Conceptualizing the duties and roles of auditors in Islamic financial institutions

What makes them different?

Radiah Othman
School of Accountancy, Massey University, Palmerston North, New Zealand, and
Rashid Ameer
Faculty of International Studies, International Pacific College, Palmerston North, New Zealand

Abstract

Purpose – The purpose of this paper is to describe the role and responsibilities of Shari'ah auditors in Islamic financial institutions (IFIs) in the auditing process in the IFIs, to highlight capacity building challenges in the Shari'ah auditing industry.

Design/methodology/approach – The authors used a legitimacy theory to understand linkages between demand for Shari'ah audit and the role of Shari'ah auditors in IFIs complemented with the review the Accounting and Auditing Organization of Islamic Financial Institutions and Auditing Standard for Islamic Financial Institutions to understand the Shari'ah audit work requirements from an Islamic perspective.

Findings – Shari'ah auditing is an emerging field of investigation. There is no doubt that conventional auditing has a significant influence on the auditing frameworks used in IFIs. Western auditing practices are undergoing a metamorphosis to meet the needs of stakeholders in the Islamic economic system. The role and responsibilities of auditors in IFIs are much broader than those found in conventional banks in relation to an examination of a variety of contracts, product structures, transactions reporting, preparation of financial statements, reports, marketing circulars and any other legal documents, which are pertinent to IFIs' operations.

Practical implications – We posit that the absence of a proper Shari'ah auditing framework and standards attuned to the needs of an Islamic economic system could dampen the future of the Islamic finance industry. The regulators and management of IFIs should meet the expectations of the stakeholders to whom they owe a duty of care by selecting competent professionals for auditing work, along with transparent policies and systems.

Originality/value – This paper presents an attempt to establish auditors' roles and responsibilities from an Islamic perspective.

Keywords Islamic financial institutions, Roles, Auditor, Shari'ah, Maqasid al-Shari'ah, Responsibilities

Paper type Viewpoint

Humanomics
Vol. 31 No. 2, 2015
pp. 201-213

0828-8666
DOI 10.1108/H-04-2013-0027

1. Introduction

Islamic finance has elements which promote conservatism by prohibiting a range of instruments and transactions including those structured around *riba* (interest rates) or involving uncertainty (*maysir*) and (*gharar*) speculation features (Venardos, 2010). Proponents of Islamic finance have argued that the Islamic financial institutions (IFIs) have financial resilience and stability because Islamic banks are subject to Shari'ah (Islamic law) requirements, in addition to the conventional auditing process which is carried out in other business organizations (Karim, 1990). Critics would contend, however, that while this may be true, Islamic finance industry lags behind in maturity and sophistication in oversight, auditing and management of risk (see e.g. Grais and Pellegrini, 2006). Specifically, risks arising from auditors' incompetence expose Islamic banks to potential losses. For instance, an internal control problem cost the Dubai Islamic Bank $50 million in 1998.

This paper has three main objectives: first, to examine the fundamental differences between conventional and Shari'ah auditing in general, focussing on *substance over form*; second, to theorize the importance of the Shari'ah auditing for legitimacy of IFIs and review Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) standards and requirements for Shari'ah auditing in IFIs; and last, to examine the differences in the Shari'ah auditing practices in selected Islamic countries to provide contemporary views on the issues and challenges of the Shari'ah auditing industry. This paper does not focus on the standard setters and regulators in the Shari'ah auditing debate. Unlike previous studies that aim to venture findings related to the Shari'ah auditing (see Shafi *et al.*, 2010), and exploring perception of accounting, auditing, scholars and academics on the practice of the Shari'ah auditing for IFIs (Hammed and Mulyany, 2007), this paper provides a theoretical framework to understand linkages between legitimacy, ethics and the role of Shari'ah auditors in IFIs.

The main contributions of this paper are as follows: first, drawing on Suchman (1995) for theoretical framework, this paper develops the idea that the Shari'ah auditing is indispensible for building and maintaining IFIs' organizational legitimacy. The audited financial statements complying with Shari'ah are used by management to enhance the stakeholders' faith in IFIs; therefore, this paper sought to acquire an understanding of the auditors' role and responsibilities in the auditing process in the IFIs. The auditor must investigate the extent to which IFIs have kept their "*Uqũd* (keeping of contracts – contractual commitments". The auditor must look into various contractual reporting commitments of the IFIs towards suppliers, customers, debtors, creditors and government; the auditor should observe for signs of *Ihtikãr* (hiking up prices artificially), *Bakhs* (any voluntary effort to diminish or decrease the value of the product being sold) and *Isrãf* (extent of extravagance) in structuring the Islamic loan according to Shari'ah. These responsibilities demand work ethics, which are different in spirit from those observed in the conventional banking loan origination and servicing; the latter relies heavily on the borrower's character, capacity, collateral, capital and conditions.

This rest of the paper is organized as follows: Section 2 gives the theoretical framework underlying the study and builds up the discussion on the fundamental differences in conventional and Shari'ah auditing. Section 3 discusses *Maqasid al-Shari'ah* as the ultimate objective of greater auditing of Shari'ah accounts and Shari'ah financing. Section 4 discusses the roles and responsibilities of auditors in IFI. Section 5 examines the Shari'ah auditing framework in Malaysia and emerging issues in three other countries with increasingly high Islamic banking progressions. Section 6 examines the current challenges for Shari'ah auditing practices from an Islamic perspective and Section 7 concludes with suggestions for future research in this area.

2. Theoretical framework

Organizational legitimacy is a generalized perception or assumption that the actions of an entity are desirable, proper or appropriate within some socially constructed views of norms, values, beliefs and definitions (Suchman, 1995, p. 574). Legitimacy enables better access to various resources that are essential to organization survival. In the context of IFIs, rules and codes of conduct are derived from the Shari'ah – the Islamic law. These rules are resources to legitimize and to negotiate organizational realities; ethics as practice demand from IFIs employees to use these resources to develop expertise (i.e. Shari'ah audit framework and audit programs for the products) to be able to mitigate the Shari'ah non-compliance risk. The Shari'ah compliance audit has important implications for IFIs legitimacy because IFIs with less legitimate behaviour will find it hard to attract employees, depositors and investors. Therefore, to build and maintain organizational legitimacy (OL), IFIs must have access to resources, knowledge, experiences and capacity for Shari'ah audit framework and audit programs to monitor Islamic products and transactions.

In the context of Shari'ah auditing, IFIs can employ two *modus operandi* in order to achieve OL:

(1) IFIs can build up competencies and structures internally, to generate the resources, skills and capabilities (such as the Shari'ah department, Shari'ah Supervisory Board).

(2) IFIs can enter into a cooperative arrangement with a company that has access to resources in question (the external Shari'ah auditor/advisor).

IFIs might not select Option 2 due to fear of leakage of commercially sensitive information to competitors and threat of becoming captive to one external organization. In addition, evaluation of external organization based on cost, quality and speed of auditing also bear heavily on the minds of the top management in IFIs. IFIs have chosen the first option with the understanding that with iterative transactions they can extract inferences from experiences gained in the past and extrapolate them for future situations in order to improve their behaviour. For instance, launching of the new Shari'ah Governance Framework in Malaysia in typifies the "learning-by-doing" approach to maintain OL in the institutional and public spheres. In the next section, we highlight the differences between *conventional* and Shari'ah auditing.

2.1 Conventional vs Shari'ah auditing

The prevalent practices in auditing have evolved over centuries to serve the needs of the capitalist economy. No doubt, the auditing in IFIs has assimilated some of these Western techniques that suit the institutional and socio-economic infrastructure of the Islamic society (Khan, 1985). The objective of conventional financial reports is to provide information to users, which is useful for making and evaluating decisions about the allocation of scarce resources in the capitalist economy. IFIs have similar objectives for financial reporting under the Shari'ah requirements, but those who transact with Shari'ah-compliant business entities (such as IFIs), or who are otherwise stakeholders in such entities (such as managers, auditors, account holders, creditors), are concerned with the business entities' compliance with Shari'ah requirements in their financial and other dealings. In an Islamic economy, the *Rabi-ul-mal* (depositor) who provides capital on the basis of profit-loss sharing needs an extended assurance that the profit (or loss) declared by the IFI management is true and correct. To ensure that business transactions are measured, recorded and reported in accordance with Islamic precepts, accounting principles compatible with Islamic laws is a key distinguishing feature of interest-free banking compared to conventional banking (Abdel Karim). According to Wallace (1987), monitoring solves problems that arise due to moral hazard and information asymmetry between depositors and the management. As the ultimate figure for profit (or loss) is subject to various business transactions, verification of the sources of income and their allocation to depositors and shareholders needs close scrutiny. In other words, the reliance on the auditor's examination is greater in an Islamic economy due to the complexity of contractual requirements. The investment account holders require an independent examination of the management processes and practices to satisfy themselves that their investments do not deviate from the Shari'ah principles or are handled negligently (Khan, 1985, p. 36).

Conventional auditing and financial reporting complies with Anglo-American laws and is not guided by any religious law or codes. A conventional auditor is not accountable to stakeholders, as in IFIs, in relation to the funds lent to the borrowers and how these are utilized by the borrowers. The auditors also have no social obligations to comment on the investments or transactions undertaken by the business which might cause the depletion of non-renewable resources or generate socio-economic externalities (Khan, 1985, p. 34). In other words, the auditor's role does not extend to the examination of management practices and their impact on society. The financial reporting and auditing standards premised on Anglo-American accounting thoughts and practices inadequately service the needs of IFIs because these do not accommodate Shari'ah requirements which form the basis of all Islamic transactions. This creates the need to have accounting and auditing standards of Shari'ah-compliant business entities (AAOFI, 2010). Hence, the work of auditors is fundamentally and conceptually different from conventional auditors. Indeed, Khan (1985) proposes that the scope of auditing in an Islamic framework is much larger as compared to the scope of traditional (conventional) auditing, as it expands from the traditional concept of attest and authority to report on various social and economic aspects of the business organization (p. 31).

AAOIFI's Governance Standard No. 3 outlines that the aim of the Shari'ah audit is to ensure that the management of an IFI discharge their responsibilities in relation to the implementation of the Shari'ah rules and principles, as determined by the IFI's Shari'ah Supervisory Board. Auditing Standard for Islamic Financial Institutions (ASIFI) No. 1 states that the objective of auditing financial statements is to enable the auditor to express an opinion as to whether the financial statements are prepared in all material respects, in accordance with Islamic Shari'ah rules and principles, the accounting standards of the AAOIFI and the relevant national accounting standards used in the country in which the financial institution operates. International Standards on Auditing apply in those matters, not covered in detail by ASIFIs (provided that these do not contravene Islamic Rules and Principles).The Shari'ah audit is an examination of the extent to which an IFI complies with the Shari'ah in all its activities. According to Rehman (2012), this examination includes agreements, contracts, policies, products, transactions, memorandum and articles of association, financial statements, reports, circulars and any other legal documents which are pertinent to an IFI's operation.

3. Shari'ah auditing – nexus of Maqasid al-Shari'ah

Maqasid al-Shari'ah reflects the holistic view of Islam as a complete and integrated code of life encompassing the individual and society, in this world and hereafter (Dusuki and Abozaid, 2007, p. 144). According to al-Imam Al-Ghazzali:

> The objective of the Shari'ah is to promote the well-being of all mankind, which lies in safeguarding their faith (*Hifz-al-din*), their human self (*Hifz-al-nafs*), their intellect (*Hifz-al-aql*), their posterity (*Hifz-al-nasl*) and protecting their wealth (*Hifz-al-mal*). Whatever ensures the safeguard of these five serves public interest and is desirable.

The *Hifz-al-mal*, *Hifz-al-din* and *Hifz-al-nasl* dictate that Muslims are obliged to deposit their savings into an Islamic bank (Cizakca, 2011). These three *Maqasid* also dictate that the savings deposits must be kept safe. While in return, Islamic banks as agent (*wakeel*) get a fee for their service of safe keeping; the depositors' get agreed profit on their savings. The protection of the depositors' funds from misappropriations of the management and misallocation in non-Shari'ah-compliant universe of assets requires vigilance and prudence (*Hifz-al-aql*) from the Shari'ah auditing perspective. The *sine qua non* condition for sound financial thought and decision is transparency, which is the only way to avoid information asymmetry. Information asymmetry means that information regarding the investment management is not shared timely and accurately by an Islamic bank. This, in itself, is un-Islamic and violates *Hifz-al-din*. Therefore, the need to provide transparency so as to eliminate information asymmetry for Islamic banks necessitates implementation of the Shari'ah auditing, as dictated by *Hifz-al-aql* and *Hifz-al-mal*. Henceforth, the auditor must not have restricted view or understanding of the Shari'ah, i.e. focussing only on its legal requirements for Islamic banking, they should also extend their expertise to achieve greater "substance" of the Shari'ah, through achieving all of the Maqasid al-Shari'ah. In summary, the Shari'ah auditors have to make sure that all the transactions that they audit are Shari'ah-compliant not only in their "*form*" and legal technicalities but also the economic "*substance*" which is premised on the objectives outlined by the Shari'ah.

4. Auditors' role and responsibilities in IFIs

In the Islamic finance industry, the demand for audit work is implied as Ali Ibn Abi Talib stated:

> Monitor the behaviour of your assistants and use them only after probation. Monitor their performance and use for this purpose people who are known for their truthfulness and loyalty. Your discreet monitoring of their work will ensure that they remain honest and considerate to their subjects.

The credibility given to the auditor's verification of his or her clients' financial statements tends to depend on the perceived competence and independence of the auditor (Watts and Zimmerman, 1981). Competence implies a professionally qualified individual who has the technical ability to discover breaches in the accounting system. Independence requires an auditor to adopt an unbiased viewpoint in all matters relating to his or her audit assignment. In the Shari'ah auditing context, auditor's competence connotes observance of rules and standards derived from the Shari'ah framework regulating the economic transactions. Therefore, the auditors in IFIs and/or conventional banks with Islamic banking operations are expected to adhere to this framework. Bank loan decisions require more than application of the standard operating procedures. Beliefs, policies and values are combined into an informed judgement by a subjective process (Wilson *et al.*, 2007). The auditor must investigate the extent to which IFIs have kept their *Uqũd* (keeping of contracts – contractual commitments) in origination and servicing of bank loans under Mudarabah, Musharakah and leasing contracts under Ijarah. In the case of conventional banks offering Islamic products, the auditor role is even more demanding for monitoring and guaranteeing that funds devoted to conventional activities are not mixed (commingled) with those destined for Islamic activities. The auditor must look into various contractual reporting commitments of the IFIs towards suppliers, customers, debtors, creditors and government. For instance, in the screening of products, the auditor should observe for signs of *Ihtikãr* (hoarding with the intention of causing scarcity or hiding up prices artificially), Bakhs (any voluntary effort to diminish or decrease the value of the product being sold) and *Isrãf* (extent of extravagance) in structuring the Islamic loan according to Shari'ah. These responsibilities demand work ethics, which are different in spirit from those observed in the conventional banking loan origination and servicing, the latter relies heavily on the borrowers character, capacity, collateral, capital and conditions.

Similarly, while verifying Islamic loans or other transactions, auditors should detect signs of *Tanãjush* (bidding up prices in auction by planting a fake bidder): speculation (disguised ribã) in the contracts. The auditor should also investigate due diligence process for restructuring of bank loans, recovery, mechanisms and dispute resolutions without any bias. The auditor is expected to investigate the extent of *Tatf ĩf* (causing damage to the other party in weights and measures) (Khan, 1985, pp. 37-38). The auditors are also expected to report on the extent to which the entity adhered to the concept of *Ihsan* (such as philanthropic and socio-cultural activities) and the extent it propagated this concept over and above its principal operations. One of most important responsibilities of the auditors in IFIs is to report that *zakat* has been calculated correctly and paid into the public *zakat* fund or spent properly. *Zakat* is an obligation on those who own wealth beyond the exemption limit (*nisab*).In this regard, the auditor would point out areas of *Khiyãnah* (embezzlement of funds).

The IFIs auditors form and express an opinion on the financial statements after the completion of the Shari'ah review. The annual management report, shareholders report and Shari'ah Supervisory Committee report all depend on the auditor's report. Though similar to auditors in conventional banks who are responsible for auditing the annual management report (including the financial statements), which later is presented to the shareholders during the Annual General Meeting, the IFIs auditors have the additional responsibility to provide facts and evidence to the Shari'ah Supervisory Committee for its preparation of a report to the Shari'ah Board. The report is to be reviewed by the Shari'ah Board before it is presented to the shareholders. So the auditors are responsible not only to the management but also to the Shari'ah Supervisory Committee. Not only do the auditors have to perform financial statements audit but also compliance audit of the organizational structure, people and processes and audit review of the adequacy of the Shari'ah governance process, providing recommendations to the Audit Committee and Shari'ah Supervisory Committee. While conventional auditor normally conduct their audit on the basis of samples, the Shari'ah auditor has to make sure that the bank has actually complied with Islamic precepts in *all* of its transactions before it can issue its report. In other words, the auditor is accountable not only for the manner in which the IFIs undertake their activities but also the effectiveness with which these activities contribute to the principle of Shari'ah to propagate the virtues of Islam in all areas of the institutions.

It needs not to be stressed that the present concepts and practices in accounting and auditing would require significant changes, as stakeholders' demand for transparency and accountability has increased in Islamic countries, symbolized by the "Arab spring" phenomenon. In the next section, we examine the Shari'ah auditing practices in IFIs in Malaysia. Malaysia has been singled out for its long-term commitment to Islamic finance, spanning over 30 years. Emerging issues from other countries are also included to help us draw meaningful recommendations.

5. Shari'ah auditing of IFIs in Malaysia

Since the early 1970s, Malaysia has progressively introduced Islamic finance into its economy. The success of Malaysian IFIs is clearly evidenced by their ability to attract capital from international investors as well as by the response of the local Muslim and non-Muslim population (Sole, 2012). In 1983, the Islamic Banking Act (IBA) 1983 was enacted in Malaysia. The first full-fledged Islamic bank was established. In 1996, an amendment to Section 124 of the Banking and Financial Institution Act was made, allowing conventional banks in Malaysia to offer Islamic banking products through an Islamic window. In 2005, Bank Negara Malaysia (BNM) (2013) issued guidelines on the Governance of Shari'ah Committee for IFIs. Recently, the new comprehensive Shari'ah Governance Framework was launched by BNM that provides guidance on Shari'ah audit, Shari'ah review, Shari'ah risk management and the Shari'ah research function. By June 2011, IFIs are to comply with the Shari'ah Governance Framework. The framework defines Shari'ah audit as 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 IFI's business operations, with the main objective of ensuring a sound and effective internal control system for Shari'ah compliance (Figure 1).

The Shari'ah audit has three levels: audit of the IFI's financial statements; compliance audit on organizational structure, people and process; and a review on the adequacy of the Shari'ah governance process. The framework outlines that the Shari'ah audit shall be performed by internal auditors who have acquired adequate Shari'ah-related knowledge and training. The internal auditor may engage the expertise of the ISI's Shari'ah officers in performing the audit as long as the objectivity of the audit is not compromised.

The approach in Malaysia differs from the approach adopted by AAOIFI, i.e. the Malaysian approach distinguishes between the Shari'ah audit and Shari'ah review with both being classified under the governance component. The Shari'ah audit is meant for auditing and ensuring that there is adherence to compliance after a product has been issued. The Shari'ah review is a continuous process and starts before any discussion takes place at the Shari'ah Committee level. The framework enhances the Shari'ah audit role and extends the scope to cover more than Shari'ah risks in products and services; it also looks at the framework, scholars' decision process, risk management and other key infrastructure areas.

The latest governance framework aims to fill the gap between the desired and the actual practice in the early days of Shari'ah auditing in Malaysia. Kasim *et al.* (2009) conducted a survey to explore the gap between the "desired" and the "actual" practice of

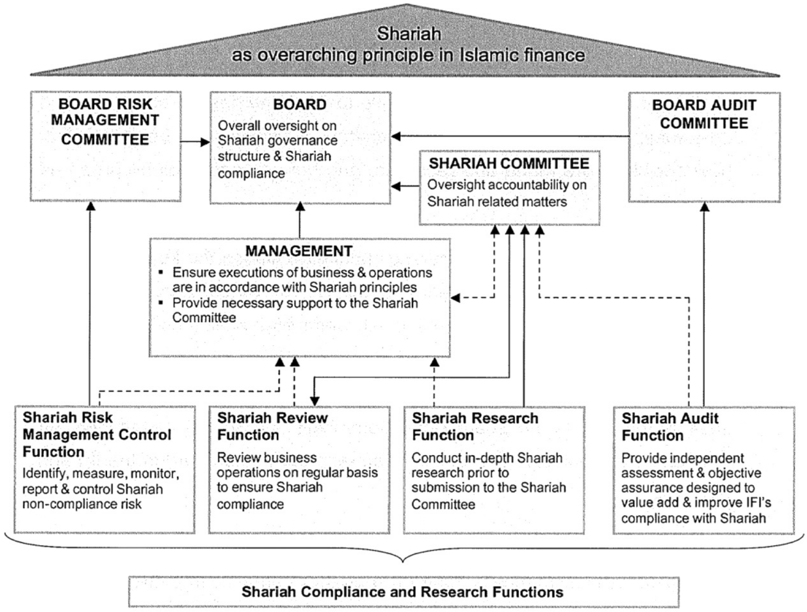

Figure 1.
Shari'ah Governance Framework model for IFIs

Source: BNM (2013)

Shari'ah auditing in Malaysia. Most of IFIs were using the conventional auditing framework because of the non-availability of a Shari'ah auditing framework in Malaysia. The lack of expertise, specification and definition on the scope of Shari'ah auditing practice concerned the respondents of the survey, especially on the scope of Shari'ah auditing to also cover the social and environmental issues. The proportion of respondents qualified in both Shari'ah and accounting was only 5.9 per cent of those who practiced Shari'ah auditing in Malaysian IFIs. Similar results were found in a later study by Kasim and Sanusi (2013) which further highlighted the need for detail standards and guidelines to be included in a comprehensive Shari'ah auditing framework.

PricewaterhouseCoopers (PwC) (2010) carried out a survey on the extent of Shari'ah auditing in Malaysia in 2010 covering 15 financial institutions (pre-2011 Shari'ah Governance Framework). PwC's (2010) survey revealed that there is an urgent need to expand the talent pool with Shari'ah audit knowledge and competencies, as only half of the respondents agreed that the Shari'ah audit staff was adequately trained in Shari'ah-related audit risks and issues. Naturally, most of them were adequately trained in banking operations and financing products. More than half of the institutions surveyed also extended the scope of Shari'ah audit to financing, credit administration, treasury, treasury operations, settlements/disbursements, recovery, legal and Shari'ah fatwa process. But only half of the respondents had further extended the scope of the audit to Human Resources and Risk Management functions. While the need for Shari'ah audit to cover all aspects of business operations is obvious, the need for Shari'ah auditors must be fulfilled first. While the Shari'ah audit methodology and tools were found to be adequate for performing the audit, the involvement of Shari'ah scholars was quite limited in: reviewing audit reports and performing follow-up queries with management; providing general guidance and strategy during the audit planning strategy; assisting in the preparation of audit report and helping recommend action plans; and facilitating the audit fieldwork process. Only half of the institutions surveyed had an IT system sufficient to provide Shari'ah auditors with all the necessary data and information to complete the audit.

While the launch of a Shari'ah auditing framework in Malaysia is notable, the same cannot be observed in other countries such as Pakistan, Brunei and the Gulf Islamic states. For instance, Shari'ah Supervisory Departments headed by notable scholars in IFIs are the norm in the Gulf Islamic states. In general, the Shari'ah Supervisory Department is responsible for ensuring that the activities of IFIs are in compliance with Shari'ah rulings and consist of two units: Shari'ah Research and Development, Secretariat and Shari'ah Audit. Each of these two units has its own policies and procedures to be followed even though both are working under the Department of Shari'ah Supervisory. This Shari'ah Governance Framework is different from the one adopted in Malaysian IFIs.

Shari'ah auditing has been getting attention in other Muslim countries too, who realize that the IFIs are in dire need of a different set of auditing guidelines in line with the Islamic Shari'ah (Donglah and Yaacob, 2012).In the case of Pakistan, several governments took the initiative of institutionalizing interest-free banking; however, it did not materialize (Khan and Bhatti, 2006). The State Bank of Pakistan was reported to have showed gross negligence in providing proper training, documentation and other technical assistance to banks for practising the approved interest-free modes of financing. Donglah and Yaacob (2012) reported that more than half of their respondents in IFIs in Brunei were not aware of Shari'ah audit due to lack of promotion by the local IFIs on their existence and operation. However, they supported the view that the Monetary Authority should be the proper institution that appoints qualified Shari'ah auditors and stressed that the auditors must be independent. It is also noteworthy that in some Islamic countries, while compliance to Shari'ah is paramount for Islamic banks, the law governing Islamic banking transactions may not necessarily give any consideration to Shari'ah. Djojosugito (2008) elaborates that contracting parties face legal risk due to uncertainty in laws, regulations and legal actions pertaining to Shari'ah as well as the legality of Islamic financial instruments. These issues might be jurisdiction sensitive, but auditors face an uphill battle in such context to hold the Shari'ah law.

6. Shari'ah auditing challenges – *where to from here*

According to Iqbal and Molyneux (2005), the rapid growth of Islamic banking has meant that the industry has not been able to produce enough of the experts needed to support this growth. Many professionals have not had enough time to gain the required experience to enable them to competently advise on or manage Islamic financial transactions. Shari'ah expertise is still so relatively scarce in some countries that different Islamic banks often share the same scholars. This phenomenon has a beneficial side-effect in that it promotes consistency across the services and products offered by those IFIs. To address this shortage in the number of trained professional auditors in IFIs, AAOIFI has offered training leading to Certified Shari'a Adviser and Auditor (CSAA) and Certified Islamic Professional Accountant (CIPA) qualification. Indeed, it is a positive initiative, but there are no pre-requisites required for enrolling in these courses. The targeted candidates are those who are currently involved with Shari'ah compliance and review for banking and finance, professionals and executives who are currently involved in accounting, auditing and finance and professionals and executives with interests in the field of Shari'ah, accounting, auditing or finance. In addition, the qualifications do not cover the full AAOIFI standards. This leads to the central question of how many auditors in the industry are truly qualified. It is not surprising that the Shari'ah department is always under-resourced, and it is most unfortunate if management keeps on treating it as low priority (Rehman, 2012) when the role is so fundamental to the existence of the IFI. In recognition of these challenges, the International Financial Standard Board (IFSB) (2006) states that:

> […] the Audit committee of institutions offering Islamic financial services should use their best effort in ensuring that the external auditors are capable of accommodating ex-post Shari'ah compliance reviews (relying, where appropriate on work carried out by internal auditors or Shari'ah reviewers), within their terms of reference. This, where possible, the audit committee and the internal auditor or Shari'ah reviewer shall work closely with the internal auditors to enhance the external auditors capabilities for conducting such Shari'ah compliance reviews as part of their audits. Most institutions offering Islamic financial services have their own internal auditors or Shari'ah reviewer who carries out this review, while some have their Shari'ah Supervisory Board or Shari'ah compliance review officer to conduct it.

7. Conclusion

It is an undeniable fact that Islamic banking is a phenomenon that has taken the financial world by storm and its continued growth during the global financial crisis has attracted even more attention to it. It is making headway in an increasing number of Western countries. As IFIs are expanding, Shari'ah compliance in the internal and external review of Islamic banking operations is becoming indispensible. This paper provides a review of AAOIFI guidelines on the parameters of Shari'ah auditing in IFIs. ASIFI No. 1 states that the objective of auditing financial statements is to enable the auditor to express an opinion as to whether the financial statements are prepared, in all material respects, in accordance with Islamic Shari'ah rules and principles, the accounting standards of the AAOIFI and the relevant national accounting standards used in the country in which the financial institution operates. We discuss the role and responsibilities of the auditors in IFIs with reference to the Islamic framework. We examine the Shari'ah auditing practices and frameworks used in Islamic countries. The contemporary views on the lack of detailed standards for Shari'ah audit and governance in Islamic countries is not healthy for a growing Islamic finance industry. There is a serious shortage of trained manpower in the Shari'ah auditing industry (Rammal and Parker, 2010). Muslim scholars have highlighted the need for qualified auditor proficiency. They propose that the individuals who meet the specified "fit and proper criteria" must be trained in religious education. This is because those who are educated in religious education may not be well-versed in banking and finance knowledge. Standardization of Shari'ah audit procedures could also benefit the Islamic finance industry. The industry, in cooperation with global audit firms, needs to establish a professional, dedicated audit body with close links to AAOIFI and other standard setting bodies. The industry needs to find ways to improve its standards on the preparation of audits, governance, human resources, social and economic performance of IFIs.

We believe that more research is needed to gauge stakeholders' opinion on IFIs operation, product and services. Are clients convinced of the superiority of Islamic financial products in contrast to the conventional interest-based products? There is a lack of research on the antecedents and outcomes of official Shari'ah audit training at auditor level and bank level. A critical look at the AAOIFI certification process might also be necessary, so that understanding of key pre-qualification criteria can be changed in line with the dynamic nature of auditing, which should act as a quality management system and limit certification to professional auditors which are accepted on an AAOIFI CSAA. Those auditing functions that are deficient in expertise could benefit from further professional studies or courses to enhance the value and standing of the certification.

Financial and non-financial impacts for non-compliance with Shari'ah rulings are severe to Muslims. The non-financial impacts are considered to be more material than the financial impacts, as any practice considered against the commands of Allah will lead to impediment from Allah's blessing and any contravention of the provisions of the IBA (in the case of Islamic banks) might jeopardize the IFI's reputation and existence. The financial impacts can be: invalidation of contract (aqad); non-Halal income, and impact on the Capital adequacy ratio. Thus, Shari'ah auditing should not be accorded as only a worldly corporate governance practice, but a religious obligation on the part of IFIs and Shari'ah auditors. Compliance with Islamic principles implies observance of ethical standards which are upheld socially. This eventually would build investors' confidence in the quality and reliability of their audited financial statements. It would be indispensable for auditors to aim for greater authenticity in the spirit of the Islam to help realize its cherished objectives (*Maqasid al-Shari'ah*) because failure to keep Islamic values would exact unbearable moral costs for auditors much greater than economic losses.

References

AAOFI (2010), *Accounting, Auditing and Governance Standards for Islamic Financial Institutions*, Accounting and Auditing Organization for Islamic Financial Institution, Bahrain.

Bank Negara Malaysia (2013), "Shari'ah Governance Framework", available at: www.bnm.gov.my/index.php?ch=en_announcement&pg=en_announcement_all&ac=81&lang=en (accessed 29 July 2013).

Cizakca, M. (2011), "Islamic capitalism and finance", *Origins, Evolution and the Future*, Edward Elgar Publishing Limited, Cheltenham.

Djojosugito, R. (2008), "Mitigating legal risk in Islamic banking operations", *Humanomics*, Vol. 24 No. 2, pp. 110-121.

Donglah, N.K. and Yaacob, H. (2012), "Shari'ah audit in Islamic financial institutions: the postgraduates' perspective", *International Journal of Economics and Finance*, Vol. 4 No. 12, pp. 224-239.

Dusuki, A.W. and Abozaid, A. (2007), "A critical appraisal on the challenges of realizing Maqasid al-Shariaah in Islamic banking and finance", *International Journal of Economics, Management and Accounting*, Vol. 15 No. 2, pp. 143-165.

Grais, W. and Pellegrini, M. (2006), "Corporate governance and Shariah compliance in institutions offering Islamic financial services", World Bank Policy Research Working Paper 4054.

Hammed, S. and Mulyany, R. (2007), "Shariah audit for Islamic financial institutions (IFIs): perceptions of accounting academicians", *Audit Practitioners, and Shariah Scholars*, paper presented at the IIUM Accounting Conference, Gombak.

(IFSB) International Financial Standard Board (2006), *Guiding Principles on Corporate Governance for Institutions Offering Only Islamic Financial Services (Excluding Islamic Insurance (Takaful) Institutions and Islamic Mutual Funds)*, IFSB, Kuala Lumpur.

Iqbal, M. and Molyneux, P. (2005), "Thirty years of islamic banking: history, performance, and prospects", *Islamic Economic*, Vol. 19, pp. 37-39.

Karim, R.A.A. (1990), "The independence of religious and external auditors: the case of Islamic banks", *Accounting, Auditing, and Accountability Journal*, Vol. 3 No. 3, pp. 34-44.

Kasim, N.B., Ibrahim, S.H.M. and Sulaiman, M. (2009), "Shariah auditing in Islamic financial institutions: exploring the gap between the 'desired' and the actual", *Global Economy & Finance Journal*, Vol. 2 No. 2, pp. 127-137.

Kasim, N. and Sanusi, Z.M. (2013), "Emerging issues for auditing in Islamic financial institutions: empirical evidence from Malaysia", *IOSR Journal of Business and Management*, Vol. 8 No. 5, pp. 10-17.

Khan, M.A. (1985), "Role of the auditor in an Islamic economy", *Journal of Research in Islamic Economics*, Vol. 1, pp. 31-42.

Khan, M.M. and Bhatti, M.I. (2006), "Why interest-free banking and finance movement failed in Pakistan", *Humanomics*, Vol. 22 No. 3, pp. 145-161.

PwC (2010), "PwC Shariah Audit Survey in Malaysia", available at: www.pwc.com/en_MY/my/assets/publications/Shariah-Audit(Secured).pdf (accessed 20 July 2013).

Rammal, H.G. and Parker, L.D. (2010), "Audit and governance in Islamic banks: selection and training of Shariah advisors", paper presented Sixth Asia Pacific Interdisciplinary Research (APIRA), Sydney.

Rehman, M.A. (2012), "The role of shari'ah auditor, new horizon-global perspective on islamic banking and insurance", available at: www.newhorizon-islamicbanking.com/index.cfm?action=view&id=11420&section=features (accessed 19 July 2013).

Shafi, Z., Salleh, S. and Shahwan, S. (2010), "Management of Shariah non-compliance audit risk in the islamic financial institutions via the development of shariah compliance audit framework and shariah audit programme", *Tokyo Bulletin of Islamic Area Studies*, Vols 2/3, pp. 3-16.

Sole, J. (2012), *Introducing Islamic Banks into Conventional Banking Systems*, IMF Working Paper WP.07/175, International Monetary Fund.

Suchman, M.C. (1995), "Managing legitimacy: strategic and institutional approaches", *Academy of Management Review*, Vol. 20, pp. 571-611.

Venardos, A.M. (2010), "Current issues in Islamic banking and finance", *Resilience and Stability in the Present System*, World Scientific, Singapore.

Wallace, W. (1987), "The economic role of the audit in free and regulated markets: a review." *Research in Accounting Regulation*, Vol. 1, pp. 7-34.

Watts, R. and Zimmerman, J. (1981), "The markets for independence and independent auditors", Working Paper, University of Rochester, Rochester, NY.

Wilson, F., Carter, S., Tagg, S., Shaw, E. and Lam, W. (2007), "Bank loan officers' perception of business owners: the role of gender", *British Journal of Management*, Vol. 18 No. 2, pp. 154-171.

About the authors

Dr Radiah Othman is a Senior Lecturer with the School of Accountancy, Massey University, New Zealand. Her current research interests are Non-profit and Public sector auditing and accountability; environmental and sustainability reporting. She has published in journals such as *Voluntas, Corporate Governance: The International Journal of Business in Society, International Journal of Disclosure and Governance, Corporate Social Responsibility and Environmental Management and Journal of Business Ethics*. Her research papers have won a Highly Commended

Award Winner at the Literari Network Awards for Excellence 2013 by *Emerald* in May 2013 and Special Award for Corporate Social Responsibility at the Malaysian Outstanding Research Paper Awards, by the Malaysian Accountancy Research and Education Fund in January 2011. Radiah Othman is the corresponding author and can be contacted at: r.othman@massey.ac.nz

Rashid Ameer obtained his PhD from Aston University United Kingdom in March 2007 where he also obtained Postgraduate Certificate in Teaching and Learning in Higher Education. He has worked as a sessional lecturer with Aston Business School. He has research and teaching interests in corporate finance, stock markets, corporate governance and corporate social reporting. He has also published papers in these areas in international peer reviewed journals. He is an active reviewer for the accounting, finance and management journals. He has contributed to research portfolio of the Accounting Research Institute, UiTM Malaysia as a Research fellow since 2008. Recently, he has been appointed as External Question Writer for Licensing Examination of Securities Development Corp Malaysia. He is also an Associate Member of Higher Education Academy, United Kingdom and Emerald Literati, United Kingdom. His co-authored research paper on Islamic investment accounts in Malaysia has been given Highly Commended Paper Award by the UK publisher, *Emerald* in May 2013.