THE CASE FOR ISLAMIC AUDITING

Shahul Hameed bin Mohamed Ibrahim discusses the development of Shari’a auditing as a profession

Auditing, in a broad definition given by the American Accounting Association (AAA), is the “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.” However, despite the AAA committee’s observation that the definition was intended to cover “the many different purposes for which an audit might be conducted and the variety of subject matter that might be focused on in a specific audit engagement,” mainstream auditing has focused on giving an opinion on the truth and fairness of the financial statements of corporations ever since the birth of the accounting profession.

Many of our corporate failures are ethical in nature, and would have been detected (and probably attenuated) if the criteria used to assess compliance were expanded to include other dimensions instead of just GAAP. Accordingly, and in line with the appearance of other accounting criteria such as social, environmental, human resource and Islamic accounting, auditing has not stood still but has evolved, as shown in Figure 1.

While basically an evidence accumulation and evaluation process, the scope and criteria of auditing has evolved. In the financial statement audit, only assertions about economic actions and events are examined, while in the social, environmental and Shari’a audits, a broader spectrum of factors is examined. Further, the criteria against which their correspondence should be examined have also evolved far beyond GAAP.

THE CASE IN FAVOUR

We can define Shari’a auditing as a systematic process of objectively obtaining and evaluating evidence regarding assertions about socio-
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economic, religious and environmental actions and events in order to ascertain the degree of correspondence between those assertions and Shari’a (Islamic Law), and communicating the results to users. Some may ask why the world should be concerned with a Shari’a audit, which is basically a Muslim issue. The answer is that the first application of Shari’a auditing appears to be in the global Islamic banking and finance arena.

The need for the serious development of a Shari’a auditing profession is the result of the phenomenal growth of Islamic banking and finance. As an Islamic institution, the Islamic bank is supposed to adhere to Shari’a principles and rules in all its activities. From the perspective of the stakeholders of Islamic banks, both depositors and customers, Shari’a compliance is a key issue in Islamic banking, as it is the raison d’être for Islamic institutions. Hence, this field is worth study and discussion to transform it into a complete profession much like the conventional accounting and auditing profession. This is particularly so as the Muslim world revitalises contemporary forms of classical Islamic socio-economic institutions such as zakat (a compulsory religious duty akin to a tithe), waqf (Islamic endowment), and Islamic corporations. The extension of the Shari’a audit to these other Islamic institutions are supported by the research conducted by Sri Mulyani Indrawati (2007), which will be discussed throughout this paper.

Currently, Shari’a auditing (termed a review by the Accounting and Auditing Organisation for Islamic Financial Institutions (AAOIFI)) is not performed by external auditors but by a Shari’a Supervisory Board (SSB). The SSB consists of a number of Islamic scholars of jurisprudence whose role is to direct, supervise and review the activities of the Islamic financial institution to ensure Shari’a compliance in all its activities. Each Islamic bank has an SSB whose expertise has been used mainly in seeking its advice on the Shari’a compliance of innovative Islamic financial products and the related contracts given to consumers. At the end of the financial year, the SSB gives a Shari’a report, which is part of the annual report. An example of one such report is given in Figure 2.

REPORT OF THE SHARI’A SUPERVISORY COUNCIL

We, Mohd Bakir Haji Mansor and Dato’ Md Hashim Haji Yahya, being two of the members of Shari’a Supervisory Council of Bank Islam Malaysia Berhad, do hereby confirm on behalf of the members of the Council, that in our opinion, the operations of the bank for the year ended 30 June 2004 have been conducted in conformity with the Shari’a principles.

On behalf of the Council:


MOHD BAKIR HAJI MANSOR


DATO’ MD HASHIM HAJI YAHYA

Kuala Lumpur,
Date: 27 September 2004

FIGURE 2

Many of our corporate failures are ethical in nature, and would have been detected if the criteria used to assess compliance included other dimensions instead of just GAAP

There are several important issues which need to be resolved if Shari’a auditing is to become a fully-fledged and respected profession (along with Islamic accounting).

One such issue is a body of knowledge and theory. Since a holistic view of Shari’a requires a multidimensional established criteria, it requires tremendous amount of research and development to obtain this body of knowledge. Research in Shari’a auditing has found difficulty in establishing the criteria and the methodology of auditing. The dearth of literature in this area has to be filled by further research by universities and other professional institutions.

Mulyani (2007) made a survey of accounting academics, audit practitioners and Shari’a scholars in Malaysia. She found that the respondents agreed strongly to the creation of a new Shari’a audit discipline with a separate regulatory framework. This Shari’a audit should be conducted by a new group of professionals termed Shari’a auditors. An overwhelming majority of Shari’a scholars rejected taking on this role, along with external auditors. The respondents also wanted a Shari’a auditor to be appointed by an external regulatory body such as the PCAOB. They opined that the question of independence was too critical to be left even to the shareholders of an Islamic bank.
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The Scope of Shari’a Auditing

Shari’a is very broad and includes ethics, worship, and law of business transactions in its scope. Currently, a narrow view of Shari’a is taken by the SSBs, i.e. the technical compliance of the financing contracts to the fatwas (opinions) of the SSB as to what is permissible and what is not.

A holistic view of Shari’a would look into business policies, processes and procedures, contracts and agreements, financial systems and reporting, human resource management, social activities and contributions, marketing and advertising, reports and circulars, zakat calculation and payment, and IT systems.

Mulyani’s research found that respondents voted to include all these areas in a Shari’a audit, although to varying degrees (agreement ranged from 3.70 for IT to 4.6 for contracts and agreements on a five-point Likert scale). While these might be very wide in scope, the size of the Islamic banks these days calls for a more holistic view of Shari’a in line with the public accountability of larger institutions.

Auditor Competencies

While members of the Shari’a Supervisory Boards are pre-eminently qualified for their role of issuing fatwas on the Shari’a permissibility of a financial product, they are not qualified auditors because they are not trained in the collecting and evaluating of evidence. Further, their advisory role in developing products would conflict with their auditing role, as this constitutes a self-review threat according to IFAC’s code of ethics.

Unfortunately, neither are those accountants trained in Anglo-American accounting and auditing principles fit for the job, as they are oblivious of Shari’a principles. What is required is perhaps a new breed of Islamic accountants and auditors who would have both a western accounting qualification and possibly a degree or certification in Shari’a. Mulyani’s research found that the most popular option was to have a professional or degree qualification in accounting with further specialised certification in Shari’a auditing.

Regulatory Framework

A Shari’a auditing profession needs a host of standards, both for the established criteria (such as IFRS in financial statement auditing) and audit methodology (such as the corresponding international auditing, review and assurance standards). To a certain extent, this has been achieved by AAOIFI, which has produced a total of 24 Islamic accounting standards, 21 Shari’a standards, five auditing standards, four governance standards and two codes of ethics as at 2005.

Mulyani’s research showed tremendous support for AAOIFI’s accounting and auditing standards, although the respondents thought perhaps international standards could also be used. While this is a tremendous booster, some of the AAOIFI standards are incomplete, others rather dated and still other areas are not covered. For example, GSIFI 1, the composition and appointment of a Shari’a supervisory board, is not comprehensive in its coverage of the role of the Shari’a supervisory board. GSIFI 3 suggests a Shari’a ‘review’ while the reporting standard suggests that it is an ‘audit’. Also there seems to be a split role between internal auditing department of Islamic banks and the SSB in performing Shari’a reviews and audits.

The central bank of Malaysia, Bank Negara Malaysia, has certain accounting and Shari’a guidelines for Islamic banks that are worth studying. Bank Indonesia (the central bank of Indonesia) has prepared an audit manual for Islamic banks. All these efforts need to be coordinated instead of being individualist in effort. Further, the Muslim world, perhaps through the Organisation of the Islamic Conference, should agree to fund and recognise the standards of AAOIFI or a similar body throughout the Islamic world, if not, in association with IFAC globally.

The Shari’a Audit Report

GSIFI 1 includes the standard form of a Shari’a audit report which should be followed by Islamic banks. This is more or less like the long-form American Audit Report.

A holistic Shari’a audit should report not only the methodology of gathering audit evidence but also the findings on a number of issues covering the scope of the Shari’a report. Mulyani’s research indicated that the Shari’a audit report should contain:

• The objective of the Shari’a audit
• Process and procedures taken in performing the Shari’a audit
• Opinion on the extent of Shari’a compliance
• Findings (e.g. detailed breach and violation of Shari’a principles by IFIs)
• Implications
• Recommendations for improvements

Mulyani observes that, “The findings clearly hint for an urgent call to go beyond the current Shari’a audit report, especially in the case of Malaysia, which only contains a short statement reporting that ‘the IFIs’ operation is compliant with Shari’a principles.’ A more detailed report is deemed necessary for: 1) the consumers to be assured that the IFIs are in compliance with Shari’a principles; 2) Shari’a auditors to be more accountable and transparent in their job; and 3) for the IFIs to identify their performance in term of Shari’a compliance.

We can conclude by saying that Shari’a auditing is a discipline waiting to be developed and it can be helped along by joint efforts between the west and the east, the west giving its superior technical methodology while Shari’a scholars can deduce Shari’a rules and principles necessary for contemporary society. Shari’a auditing will not only be beneficial to Muslim societies, but its universal social welfare principles can only be beneficial for the whole of mankind in ensuring we manage our business and NFP institutions to promote human and environmental welfare.