

Shariah Audit for Islamic Financial Institutions (IFI's): Issues and Challenges

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Abstract

The emergence of Islamic financial institutions (IFI's) has created a phenomenon within the global finance industry and stated to be one of the fastest growing industry and resilient during financial crisis. Plethora of study has been given attention in the aspect of Islamic economics and finance. Nevertheless, efforts are still needed in creating appropriate principles governing Islamic economics and finance in the aspect of auditing. Since, the operation and the features of IFI's is distinctively unique of as compared to its conventional counterpart. Therefore, Islamic auditing has a broader scope than the current practice of auditing as the main objective of Shariah auditing is to embrace the Maqasid Shariah as well as to uphold the shariah principles in all practices and process. Thus, this has posed a challenge to IFI's in ensuring proper implementation of Shariah auditing in their activities. Therefore, this paper highlights on contemporary view on the issues and

challenges of Shariah audit in IFI's as well as the solutions in ensuring all activities and operations of IFI's is upholding the Islamic principles.

Keyword: Shariah audit, Shariah auditor, Islamic financial institutions

1. Introduction

Islamic finance is often observed as a sector that is experiencing aggressive growth within the global financial industry. With long track record for 30 years of structuring a flourishing Islamic Financial industry, Malaysia has a step ahead in having firm foundation and robustness development with growth rate annually. Supported by a conducive regulation and strong human capital development have transformed Malaysia into most developed Islamic Financial Industry in the world. Therefore, institutions that offer Islamic financial services are expected to operate within the code of Islamic principle. Thus, to examine the IFIs compliance with the Shariah in terms of its financial and operational activities, it is essential that the Shari'ah audit is conducted.

Shariah audit is essential to corporate governance body in the overall Shariah governance framework in Islamic finance. Hence, there is a need for Shariah audit guideline to be initiated the market to guide the industry to conduct a proper Shariah audit exercise. Shariah audit has to be conduct in accordance to the fatwas, ruling and guidelines issued by the Shariah Supervisory Board (SSB), the accounting standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), national accounting standards and practices and relevant legislation and regulations applied in Malaysia. This signifies that the Shariah audit does not just has to comply with the Islamic law, but also the conventional law. Without bothering the standards of the conventional, Shariah audit practices are mainly to strengthen the focused more on financial aspect of an institution that Shariah compliance and enhance the integrity of the report (N. Kasim & M. Sanusi, 2013). Therefore, the demand for Shariah audit practices is mainly to strengthen Shariah compliance and enhance the integrity of Islamic Financial Institutions (IFI).

Issues on Shariah audit has been widely discussed and debated in discovering an ideal shariah audit (Bosi & Joy, 2017; ISRA, 2016; Aishah, Ali, Muhammadun, & Shahimi, 2015; Kasim & Sanusi, 2013). Therefore, the main objective of this paper is to evaluate the issues for Shariah audit in order to harmonize the Shariah compliance mechanisms that are already in place. On top of that, this study to expand the literature relating to Shariah auditing for IFI's and to discover the challenges and constraint faced by institution in implementing Shariah governance as to make recommendation for enhancement of Shariah governance practices.

2. Issues and Challenges of Shariah Audit for Ifi's

2.1 Qualification of Shariah Auditor

Shariah audit differs from statutory audit. In the Malaysian context, shariah auditing are clearly set out in the Shariah Governance Framework (SGF 2010) issued by Bank Negara Malaysia (BNM) on 20 May 2010. As stated in the guideline, the internal auditors must carry out shariah auditing with regard to well verse in Shariah knowledge and full knowledge related to Islamic finance products and businesses. Thus, Shariah auditors are expected to fulfil the requirements and needs of Islamic society who's searching for ethical and compliance product and services in the industry.

Therefore, it is important in providing adequate amount of competent human capital in order to advocate the genuineness of Islamic financial products and services. This is consistent with the study made by Bosi & Joy, (2017), N. Kasim & M. Sanusi, (2013) and Laldin, (2011). The Shariah audit can be performed by the internal auditors who have adequate shariah related knowledge and skills. However, Shariah auditors expected to have knowledge in both Shariah and accounting field. Previous study made by N. Kasim & M. Sanusi, (2013), shows that most shariah auditor does not qualified in both field og knowledge. On top of that, study done by N. Kasim & M. Sanusi (2013) explains that the Shariah auditors who qualified in both Shariah and accounting is only 5.9%. While for those Shariah auditors who practice Shariah auditing in Islamic Financial Institutions (IFI) in Malaysia is 69%. Another latest research which have consistent findings was performed by Mahzan and Yahya (2012) using a survey involving 158 internal auditors in IFIs that offer Islamic banking products prove that majority of the respondents (39%) have 10-20 years of general banking experience, however only 6% of them have 10-20 years in Islamic banking and finance working experience.

This signifies that there is lack of Shariah auditors who have both qualifications, which is very important in determining the vision and mission of Islamic ruling within the Islamic Financial Institutions (IFI). Therefore, in ensuring effective Shariah audit in Islamic Financial Institution, Shariah auditors should have both talents in the understanding and audit matters for the Islamic Financial Institutions (IFI) (Rahman 2011) and the lack of auditing practitioners that is qualified in both Shariah and contemporary accounting could unconstructively affect the development of Shariah auditing and Islamic Financial Industry as a whole (Bosi & Joy, 2017).

With this regards, the call to fulfilling this gap has gained the attention from the tertiary education level in which the university took the responsibility in producing graduates which equipped with the comprehensive knowledge in Shariah audit. In Malaysia, there are only few local universities that offered Shariah

Audit as part of the subject in the accounting course such as Islamic International University (IIUM) and Selangor International Islamic University College (KUIS). Nevertheless, only one local university is offering course specialized in Shariah audit known as master of accounting and Shariah audit (MASA) which offered by Islamic Science University of Malaysia (USIM). On top of that, in terms of professional training level is also at scarce, since there is only a few local training agencies that provide professional certificate to the Shariah audit practitioner with regards to Shariah audit such as Institute of Banking and Finance Institution (IBFIM), International Centre for Education in Islamic Finance (INCEIF) and Centre for Research and Training (CERT).

2.2 Independence and accountability of Shariah Auditing Practitioners

Despite of issues in accounting scandal, yet IFI's faced another issue in term of Shariah audit in ensuring the IFI's is comply with the Shariah guideline and to sustain future confidence and growth in the Islamic finance sector. In the case of independency, the issue is on scrutinizing the independence between Shariah auditors in Islamic Financial Institutions (IFI).

According to AAOIFI's Auditing Standard for Islamic Financial Institutions No. 1 (ASIFI 1), the objective of an audit of financial statements of IFIs "... is to enable the auditor to express an opinion as to whether the financial statements are prepared, in all material respects, in accordance with the Shari'ah Rules and Principles, the accounting standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and relevant national accounting standards and practices in the country in which the financial institution operates" AAOIFI. (2010). On top of that, Islamic Financial Services Act (IFSA 2013) under Division 3, Section 37 states that IFIs may appoint certified organization to appoint any individual to perform such an audit on shariah compliance for the institutions (Yahya 2016). While, in Section 28 (5) of IFSA 2013 authorize that any individual who breach this act shall be legally responsible to imprisonment for a term not more than eight years or to be fined not beyond 25 million or both.

Therefore, it is clear that the act has took a serious measure on this issue in ensuring that the Shariah auditor are accountable on carry out the responsibility in expressing their judgment truthfully, fair assessment on whether the financial statements and materials that have been prepared are in accordance with the Shariah guideline and principles as well as relevant accounting standards.

However, despite of given act and guideline, one of the foremost challenge faced in Shariah auditing is the integrity of Shariah auditor whereby they being employed by the institution itself. There are clear hurdles in the aspect of independence and conflict of interest for Shariah auditor in carry out the duty. Nawal Kasim, Shahul Hameed Mohamed Ibrahim & Maliah Sulaiman (2009) proposed that the shariah auditor are expected to be independent enough to give

opinion on state whereby whether the IFI's is being operated accordance to Shariah ruling. On the other hand, study completed by Farook, (2011) suggested that there is serious conflict of interest between the responsibility to uphold the independency in shariah audit and fulfilling one's need to get paid for their services accordance to the requirement of the institution they attached to. The finding is also consistent the study done recently by Rahim & Sains, n.d (2017) and Bosi & Joy (2017) stated that since shariah audit is done internally and employed by the company, thus, the competence of the individual performing the audit been question pertaing to biased issues.

For that reason, it is crucial for IFIs to ensure their activities and operations must be compliance with the Shariah ruling as to be able to ease the Shariah non-compliant risk that have the potential to cause severe aftermath and potentially tarnish the reputation which could place the entire Islamic finance industry at risk .

Given to that Shariah auditors have a big responsibility to the institution, shareholders and the foremost is to God. Therefore, a muslim always believe that Allah knew every deeds and intention done by them. Allah has mention several time in Quran pertaining to accountability, as stated in Surah An Nisa verse:86 *"...surely Allah will take account of all things"*. Besides it is also stated in Surat Al-Imran verse:30 *"The Day every soul will find what it has done of good present (before it)and what it has done of evil, it will wish that between itself and that (evil) was a great distance. And Allah warns you of Himself, and Allah is kind to (His) servants."*

2.3 External Shariah Auditor and Hisbah Institution for Islamic Financial Institutions.

The primary objective of IFI's is to fulfil the needs of of society which looking on ethical and permissible products and services in the financial industry. In this instance, Shariah Supervisory board as well as the Shariah auditor plays a significant role in ensuring the institution operated accordance to the shariah ruling. However, questions arise in the context of accountability and transparency of the Shariah auditor on auditing their own products and operations. Therefore, here comes the need of the external Shariah auditor to verify the business undertaken is does not have conflict to Shariah principle.

According to ISRA (2016) in its article, there is no existence of external Shariah audit be imposed in Islamic Financial Institutions (IFI's) in Malaysia, yet only a few country out of the many which under the Islamic finance jurisdictions have construct specific guidelines for external Shariah audit for instance are Oman and Pakistan. This is vital in order to uphold and preserve the integrity of Shariah principle in Shariah auditing as it has not yet made compulsory by regulators for IFI's to go through external Shariah audit in Malaysia. Thus, a review on the Shariah

matters only is done on upon voluntary by IFI's by appointing Shariah Advisory Council (SAC). Therefore, International Shariah Research Academy for Islamic Finance (ISRA) in their article on October 2016 had made a strong call for mandatory independent Shariah audit for IFI's. Therefore according to Dr Ahmed Abdul Hameed AlShaikh, the deputy director of the Bahrain Institute of Banking & Finance as cited by ISRA, (2016) stated that introducing an appropriate external Shariah audit framework would be the next step in creating robustness in the industry.

From the Islamic perspective, auditing is not a new concept in the Islamic tradition. The development of Islamic auditing started in the time holy Prophet s.a.w by the establishment of an institution called Hisbah which the main function was to safeguard the the public and ensure their religious and worldly matters strictly follow the divine law by appointed a group of supervisor known as 'muhtasib'. As mentioned in the Quran with regards of enjoining the good and forbidding the evil in Surah Al-Imran verse 104, "And let there be (arising) from you a nation inviting to (all that is) good, enjoining what is right and forbidding what is wrong, and those will be the successful".

Since the scope of work of muhtasib is similar to present shariah auditor (Kassim, 2010), therefore it is importance revisit on the role of Hisbah institution to gain insights as has been proven to be effective in Shariah assurance for the past years in ensuring an effective implementation of Shariah audit. This statement is consistent with Yaacob (2012), suggested the significance to look back on the importance of Hisbah institution. Since Hisbah institution is independence and non- related with the market or institution, thus they are expected to be more transparent and independence in making their assessment.

3. Conclusion and Future Recommendations

The Islamic Finance Institutions (IFIs) has gained international recognition as a feasible component of the global financial system. The Islamic financial industry expanded over the past few decades tremendously. Since every vocation has its own body of knowledge and objective, therefore IFI's is bound to comply with the Shariah ruling as ensuring their business, affairs, and activities in accordance with the Shariah principles. Therefore, Shariah auditor plays crucial roles as to maintain the transparency and public confidence with regard to the integrity of IFI's as Islamic institution.

Plethora of studies done by previous researchers discussing the gap and hurdles of shariah audit for IFI's, unfortunately, there are still few unresolved issues till today in term of qualification, independency of shariah auditor and non-existence of external Shariah auditor. If these remain unresolved the smooth development of the Islamic banking and finance industry will be distorted. Thus, an integrated standard of auditing which covers the entire IFI's operation is crucial.

In this regard, it is essential to have a competence Shariah auditor, comprehensive, robust and well-functioning Shariah audit control system to ensure the aim of rectifying and improving performance in a continual and sustainable manner. On top of that, Shariah audit has to be improve from time to time to ensure that the approval from the auditors leads to the accountability, transparency and trustworthy towards the corporate auditing.

In the nut shell, even though Islamic finance industry faces many challenges and hurdles but it should be taken as opportunities to move forward in the future. Therefore, in viewing of these challenges and issues, more research in the area of accounting and auditing are needed to capture the impacts of the compliance of Islamic beliefs on the operations of Islamic financial institutions within the Islamic framework or shariah principles.

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