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## **PART 1 INTRODUCTION**

- 1.1 This circular sets out Bank Negara Malaysia's (the Bank) minimum expectations regarding the role and responsibility of the board of directors (the board) of Islamic banks in relation to the appointment of auditors under section 17 of the Islamic Banking Act 1983 (IBA). While the preparation and integrity of financial statements are the responsibility of the board and senior management of Islamic banks, assurance of a properly conducted audit serves to provide an independent view of the financial statements' reliability. This assurance is important in the light of the increasing reliance placed on management's judgement under the new financial reporting standards being adopted in Malaysia. Such assurance would depend significantly on the exercise of appropriate due diligence by Islamic banks in the selection and engagement of auditors.
- 1.2 This circular addresses the qualifying criteria for the appointment of auditors by Islamic banks, the Bank's supervisory expectations regarding the terms of audit engagements, application procedures and reporting obligations to be observed by Islamic banks.
- 1.3 The provisions are aimed at promoting the accuracy and reliability of financial statements issued by Islamic banks for supervisory and general purposes, thereby enhancing the efficacy of the Bank's risk-based supervisory process and reinforcing effective market discipline.

## **PART 2 APPLICABILITY**

- 2.1 This circular is applicable to all Islamic banks licensed under the IBA.
- 2.2 References to the board in this circular shall mean the board as assisted by the Audit Committee.

### **PART 3 LEGAL PROVISION**

3.1 This circular relates to section 17 of the IBA and is issued pursuant to section 53A of the IBA.

### **PART 4 CRITERIA FOR APPOINTMENT OF AUDITORS**

4.1 Islamic banks must be reasonably satisfied that an auditor to be appointed under section 17 of the IBA has met the qualifying criteria set out in this circular, both prior to and during the entire audit engagement. For this purpose, the board is expected to obtain, independently verify through reasonable means and review relevant information necessary to support its assessment of the auditor's compliance with the matters dealt with under paragraph 4.2.

4.2 Auditor appointed under section 17 of the IBA must:

(i) not be disqualified -

- An auditor shall be disqualified from being appointed as an auditor of an Islamic bank if such person:
  - (a) is not an approved company auditor;
  - (b) has any interest whatsoever in any form or of any description in that bank, including an interest in the shares of the bank;
  - (c) is a director, controller or officer of that bank;
  - (d) is indebted to that bank or to any related corporation of that bank;
  - (e) is a partner, employer or employee of a director, controller, or officer, of that bank;
  - (f) is a partner or employee of an employee of a director, controller, or officer, of that bank;
  - (g) is a shareholder, or his spouse is a shareholder, of a corporation whose employee is an officer of that bank;

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- (h) is responsible, or is the partner, employer, or employee of a person responsible, for the keeping of the register of members or the register of holders of debentures of that bank; or
- (i) has been convicted of any offence under IBA or the Companies Act 1965, or of any offence under any other written law involving fraud or dishonesty.
- A firm shall not be appointed as an auditor of an Islamic bank unless:
  - (i) All partners of the firm resident in Malaysia are approved company auditors and, where the firm is not registered as a firm under any law for the time being in force, a return showing the full names and addresses of all the partners of the firm has been lodged with the Bank; and
  - (ii) No partner is disqualified under 4.2 (i) (b)-(i), inclusive, from acting as the auditor of the Islamic bank.
- (ii) have adequate resources and the necessary skills, knowledge and appropriate experience to perform their duties with professional competence and due care in accordance with approved professional auditing standards<sup>1</sup> and applicable regulatory and legal requirements;
- (iii) not have relationships with, or interests in, the Islamic banks or any other entity that are likely to impair their objectivity or independence, and which cannot be reduced to an acceptable level through the application of appropriate safeguards;
- (iv) not have any record of disciplinary actions taken against them for unprofessional conduct by the Malaysian Institute of Accountants (MIA) and the decision for such disciplinary action has not been reversed by the Disciplinary Appeal Board of the MIA; and
- (v) not have served as an engagement partner for a continuous period of more than five (5) years with the same Islamic bank. An auditor who has been rotated off the audit of an Islamic bank may resume the role as engagement partner only after a lapse of five (5) years from the last audit engagement with the Islamic bank.

<sup>1</sup> Malaysian Approved Standards on Auditing (MASA) issued by the Malaysian Institute of Accountants.

4.3 The board may rely on attestations provided by the auditor on matters covered in paragraph 4.2, provided that reasonable steps have been taken to establish the veracity of the attestations. Among other things, the board should consider information available from public or independent sources which are relevant to the professional conduct of the auditor, and the auditor's conduct and performance in past assurance engagements with the Islamic bank. In particular, the board should be satisfied that appropriate measures have been taken by the auditor to prevent the recurrence of past audit lapses that have been observed, including but not limited to, delays in the issuance of audit reports and inadequate audit procedures resulting in the failure to detect material misstatements or control deficiencies.

## **PART 5 TERMS OF AUDIT ENGAGEMENTS**

5.1 The board should carefully review the terms of audit engagements prior to confirming an engagement. The agreed terms should be documented in a clearly written audit engagement letter.

5.2 The Bank expects the terms of audit engagements to clearly address:

- (i) the objective of the audit;
- (ii) scope of the audit engagement;
- (iii) agreement on the audit plan;
- (iv) responsibilities of the engagement and concurring partners;
- (v) reports to be prepared by the auditor;
- (vi) timing and fees;
- (vii) the use of experts in certain aspects of the audit; and
- (viii) other significant arrangements in relation to the audit, including responsibilities of the auditor with regard to any change to members of the engagement team during the audit.

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5.3 For recurring audits, the existing terms of the audit engagement should be confirmed for each reporting period and appropriate modifications made as necessary to reflect any material changes in the Islamic bank or existing audit arrangements.

### **Scope of Audit Engagement**

5.4 The scope of the audit engagement shall have regard to the Islamic bank's financial reporting risk areas.

5.5 The audit programme and audit plan must *at least* include specific procedures to test the Islamic bank's internal controls over financial reporting in relation to the loan and investment portfolios. These procedures should include a review and validation of management's processes for determining the adequacy of provisions for loan impairments and values ascribed to financial instruments. The procedures should be adequate to enable the auditor to form a view as to whether management's process is based on a comprehensive, adequately documented and consistently applied analysis of the Islamic bank's loan and investment portfolios.

5.6 The audit scope and plan should similarly address any other area identified by the board which presents a significant financial reporting risk to the Islamic bank.

5.7 The board should also consider any significant changes in the bank during the reporting period which may have contributed to an increased risk inherent in the bank's internal controls over financial reporting, the accuracy of its recording of transactions, and ability to comply with financial reporting standards. Such changes include business combinations, significant changes in operating structures, processes or key management personnel, the implementation of new reporting standards or regulatory requirements and major systems changes or upgrades. Where appropriate, the scope of the audit engagement should address any additional and specific procedures needed to address areas

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identified as being of high risk or particular concern in any particular financial year(s).

- 5.8 As an extension of the financial statement audit, the scope of the audit engagement should include recommendations to management for improving internal controls to ensure the fair presentation of financial statements. The Bank expects the issues raised and recommendations made by the auditor to be deliberated by the board in a timely manner with appropriate remedial actions identified and followed through.

### **Responsibilities of Engagement and Concurring Partners**

- 5.9 The engagement partner is principally responsible for the performance of the audit engagement and the auditors' report issued on behalf of the audit firm.
- 5.10 The terms of the audit engagement should clearly state the Islamic bank's expectations of the engagement partner. This shall include an explicit expectation that the engagement partner will:
- (i) effectively direct, supervise and perform the audit in compliance with professional standards and the audit firm's internal quality control procedures throughout the audit engagement;
  - (ii) ensure that the engagement team collectively has the appropriate capabilities, competence and time to devote to the audit of the Islamic bank. This should include relevant audit experience in the banking industry; and
  - (iii) ensure that the auditors' report, including any opinions expressed and emphases of matter, is reliable based on sufficient audit evidence and is not misleading in any material respect.
- 5.11 The board shall ensure that a concurring partner is identified for each audit. The concurring partner is responsible for objectively evaluating, before the audit report is issued, the significant judgements made by the engagement team and conclusions reached in formulating the report.

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5.12 The terms of the audit engagement should establish an expectation of the concurring partner to form an objective assessment, *based on an appropriate review of selected audit working papers*, of:-

- (i) significant risks identified by the engagement team during the audit and the appropriateness of the team's responses to those risks;
- (ii) whether the audit evidence obtained is sufficient to support the significant judgements made and conclusions reached;
- (iii) whether differences of opinion with management or other contentious matters were appropriately dealt with; and
- (iv) matters which should be communicated to management and where applicable, the Bank or other regulatory authority.

For this purpose, the board should be satisfied that the concurring partner is suitably qualified and commits the necessary time to carry out the required review of audit documentation to support his assessment.

### **Reliance and Accountability for Auditors' Report**

5.13 The terms of engagement shall clearly establish the Bank's expectation of reliance on the auditors' report for its supervisory purposes. In this regard, the auditor should be aware that the work of the auditor will be used as input to the Bank's supervisory plans under the risk-based approach to supervision, and its ongoing assessments of the safety and soundness of the Islamic bank.

5.14 To support such reliance, the auditor is expected to perform all necessary procedures to comply with the Malaysian Approved Standards on Auditing, and should be held accountable for any departure from such standards.

5.15 The Bank therefore considers it inappropriate for Islamic banks to include any provisions in the terms of the audit engagement that limit the auditor's responsibility with respect to audit opinions expressed. In particular, the terms of engagement shall not contain any provisions under which the Islamic bank

agrees to indemnify the auditor against claims made by third parties, release the auditor from liability for claims or potential claims that might be brought by the Islamic bank against the auditor, or limit the remedies available to the Islamic bank for professional misconduct.

### **Audit Fees**

5.16 The board should ensure that audit fees are commensurate with the scope of the audit and accountability assumed by auditors, taking into account, among other things, the required skills, knowledge and the allocation of time and resources needed to complete the audit assignment. The audit fees paid to the auditor should also not impair, either in fact or appearance, the auditor's professionalism, judgement or independence.

### **Use of Experts**

5.17 If specialised skill or expertise is required to obtain sufficient audit evidence to support the audit, the auditor may decide to use the work of an external expert. In such circumstances, the terms of engagement must clearly provide that the use of the expert does not diminish the auditor's responsibility for audit reports issued or opinions expressed.

## **PART 6 APPLICATION PROCEDURES AND REPORTING OBLIGATIONS**

6.1 Pursuant to section 17(1) of the IBA, Islamic banks shall submit an application to the Bank for approval to appoint an auditor for each financial year no later than two (2) months before the Islamic bank's annual general meeting of the preceding financial year.

6.2 An application to the Bank shall be made using the form enclosed in **Attachment I**, together with the complete information required therein. The application should be addressed to Pengarah, Jabatan Penyeliaan Perbankan.

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- 6.3 An application shall not be submitted to the Bank unless the board is reasonably satisfied that the requirements and expectations of this circular have been, or will be, met. The board should determine the appropriate documentation to be maintained by the Islamic bank to support its assessments against the expectations of this circular.
- 6.4 If during the course of an audit, the auditor no longer fulfils or may not be able to fulfil any of the qualifying criteria or terms of the audit engagement as expected under this circular, the Islamic bank shall immediately report that fact to the Bank.

## **PART 7 CIRCULAR SUPERSEDED**

- 7.1 This circular supersedes the circular dated 8 August 2003 titled “Pelantikan Juruaudit Luar menurut Seksyen 17 Akta Bank Islam 1983”.

**Application Form for Appointment of Auditor under  
Section 17 of the Islamic Banking Act 1983**

1. Name of Islamic bank : \_\_\_\_\_
2. Appointment for financial year ending : [e.g. 30 Jun 20x8]
3. Proposed date of Annual General Meeting : \_\_\_\_\_

4. Particulars of the Audit Firm

Name	
Firm No.	
Address	

5. Particulars of engagement and concurring partners

	Engagement partner	Concurring partner
Name		
Audit Licence No.		
NRIC No.		
Contact No.		
E-mail		

Engagement partner since [ financial year ]

6. New appointment  Reappointment

7. If new appointment, please state reason(s) for change of auditor

\_\_\_\_\_

\_\_\_\_\_

8. Particulars of fees and non-audit services provided by the audit firm for the last two financial years

Type	RM		Nature of non-audit services
	[e.g. 30/6/X6]	[e.g. 30/6/X7]	
Non-audit fee			
Audit fee			
Total			

9. Additional information to be enclosed with application:

- Extract of board minutes endorsing the proposed appointment/reappointment of the audit firm and confirming that the board is satisfied that the auditor has met the criteria for appointment as specified by Bank Negara Malaysia
- Statutory declaration by the engagement partner (Attachment II)
- List of public interest entities<sup>1</sup> audited by the engagement partner in the last two years<sup>2</sup>, prior to the date of statutory declaration

\_\_\_\_\_  
Date

\_\_\_\_\_  
Name and Signature  
Chief Executive Officer/  
Company Secretary

<sup>1</sup> For this Circular, public interest entities means public listed companies, conventional and Islamic banking institutions, development financial institutions, insurers and takaful operators regulated by Bank Negara Malaysia or the Securities Commission.

<sup>2</sup> For reappointment of the same engagement partner, disclosure is only needed for audit engagement since the last statutory declaration.

**STATUTORY DECLARATION BY ENGAGEMENT PARTNER OF AUDIT FIRM**

I, [ name of engagement partner (Audit Licence Number) ], of [ name of audit firm (Firm's Number) ], [ NRIC No. ], being the partner primarily responsible for the audit engagement, do solemnly and sincerely declare that:

- A. I am not disqualified under any of the circumstances specified in paragraph 4.2 (i) of the circular on "Appointment of External Auditor by Islamic Banks" from being appointed as an auditor for [ name of banking institution ].
- B. I have no relationships with, or interests in, [ name of Islamic bank ] or any other entity that are likely to impair my objectivity or independence, and which cannot be reduced to an acceptable level through the application of appropriate safeguards.
- C. I have no record of disciplinary actions taken against me for unprofessional conduct by the Malaysian Institute of Accountants (MIA) and the decision for such disciplinary action has not been reversed by the Disciplinary Appeal Board of the MIA.
- D. The information submitted together with the Application Form for Appointment of Auditor on public interest entities<sup>1</sup> audited by me as engagement partner in the last two years/since the last statutory declaration (delete whichever is not applicable) prior to the date of this statutory declaration is true and complete.

<sup>1</sup> *Public interest entities means public listed companies, conventional and Islamic banking institutions, development financial institutions, insurers and takaful operators regulated by Bank Negara Malaysia or the Securities Commission.*

**AND I MAKE THIS SOLEMN DECLARATION CONSCIENTIOUSLY BELIEVING THE SAME TO BE TRUE, AND BY VIRTUE OF THE PROVISIONS OF THE STATUTORY DECLARATIONS ACT 1960.**

**SUBSCRIBED AND SOLEMNLY DECLARED BY THE ABOVENAMED**

\_\_\_\_\_

**AT** \_\_\_\_\_

**IN THE STATE OF** \_\_\_\_\_

**THIS DAY OF** \_\_\_\_\_ **20** \_\_\_\_\_

Before me:

(Signature of Sessions Court Judge,  
Magistrate or Commissioner for Oaths)

## Frequently Asked Questions

### Scope of Audit Engagements

**1. Are Islamic banks expected to extend the normal scope of a statutory audit engagement in order to meet the requirements of the Bank's supervisory expectations under Part 5 of the Circular?**

No, the matters dealt with under Part 5 of the Circular does not extend the normal scope of a statutory audit which is carried out by external auditors in accordance with Malaysian Approved Standards on Auditing (MASA) issued by the Malaysian Institute of Accountants (MIA) and applicable regulatory and legal requirements. In particular, references to the auditor's review of the institution's financial reporting processes and internal control environment (paragraphs 5.5 – 5.7) and recommendations to be made to management for improving internal controls (paragraph 5.8) are consistent with auditing procedures required to be carried out in the normal course of a financial statements audit pursuant to MASA, and does not impose an expectation on auditors to undertake additional procedures outside the normal course of a financial statement audit. Hence, the auditor is not expected to express a separate opinion in the audit report on management's financial reporting processes and internal controls.

Islamic banks may refer to MASA issued by MIA for a better appreciation of the expectations of auditors performing financial statement audits, including the following:-

- ISQC 1: Quality Control for Firms that Perform Audits and Reviews of Historical Financial Information, and Other Assurance and Related Service Engagements
- AI 315: Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement
- AI 1006: Audits of the Financial Statement of Banks

### Chronological Sequence of Events

**2. Should Islamic banks submit the engagement letter together with the application letter?**

No, the information required by the Bank to process the application for appointment of auditors is outlined in Part 6 of the Circular i.e. Attachment I together with the additional information required therein. Paragraph 6.3 provides for situations where some of the supervisory expectations would only be met after the auditor is appointed (e.g. detailed audit plan). This would not preclude Islamic banks from submitting an application for the appointment of the auditor to the Bank, as long as the Board is reasonably satisfied that those expectations will be met in due course prior to the commencement of the audit.