidelines nor disclosure is being made by the banks with the exception of a few such as the Al-Rajhi Bank. In Malaysia, BNM provides emphasis on internal control systems with vested power to the banks to establish their own guidelines on operational dimensions of Shariah governance (Ginena, 2014). The BNM also highlights that Shariah audit should cover both the financial statements and the internal control system whereas there is no mandatory regulation relating to religious compliance which exists for IBs in Saudi Arabia. This implies that the rules pertaining to financial statements or internal control system for Saudi Arabian IBs are the same as conventional banks. However, in some full-fledged IBs, the shareholders can influence IBs by supporting the decisions issued by SBs on religious compliance related issues.

**Table 1**
**Comparison of Shariah Audit between Malaysian (BNM) Guidelines and Saudi Practice**

| | *Central Bank Guidelines for Shariah Audit (Bank Negara Malaysia, BNM)* | *Current Shariah Audit Practice in Saudi Arabia* |
|---|---|---|
| Shariah audit objective | To provide an independent assessment and objective assurance to ensure a sound and effective internal control system for Shariah compliance. | No formal objectives declared because neither SAMA nor CMA have regulation for IBs (Asaad, 2007), thereby most IBs ignore to disclose objectives |
| Shariah audit scope | All aspects of the IFI's business operations and activities, including:<br>• Audit of financial statements;<br>• Compliance audit on organizational structure, people and IT application systems; and | • Not possible to determine any scope in general; each Islamic bank or Islamic window follows its own practices (Asaad, 2007).<br>• Because of the absence of any specific regulation, the scope differs from one bank to another (Grassa, 2013b). |
| Shariah audit function | • Review of adequacy of the Shariah governance process.<br>• Understanding the business activities of the IFI – to allow for better scoping of an audit exercise;<br>• Developing a comprehensive internal audit program;· Obtaining and making reference to relevant regulations.<br>• Communicating results or findings to the Board Audit Committee and the Shariah Board; and<br>• Providing recommendations on rectification measures taken as well as following up on the implementation by the IFI | |
| Shariah audit Responsibilities | • Internal auditors, who have acquired adequate Shariah-related knowledge and training.<br>• Also the internal auditors may engage the expertise of the IFI's Shariah officers in performing the audit, as long as the objectivity of the audit is not compromised | There are no mandatory rules regarding Shariah compliance for financial statement and internal control system; thus, these actions vary from one bank to another (Grassa, 2013b).<br>• Main responsibility for Shariah supervision lies with the Shariah Board (Grassa, 2013b; Hasan, Z. 2011). |

Interestingly, we find that the function of the Shariah audit outlined by BNM is more detailed such as understanding business activities, developing internal audit programs, communicating with audit committees and providing recommendations. However, in Saudi Arabia, each IB has its own guideline based on the kind of IB it operates (i.e., whether full-fledge or Islamic windows), the SBs, the general assembly and its experience. Finally, according to BNM's guidelines, the Shariah audit should be conducted by internal auditors who have the necessary knowledge and training in Shariah. In the case where internal auditors lack this knowledge, the bank must engage the expertise of IB's Shariah officers. In contrast, in fully-fledged IBs in Saudi Arabia, all Shariah reviews or audits are conducted by the Shariah department. Banks with Islamic windows, however, may engage some internal auditors who have the required certification or experience in the Shariah discipline to conduct the religious audit. It appears, therefore, that the system practiced in Saudi Arabia is one in which complete autonomy and full flexibility is provided to management to select their own modus operandi.

## V. CONCLUSION

This study provides a review of the limited extant literature and sheds light on the meaning, function, scope and responsibility of Shariah audit as experienced in Saudi Islamic banks. We further evaluate the guidelines issued by Malaysia's central bank (BNM) which stipulate that the Shariah audit function is an independent assessment conducted to ensure a sound and effective control system for religious compliance in the institution. Based on our review, we find that this function still remains vague without any current guidelines issued. Hence, Islamic institutions in Saudi Arabia are required to develop their own internal policies, which are to be applied by SBs and internal auditors. In addition, in relation to the scope of Shariah audit, we find that there is no clear criterion established even in Malaysia, which is regarded as a trend setter for Islamic finance, but still has an inherent weakness in terms of Shariah audit scope.

In Saudi Arabia, we find that regulators have avoided issuing mandatory or voluntary guidelines for Shariah governance; thus, any decision regarding religious compliance for transactions and activities is based solely on an individual bank's SB. This means that each IB or Islamic windows relies heavily on self-made regulations by individual SBs relating to Shariah compliant procedures; thereby the level and extent of compliance differs among IBs reducing the level of confidence and increasing possible tension between banks and investors. Therefore, our study highlights that Saudi authorities should perhaps introduce regulation aimed to standardize its IB industry by moving away from a self-styled autonomous form of Shariah governance to a central governance system to effectively regulate its IB industry.

Focusing broadly on the GCC, Shariah authority generally tends to be delegated to government bodies to assure independence of SBs unlike what is evidenced in Saudi Arabia where authority and power is totally vested in the SBs of each individual bank. We are of the view that to bring about independence and effectiveness of SBs, Saudi regulators should consider establishing an over-arching central level SB which would have responsibility for overall Shariah regulation. This would assist in determining the broad lines of religious compliance in IBs and to act as a point of reference in case of conflict or contradictions between SB members within IBs. Furthermore, external auditors can also play a significant role in religious compliance as an independent institution from IBs. Particularly so, because external audit firms already train their employees for working in various sectors, it is therefore not inconceivable that they secure the services of experts in Shariah practice who also have the benefit of an accounting background. Nonetheless, such steps should be undertaken in parallel with internal audit training in Shariah compliance to achieve effectiveness and raise standards of best practice. This would contribute to achieving the high level of compliance expected by stakeholders.

In addressing the question 'who should have overall responsibility for Shariah audit in the Islamic finance industry?', we highlight that internal auditors are more likely to succeed in this task if they are equipped with adequate Shariah-related knowledge coupled with training and maintaining effective communication with SBs. In particular, we suggest that Saudi IBs and the regulator should collaborate more closely with the Saudi accounting profession (SOCPA) in order to improve Shariah audit by employing strategies such as (1) allowing internal auditors to communicate more with board of directors, audit committees and external auditors; i.e., SBs should also engage in the wider circle of governance mechanisms; (2) internal auditors in Saudi Arabia should employ auditing standards promulgated by international organizations in order to improve their own auditing systems and procedures and (3); because of the nature of both jurisprudential and jurisdictional differences in Islamic law, it would appear that the internal audit function would offer the optimal solution for implementing religious compliance policies and procedures. Finally, perhaps the first step for Saudi authorities is to become more regulatory driven by adopting a more rigorous approach by moving from its current self-regulatory governance style to a dual regulatory structure. The benefit of such a move would enable its Islamic banking business to become imbedded similar to that experienced in other jurisdictions such as Malaysia. However, if such an opportunity is missed, then it is not inconceivable that Saudi Arabia may lag behind in its quest for establishing an effective and efficient regulatory and governance landscape for its thriving Islamic finance industry.

## NOTES

1. The World Islamic Banking Competitiveness Report 2016 highlighted that Saudi Arabia is the largest player in Islamic finance globally, with total assets worth US$ 343b in 2015 and expected to reach US$ 766billion by 2020.
2. The word Shariah is also taken to denote 'the straight path' and is often equated with Islamic law (Choudhury, 1997). In the eyes of Muslims, Islam offers comprehensive guidance for human kind and specifies the principles that aim to protect the interests of human beings
3. The survival products (necessities) that satisfy basic needs such as mortgage and financing which is required for essential activities.
4. The security or complementary products would satisfy additional needs beyond the necessity level.
5. The growth or higher level needs such as investment in stocks and mutual funds.
6. SAMA in 1990 established the Saudi Payment Network (SPAN). SARIE means the Saudi Arabia Riyal Interbank Express Electronic System and established in 1997. MAQASA means Clearing, the reciprocal exchange between banks, and the settlement of the differences. SADAD is a developed payment system approved by SAMA in 2004.
7. The GCC banks are: Gulf International Bank (Bahrain) started in 2000, followed by the Emirates Bank International (UAE), National Bank of Kuwait (Kuwait), National Bank of Bahrain (Bahrain), Bank Muscat (Oman) all started in 2002.
8. Charter of the Saudi Arabian Monetary Agency (SAMA) 1957, Art. 1.
9. See the official website of the Capital Market Authority (CMA), available at: *http://www.cma.org.sa/En/AboutCMA/Pages/default.aspx,* [Accessed 9 April 2016].

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