Auditing Islamic Financial Institutions
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Executive Summary

Auditing Islamic financial institutions (IFIs) covers a wider scope than statutory financial statement auditing. External auditors of IFIs not only conduct financial audits, but also conduct tests on the shariah compliance of IFIs, according to fatawa (religious opinions) and guidelines set by the Shariah Supervisory Board (SSB). Shariah review is unique to IFIs, due to the requirement to ensure that all business activities and operations of IFIs adhere to shariah precepts.

Scope of audit of IFIs needs to be comprehensive in order to achieve maqasid al-shariah (wider objectives of the shariah).

Challenges in auditing of IFIs include lack of standardized shariah guidelines, lack of independence of SSB, and lack of competence of external auditors to conduct comprehensive shariah audit.

Introduction

The purpose of the statutory or financial statement audit is to enhance the degree of confidence of intended users of the financial statements as to whether the financial statements are prepared in accordance with an applicable financial reporting framework. The most widely accepted and adopted auditing standards are those issued by the International Federation of Accountants (IFAC).

Following the emergence and phenomenal growth of Islamic financial institutions (IFIs) in recent years in various parts of the world, the scope of conventional statutory financial audit is inadequate to fulfill the needs of the stakeholders of IFIs. Because IFIs need to adhere to shariah principles in all their business transactions and operations, a new dimension in auditing, as well as auditing standards which can cope with such principles, is needed. Recognizing the limitations of the International Standards of Auditing (ISA) in addressing issues related to religious compliance, the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) has taken steps in producing a number of auditing standards and audit methodologies specifically for IFIs.

Objective of Auditing IFIs

Auditing forms an important element in the process of securing corporate accountability and in enhancing stakeholder faith in management’s stewardship. 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.”

Unlike conventional statutory financial audit, which requires auditors to express a true and fair view that the financial statements have been prepared according to relevant auditing standards, the audit of IFIs covers a wider scope. This is because auditors must also attest that management has complied not only with the shariah precepts, but also with the wider objective of shariah (maqasid al-shariah), which is to protect and improve the condition of human life in all dimensions. In other words, auditing of IFIs is not only confined to the statutory financial audit but also to what is known as the shariah review, which is the raison d’être for IFIs.

Hence, auditing of IFIs can be defined as a systematic process of objectively obtaining and evaluating evidence regarding assertions about religious and socioeconomic actions and events, in order to ascertain the degree of correspondence between those assertions and the applicable financial reporting framework, including the criteria specified based on shariah principles as recommended by the Shariah Supervisory Board (SSB), and communicating the results to all interested parties. Noncompliance with shariah principles
is an area of risk for IFIs that could translate into legal, image, and reputational risks, which would have far-reaching consequences not only for the individual IFI but also for the entire Islamic financial system.

Characteristics of the Audit of IFIs

Role of Key Players in the Audit

Due to the need to ensure proper adherence to the *shariah* principles in operations and activities, external auditors are not expected to conduct both types of audit for IFIs. This is because the criteria in deciding whether an activity complies with *shariah* principles or not are a matter for the SSB of the individual IFI to decide, as they have expert knowledge in Islamic jurisprudence. Given the accepted divergence in *shariah* principles between, and even within, national groups, the additional attestation of *shariah* compliance is measured against the Islamic *shariah* rules and principles, as determined by the SSB in each IFI.

The role of the external auditor with respect to *shariah* compliance is only to test for compliance based on the outlines provided by the SSB. Besides the SSB and external auditors, the other two key players involved in the audit of IFIs are the internal auditors and the Audit and Governance Committees. The role of each key player in the audit of an IFI is illustrated in Figure 1.

![Figure 1. Key players and their role in the audit and governance of IFIs](image)

*Shariah* Supervisory Board

The SSB plays a key role in the overall audit and governance framework, both *ex-ante* and *ex-post*. Their role *ex-ante* is to formulate policy and guidelines to be followed by management in their activities, including approval of products. The *ex-post* role is to conduct *shariah* review, which is an examination to ensure that the activities carried out by an IFI do not contravene the principles of *shariah*. The *shariah* review involves three phases: planning and designing the review procedures; executing the review procedures and preparing and reviewing the working papers; and last, documenting the conclusions and producing a comprehensive *Shariah* Supervisory Report. When executing the *shariah* review procedures, a draft report from the external auditor regarding *shariah* compliance testing, and the internal *shariah* review report from the internal auditor, will help the SSB in documenting their conclusions and expressing a *shariah* opinion in their comprehensive report. In short, the *shariah* review is a comprehensive review of not only the financial statements but also of contracts, agreements, and transactions, to ensure *shariah* compliance and to add credibility to management’s activities.

External Auditor

One of the unique roles played by the external auditor of an IFI, besides performing the financial statements audit, is to conduct a test of *shariah* compliance. The audit process involves a structured, documented plan involving a series of steps beginning with planning the audit and ending with expressing an opinion in an external audit report as to whether the financial statements are prepared in accordance with the fatawa (religious opinions), rulings and guidelines issued by the SSB of the IFI, the accounting standards of the AAOIFI, and relevant national accounting standards and practices in the country in which the IFI operates. In order to provide reasonable assurance that the IFI has complied with *shariah* rules and principles as determined by the SSB, the auditor needs to obtain sufficient and appropriate audit evidence. In order to guide the auditor in making judgment as to whether the financial statements of the IFI have been prepared...
in accordance with shariah rules and principles, the auditor will rely on the fatawa, and rulings and guidance issued by the SSB. However, the auditor is not expected to provide interpretation of the shariah rules and principles.

Hence, when conducting the audit, the auditor will include procedures in his or her examination to ensure that all new fatawa, rulings, and guidance, and modifications to existing fatawa, rulings, and guidance, are identified and reviewed for each period under examination. The auditor will review the reports issued by the SSB to the IFI concerning shariah compliance as well as the SSB’s minutes of meetings to ensure that all types of products offered by the IFI have been subjected to a review by the SSB. The auditor must also examine the findings of all internal reviews carried out by the IFI’s management, the internal audit, and the report of the internal shariah review. The auditor will send his or her draft report and conclusions related to shariah compliance to the SSB, and if the SSB’s draft report indicates that compliance is lacking, the auditor may modify his or her draft report, providing adequate explanation of the nature of, and reasons for, the modification.

Internal Shariah Review

According to AAOIFI Governance Standards for Islamic Financial Institutions No. 3 (GSIFI 3), the conduct of the internal shariah review process may be undertaken by the internal audit department, provided that the reviewers are properly qualified and independent. Before the review process can take place, management prepares a charter containing a statement of purpose, authority, and responsibility, and sends it to the SSB for approval. Once the charter is approved, the board of directors will send the charter to the head of the internal shariah review, who will then appoint a team that has competence to carry out the task.

The reviewers will first plan each review assignment and the documentation. Then they will collect, analyze, and interpret all matters related to the review objectives and scope of work, including examination of documentation, analytical reviews, inquiries, discussions with management, and observations to support their review results. Working papers that document the review will be prepared by the reviewer and reviewed by the head of internal shariah review, who will then discuss the conclusions and recommendations with appropriate levels of management before issuing the final written report.

Audit and Governance Committee

The role of the Audit and Governance Committee (AGC), comprising nonexecutive directors, is described in detail under GSIFI No.4. It is responsible for checking the structure and internal control processes and ensuring that the activities of the IFI are shariah-compliant. The duties of the AGC also include the review of the reports produced by the internal shariah review and the SSB to ensure that appropriate actions have been taken.

Scope and Extent of Audit

As mentioned earlier, the scope of audit for IFIs is much broader. AAOIFI defined “scope of an audit” as the audit procedures deemed necessary by the auditor in the circumstances to achieve the objective of the audit for the IFI. It further stated:

“The procedures required to conduct an audit in accordance with ASIFIs should be determined by the auditor having regard to the requirements of appropriate Islamic Rules and Principles, ASIFIs, relevant professional bodies, legislation, regulations, which do not contravene Islamic Rules and Principles, and, where appropriate, the terms of audit engagement and reporting requirements, International Standards on Auditing (ISAs) shall apply in respect of matters not covered in detail by ASIFIs providing these do not contravene Islamic Rules and Principles.”

From the above statement, it is clear that external auditors of IFIs are expected to deal with wider rules and guidelines. Since they are expected to conduct tests of shariah compliance, they will have to ensure that management has adhered to the interest-free and permissibility (halal) principles as specified by the SSBs. External auditors should also be concerned with elements of socioeconomic justice in line with maqasid al-shariah, even if they have not been addressed by the SSB.
Challenges on the Audit of IFIs

There are currently a number of challenges with regard to the auditing of IFIs, especially in terms of shariah compliance audit. First, despite the efforts of AAOIFI in promulgating auditing standards, the focus and scope tend to be on financial statements rather than the broader concept of shariah audit, which involves the audit of all activities of IFIs based on maqasid al-shariah. Furthermore, the use of the term “shariah review” rather than “shariah audit” by AAOIFI may implicate a lower level of assurance in the case of the former.

Second, based on AAOIFI’s auditing standards, the functions of shariah audit or review are distributed to different entities, for example, external auditor, SSB, internal shariah reviewer, and the Audit and Governance Committee. While external auditors act as the external mechanism in monitoring compliance, their lack of competence makes them rely heavily on the SSB’s fatwa, whereas in fact they should be making an independent judgment on the issue of compliance.

Third, the independence of the SSB has been questioned as they are involved in making fatwa and in setting up the guidelines on shariah compliance as well as in conducting a shariah review or audit of the IFI concerned.

Given the rapid growth of IFIs globally, there is little doubt that the auditing of IFIs will have to change to overcome these challenges and, perhaps, a new shariah auditing professional body will soon emerge.

More Info

Books:

Article:

Websites:
• Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI): www.aaoifi.com
• Journal of Islamic Accounting and Business Research: www.emeraldinsight.com/products/journals/journals.htm?id=jiabr

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