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Issues and Challenges of Auditing In Islamic Financial Institutions

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ABSTRACT: *The Islamic Finance Institutions (IFIs) has gained international recognition as a viable and vibrant component of the global financial system. As a matter of fact, Islamic Finance has seen an increased adoption across the globe, and is growing faster than any other industry at a rate of 15 to 20 percent a year. This study aims to expand the literature relating to IFIs and to provide a coeval outlook on the issues and challenges of Shari'ah audit in IFIs specifically in Malaysia. Hence, the earlier part of this study explains the current auditing standards for IFIs and the roles of Shari'ah auditors, followed by a close look up on the issues and challenges facing the audit of IFIs such as the standards and regulatory requirements of Shari'ah audits, independence of Shari'ah auditors and qualification as well as the accountability of the Shari'ah auditors. This study concludes that there is a need of regulatory framework specifically designed for Shari'ah audits along with the need of independent and accountable Shari'ah auditors to conduct the audit of IFIs.*

I. INTRODUCTION

Auditing is the examination of financial report by an independent third party to provide reasonableassurance and give an opinion on the true and fairness of the financial report. The timeliness and credibility of financial report is very important so as to enable the stakeholders especially investors to make important decisions. However, given the recent accounting scandals, where companies prepared fraudulent accounting records, have given rise to the question of the audit quality as well as audit independence, thus led to damaging reputation of audit firms. Despite the evolving issues in the audit independence and audit quality, auditors nowadays face yet another challenging issue, which is the audit of Islamic Financial Institutions (IFIs), in this study particularly Islamic Banking.

IFI is the blanket term for all financial institution operating within the scope of *Shari'ah*Law, which includes the Islamic Banking, Islamic Insurance etc. The Islamic Finance industry isclaimed to be among the fastest growing industry, with a growth between 15 to 20 percent for the past decade (Yaacob&Donglah, 2012). According to (N. Kasim & M. Sanusi, 2013), the new expectations and requirements for accountability have led to new demands on the audit function of the institutions caused by drastic development of IFIs globally. Moreover, the IFIs offer Islamic products, which should be in compliance with the *Shari'ah* Law. Yet IFIs currently depend on the current auditing system even though governance structure and the operations are different from the normal financial system (N. Kasim & M. Sanusi, 2013). According to Harahap (2002), conventional auditing is based on a value-free system, which does not take into account the moral and ethical values laid down, by Islam. There have been many debates on auditing of IFIs on what ought to be the ideal audit function. Issues such as *Shari'ah* audit framework, the audit scope, auditor's qualification and independence are among issues that are widely discussed.

II. LITERATURE REVIEW

The separation between spiritual and temporal affairs is not recognized in Islam and any substance of finance is subject to ethical conduct and the perception of Shari'ah (Karim, 1990). Following this, the IFIs are obliged to the principles of *Shari'ah* in all aspects of business and financial affairs.

According to Sultan (2007),*Shari'ah* audit and conventional company audit share similar functions but it focuses more on the compliance of the IFIs to the *Shari'ah* principles and requirements. It was also emphasized by Haniffa (2010) that the conventional financial audit is insufficient to cater the needs of the stakeholders of IFIs as the Internal Standards on Auditing (ISAs) did not cover the *Shari'ah* aspects. The current standards were set to fulfill the requirement for conventional auditing that includes standards for auditing, quality control and assurance related services, which serves as a reporting purpose for the stakeholders' interests. Apart from that, the ISAs also set standards specific to the requirement of different countries or environmental needs. Now, as the number of Islamic-based transactions is growing, the implementation of *Shari'ah* audit is on the rise for IFIs as it sets the fundamentals of good governance (N. B. Kasim, Mohamad Ibrahim, & Sulaiman, 2009).

To examine the IFIs compliance with the *Shari'ah* in terms of its financial and operational activities, it is essential that the *Shari'ah* audit is conducted. As such, the *Shari'ah* audit is to give a true and fair view of the IFIs financial statements and that they have sound and effective internal controls in compliance with the *Shari'ah* principles (ISRA, 2011). The audit should cover several areas such as audit of the financial statements, operational audit, information technology audit and the audit of organizational structure and human resource (Sultan, 2007). In addition to that, *Shari'ah* audit is to ensure that the products and services of the IFIs do not contravene with the *Shari'ah*(N. Kasim & M. Sanusi, 2013).

It was well understood since few decades ago that the IASsis unable to fully address the requirement of *Shari'ah*audit (Khan, 1985). Therefore, according to Haniffa (2010), it is the responsibility of the *Shari'ah*auditors to ensure that IFIs are *Shari'ah* compliant. On top of that, is it the role of *Shari'ah* advisors to ensure that all IFIs' products and services, policies and contracts strictly adhere to the *Shari'ah (*Shafii et al., 2010)

2.2 Auditing Standard Setters in IslamicFinance

IFIs transactions as reflected in the financial reports are prepared based on many accounting standards, which could result in threat to the accounting system and financial reporting as a whole. Therefore the need for specific accounting standards that cater for Islamic or specifically the *Shari'ah* principles possesses the prospective for compatible and comparable accounting system and financial reporting with the conventional financial institutions(Sarea & Hanefah, 2013).

As such, the Accounting and Auditing Organization for Islamic Financial Institution (AAOIFI) was established in 1991in accordance with the Agreement of Association, which was signed by Islamic financial institutions. It is an Islamic international autonomous non-profit making corporate body that prepares the accounting, auditing, governance, ethics and *Shari'ah* standards for IFIs. Formally known as the Financial Accounting Organization for Islamic Banks and Financial Institutions, this organization aims to provide standards and guidelines that can support the growth of the industry. However, the AAOIFI does not have the authority to force IFIs to implement the standard set by them. Therefore, to capitalize their position as standard setters in the Islamic financial service industry, AAOIFI pursued a strategy of having its standards implemented by cooperating with the concerned governmental and professional agencies namely, the central banks and bodies responsible for implementing accounting standards.

Apart from AAOIFI, another independent standard setter that caters for the IFIs is the Islamic Financial Service Board (IFSB). IFSB serves as international standard-setting bodies of regulatory and supervisory agencies that have confer interest on ensuring the stability and soundness of the Islamic financial services industry. In advancing this mission, the IFSB promotes the development of a prudent and transparent Islamic financial services industry through introducing new, or adapting existing international standards consistent with *Sharî'ah* principles, and recommend them for adoption. Following this, in December 2006 the IFSB issued a comprehensive guiding principles paper on corporate governance of IFIs with the objective to assist IFIs in improving their framework of corporate governance and at the same time to assist IFIs regulators (N. Kasim & M. Sanusi, 2013). However, based on IFSB (2006), application of corporate governance framework would differ from one IFI to another as it depends different nature of each IFI.

2.2 Roles of *Shari'ah* Auditors

*Shari'ah*auditors play a pivotal role in IFIs governance structure. According to Karim (1990), all *Shari'ah* requirements must be complied with and the auditors are entrusted to ensure that objectives are met. The *Shari'ah* audit function can be performed by the internal auditors who have adequate *shari'ah*related knowledge and skills. In order to archive the ultimate goals, the internal auditors are required to play their part in ensuring a sound and effective internal controls system have been put in place in line with the *Shari'ah*practices strictly. Whenever, they encounter challenges or difficulties while performing the audit, the matter can be solved by obtaining assistance from the experts in the Islamic finance so long as the audit objectives are preserved. According to IFIs, external auditor may also be appointed to perform *Shari'ah* audit (PwC, 2011). However, *Shari'ah* audit tasks should be split between auditors and management, in that, the audit engagement may be performed by internal or external auditors in order to maintain integrity, whereas the review for the*Shari'ah*report shall be perused through by the management. Consequently, according to AAOIFI, when testing for compliance to *Shari'ah* principles, sufficient and appropriate audit evidence must be gathered by the external auditor to give assurance that the financial report of IFIs are *Shari'ah* compliant. As explained in the AAOIFI's governance standards, although the auditor is expected to posses certain level of knowledge in *Shari'ah* in order to form and express opinion on the financial statements of IFIs, it is not mandatory that the auditor must possess the same *Shari'ah*knowledge as the members of Shari'ah Supervisory Board (SSB).

Similar to conventional auditor practices, *Shari'ah* auditor also has no responsibility to prevent or detect fraud and errors on the financial statements. However, should they encounter any red flags related fraud during their audit course and did not take any further step to investigate on it, they could be held as negligent and potentially face legal suit.

III. DIFFERENCES BETWEEN ISLAMIC FINANCIAL INSTITUTIONS AND CONVENTIONAL FINANCIAL INSTITUTIONS

Before we discuss on the issues and challenges of auditing in IFIs, it is equally important to note the difference between these two institutions. The differences of conventional banks and Islamic banks that affects the auditing process can be classified into few characteristics, which are discussed in the following paragraphs, particularly in Islamic Banking.

i. Products

Products and services offered by conventional and Islamic banks are mostly homogeneous except for the element of profit sharing and interest, with the aim of profiting the business. The market or industry in which conventional banks operated is very competitive, hence, rivalries would need to strategize their products in order attract more customers. Hanif(2011) enlightens on how conventional banks generate their income is by spreading interest rates charges among debtors and the interest rates paid to depositors. Two contemporary approaches that had leveraged the product features of conventional banks are deposits and lending activities. The common business activities for these particular product features are such as mortgages dealing institutions or credit card institutions. Selling loans and then earning profit through payment of fees by debtors is one of the ways on how revenues are generated.

Contrary to the Islamic ways of banking, the core principles that run within the banks are derived from the Holy Quran, which parallel with the customs of the Prophet Muhammad and through the reading of His followers of different Fiqh. The Fiqh is known as the arrangement of *Shari'ah*philosophiesandunder the *Shari'ah*practices, interest on loans and deposits are forbidden among Islamic banks. Although, Islamic banks prohibit the idea of interest on transactions, they do not reject the time value of money. This is how the financier from the perspective of Islamic banking generating their income out of *Shari'ah*transactions. Thus when auditing the Islamic financial institution, it is important for the auditors to note the different types of products that these two offers and their effect on the revenue recognition.

ii. Standards/guidelines

Conventional banks operation is accordance to Financial Service Act (FSA) 2013 and Banking and Financial Institution Act 1989 (BAFIA).Whereas for Islamic banks is bound to followed Islamic Financial Service Act (IFSA) 2013 and the reporting guidance issued by Bank Negara which is GP8-i. Auditors need to consider these guidelines when conducting audit so as to setthe level of material misstatement and the relevant audit procedures in auditing the institutions.

iii. Reporting

Conventional and IFIs have different reporting guidelines as stipulated by Bank Negara Malaysia. Conventional banks shall accord to section 41 of BAFIA, in that, banking institution are required to submit audited financial statements to JabatanPenyeliaanKonglomeratKewangan or JabatanPenyeliaanPerbankan, Bank Negara Malaysia, as applicable, within 3 months after the financial year ends. Furthermore, according to section 41 (4), conventional banks are not required to publish or present the annual audited financial report at its annual general meeting.

Conversely, in pursuant to Reporting of Islamic Banking Institutions, Islamic banks required to disclose their *Shari'ah* Committee's Report to board of the banks and at least two members must sign. Shari'ah Committee's Report is document that discloses attestation provided by *Shari'ah* Committee with regards to compliance of Islamic Financial Institution (IFI). Among other information that include in it are *Shari'ah* Committee engagement and their responsibility in expressing opinion over licensed person's compliance with *Shari'ah*. Thus when auditing in Islamic Financial Institution, it is crucial for the auditors to look also at the *Shari'ah* committee report to ensure that all areas have been looked into during the examination of the financial statements.

iv. Risk management features

Conventional banks bridge financing and long-term loans lending are not made on the basis of existence of capital goods. Moreover, conventional banks only compliance to conventional regulatory standards. On the other hand Islamic banks provide financing which financing due to the assets backed nature results in productive economic activities; hence, it does not result in inflation. Furthermore, the underlying asset collateralizes the loan transaction provided by Islamic banks. Apart from that, double audit was happen in Islamic banks as to comply with conventional standards as well as *Shari'ah* standards. These duals check coversthe legal risks as there is a double check on money laundering and other fraudulent activities. Therefore it is important to understand the risk of the industry so that the auditors are able to determine the level of audit risk and then set the appropriate materiality level.

IV. ISSUES AND CHALLENGES OF AUDITING IN ISLAMIC FINANCIAL INSTITUTIONS

Due to the above-mentioned differences between the Islamic and Conventional Financial Institutions have imposed several issue and challenges of auditing in the Islamic Financial Institutions. The issues and challenges will be discussed in accordance with study conducted by Yaacob (2012) and (N. Kasim & M. Sanusi, 2013). In their study, few issues and challenges were highlighted such as the sufficiency standard for *Shari'ah* auditing practices, independence of *Shari'ah* auditing practitioners, qualification of *Shari'ah* auditing practitioners, and lack of accountability of *Shari'ah* auditors.

i. Sufficiency Standard for *Shari'ah*AuditingPractices

The IFIs is bound to the principles of *Shari'ah,* which among other things proscribe interest element in business transactions. This indicates the need for an integrated *Shari'ah* auditing standards that covers all aspects of *Shari'ah*. At the present stage, the accounting policies and standards adopted by IFIs in the process of preparing financial reports is not regulated. This predicament has led to the IFIs into developing their own set of policies and standards for various business transactions based on conferment between the management, *Shari'ah* supervisory board (SSB) and external auditors. For example, a study by Hassan (2010) found that in order to ensure proper monitoring and implementation of *Shari'ah* principles and rulings, Al-Rahji has developed its own *Shari'ah*guidelines and procedures known as *Shari'ah*Monitoring Guide and *Shari'ah*Control Guidelines. However, the insufficiency of auditing standards that cater for *Shari'ah* principles may lead to misinterpretation of *Shari'ah*rulings and could offer a legitimate platform for any case against the regulation of IFIs to be made.

ii. Independence of *Shari'ah* Auditors

The stakeholders of IFIs deem auditors to have integrity through the perceived independence of the *Shari'ah* auditors themselves, in appearance and in act. The integrity of the *Shari'ah* auditors could be further enhanced if they are independent enough to give opinions on the position of the IFIs in being *Shari'ah*compliant (Kasim et al., 2009). In IFIs, the *Shari'ah* Supervisory Board (SSB) oversees the governance in order to bring transactions under strict adherence to the *Shari'ah* principles (Toufik, 2015). Though with no direct influence to the top management, the function of SSB is seen as being similar to the company auditors as they too conduct audits to ensure compliance to *Shari'ah*. In other words, the SSB who are paid by the institution that they worked in conducts audit of their on work thus raise the issue of independence and conflict of interest.

According to Haniffah (2010), the independence of the SSB is impaired as they are involved in supervising the products and operations of IFIs while at the same time conducting *Shari'ah* review or *Shari'ah*audit. With this in mind, there is no clear line of separation of duties that is fundamental in the practice of good governance. As such, the IFIs will have to reassess the needs for clear separation of duties to avoid the misperception of stakeholders of the SSB or *Shari'ah* auditor independence.

iii. Qualification of *Shari'ah* Auditors

*Shari'ah*auditors are expected to serve the needs of the Islamic society whose focus and priorities are different from other contemporary views(N. Kasim & M. Sanusi, 2013). As such, *Shari'ah* auditors are not only accountable to maintain the transparency of financial reports but also ensure that funds in the IFIs are appropriately utilized. However, *Shari'ah* auditors are expected to be qualified in both *Shari'ah* and conventional auditing and accounting matters. They must have adequate knowledge in all finance and accounting related areas including auditing in order to effectively play the role as *Shari'ah*auditors for IFIs. Empirical finding shows that there are very few audit practitioners that are qualified in *Shari'ah* auditing as well as the conventional auditing. A study by (N. Kasim & M. Sanusi, 2013) found that those practitioners who possess accounting qualification mostly do not have the *Shari'ah* qualification at the same time. The lack of auditing practitioners that is qualified or experienced in both *Shari'ah* and conventional auditing could negatively affect the growth of *Shari'ah* auditing and Islamic Financial Industry as a whole. This subsequently may fail in determining the vision and mission of Islam that preserved within the IFIs. Therefore, this crucial need of the IFIs of having competent auditors that is *Shari'ah*qualified with the accounting and auditing background needs to be address promptly.

iv. Lack of accountability of *Shari'ah* auditors

Either internal auditors or external auditors can perform*Shari'ah*audit provided they have adequate knowledge on principles of*Shari'ah*with sufficient training on conducting such audit. Financial report is then forwarded to the committee of SSB to gather their opinions on*Shari'ah* matters to be tabled to the Board of Directors who will make final decision (ISRA, 2011). In view of this, it is perceived that the roles of *Shari'ah*auditors are limited to preparation of financial report rather than influencing the decision making process of IFIs. Board of Directors holds a greater capacity in making important decisions on the products and services of IFIs.

The limitation of power in influencing decision of the Board by the *Shari'ah* auditors indicates that the auditors have lack of accountability. By right, *Shari'ah*auditor should have been more accountable because they have to be accountable to the stakeholders, which include the shareholders, the society and theUmmah. Next, they are accountable to Allah for every actions and inactions(N. Kasim & M. Sanusi, 2013).

V. CONCLUSION

The compliance to Islamic accounting standards has escalated over the years and become the focus among IFIs. The rapid and tremendous growth in Islamic finance requires the IFIs to have competent *Shari'ah*auditors (Yaacob, 2012). However, it is not an easy task to conduct a *Shari'ah* audit as the scope of *Shari'ah*Lawis very wide especially in meeting the objectives of profit maximization and the competitive conventional banking industry. There are still many unresolved issues in *Shari'ah* audit and auditing practices as well as *Shari'ah* auditor's independence and qualification.

Despite the challenges faced in *Shari'ah*auditing itself, the IFIs are also facing challenges from well-established conventional financial institutions. *Shari'ah* auditors may face with immense challenges from the policy makers and top management who are progressive thinkers of diverse faiths and practices (Rahman, 2008). In short, the lack of comprehensive *Shari'ah* audit framework and expertise contributed to the problem of effective and efficient implementation. Nevertheless, the cooperation between the *Shari'ah* experts and the auditors is possible in making the successful implementation of the *Shari'ah* auditing practices.

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