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ISSUES AND CHALLENGES OF SHARIAH AUDITING IN ISLAMIC FINANCIAL INSTITUTION AND CORPORATE GOVERNANCE COMPLIANCE

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Abstract

The study examines the perspective of practitioners who are involved directly and/or indirectly with the process of shariah compliance/auditing from Islamic financial institutions (IFIs) on the issues of standards for shariah auditing, auditors qualifications, and independence. Auditing Islamic financial institutions (IFIs) covers a wider scope than legal 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. The scarce resourceful auditors with both shariah and accounting/auditing qualifications and the issue of self-review threat to independence may affect the reputable image of Islamic financial institutions. This article is the literature method. The findings reinforce the importance of auditors' qualification and independence as currently there is no mandatory regulated professional shariah auditor code to be in tandem with the drastic growth of the IFIs. The paper offers practical implication to regulators in providing a direction to revise the existing standards for shariah auditing practices and to formulate a mandatory professional governance structure for shariah auditors.

Keyword: *Shariah Auditing; Islamic financial institutions; Corporate Governance.*

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INTRODUCTION

Shariah auditing has a key importance as there is a growing awareness among Islamic institutions that every such institution should contribute towards achieving the objectives of the Islamic law- the Maq'asid Ash-Shariah (Shahul, and Yaya, 2005). It is recommended that there is a need to have regular independent shariah audits in IFIs as people are now experiencing a movement along a continuum from a society that trusts

everything and audits nothing to a society that trusts nothing and audits everything. The concept of shariah auditing should be extended to the activities relating to among others, the system, the products, the employees, the environment and the society (Sultan, 2007). There is a need to develop a useful shariah audit framework to ensure the effectiveness of the goals of shariah compliance in IFIs which in turn can contribute positively to large society (*ummah*).

The objective of the legal 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).

Consequent the emergence and phenomenal growth of Islamic financial institutions (IFIs) in recent years in various parts of the world, the scope of the conventional legal 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 (Kasim, Ibrahim and Sulaiman, 2009).

Topical accounting scandals, where companies prepared fraudulent financial statements and auditors issued clean opinions on the fraudulent statements have eroded trust among participants in the financial markets. Barlup has questioned whether increased regulation is the only solution to fraudulent financial reporting and auditing. Audit failures have led stakeholders to question the importance of the audit process. Stakeholders wonder about the independence of auditors when management fraud occurs and questioned whether auditors improve the value of information available to outsiders. People have started to re-evaluate the level of trust they put on the audit to provide assurance for investment and financial information, and the trend of solely depending on the audit as the best source of credibility for such information may have now become defunct (Barlaup, Dronen, and Stuart, 2009). The profession's problems started after high-flying Enron Corporation suddenly declared bankruptcy, followed by a few more giant conglomerates. Like it or not, auditors became regular features in front-page news stories and banner (Humphrey, 2000). It has also been argued that the role of financial reporting and auditing should not be confined to the needs of investor decision-making, but should also be viewed in relation to the more general concerns of corporate governance (Houck, 2003). To the extent that an IFI is principally a company structure, it ought to align, adopt and submit by the generic global corporate governance principles and models including the OECD principles of Corporate (Ball, Kothari, and Robin, 1998). Governance, originally issued in 1992 and other complicated guidelines that have emerged internationally as well regionally. Islamic finance, however, is a specialized industry which is based on the Quran and Sunnah. It offers a distinct view of eligible financial transactions and implicitly brings to the forefront a rich and superior architecture and texture to the field of corporate governance. The driving force of corporate governance for IFIs, on one hand, is the concept of justice, moral obligation, accountability, and equality that are fundamental to Islamic ideology and on the other hand, is the nature of permissible transactions

which tend to have different risks associated with it than conventional banking business (Akhtar, 2006).

The corporate governance and its characteristics such as the board of directors and audit committee have received great concern in the recent years by accounting and finance researchers. In this context, many countries around the world have updated their own corporate governance systems in order to protect the rights of the shareholders. The audit committee as one of the corporate governance characteristics can increase the quality of financial reporting throughout open and candid communication and good working relationships between the companies' board of directors, audit committee, internal auditors and external auditors. Furthermore, The Blue Ribbon committee BRC (1999) descript the integrity, transparency and the quality of financial reports can effectively improve and enhance the investors' confidence in the capital markets. By contrast, the financial fraud diminishes their confidence (Alkdai and Hanefah, 2012).

RESEARCH METHODS

Each research has a specific purpose and usefulness, in general, the purpose of research there are three kinds of that is the nature of discovery, proof, and development. The discovery because the data obtained from the results of the research is data that is completely new and previously never existed. The proof means that the data obtained is used to prove the existence of any doubt about certain information or knowledge. development, the result of the research is the deepening and extension of existing knowledge (Sugiyono, 2016). One of the research literature (library research) retrieval of data or materials needed to complete the study came from the library, including books, encyclopedia, dictionaries, journals, documents, magazines and so on. Criteria used to select reading materials that (a) recency and (b) relevance (Komidar, 1995). The literature review in a scientific study is an important part of the overall steps of the research method. Cooper in Creswell suggests that literature review has several objectives namely; informing readers of other research results closely related to current research, linking studies with existing literature, and filling the gaps in previous studies (Cresswell, 2014). While Sugiyono states that literature is a record of events that have been passed in the form of writing, drawings, or the monumental works of a person (Sugiyono, 2016). The method or literature study, although initially rarely noticed in qualitative research methodologies, is today an important and integral part of the qualitative research methodology. This is due to the growing awareness and new understanding of the researchers, that a lot of data is stored in the form of literature and artifacts. So that the extracting of data sources through literature study become complementary to the qualitative research process. The method in this paper the author using literature methods of prescriptive tried to explain emerging Issues for Shariah Auditing in Islamic Financial Institutions and Compliant Corporate Governance.

RESULT AND DISCUSSION

Shariah audit of Islamic financial services means the accumulation and evaluation of evidence to determine and report the level of suitability between information and criteria that have been established for the purpose of sharia compliance (Shafii, Salleh, & Zakaria, 2014). Audits must be carried out by a competent and independent person.

To conduct an audit, there must be information in a verified form and several standards (criteria) where the auditor can evaluate information. Information is obtained and taken from all lines. Islamic auditors conduct audits on two objectives of objective information (eg profit sharing financial information) and subjective information (shari'ah information) to ensure shari'ah compliance with Islamic banks.

Guidelines or proof of Shariah Audit is to conduct a sharia audit in determining audit evidence. Sharia audit evidence or evidence can be defined as any information used by the auditor to determine whether the audited information is stated in accordance with the criteria of the Guidelines or Shariah Audit evidence is to conduct a sharia audit in determining audit evidence. Shariah audit evidence or evidence can be defined as any information used by the auditor to determine whether the audited information is stated in accordance with the criteria set for the purpose of sharia guarantee. The criteria for evaluating information vary depending on the information being audited. In an audit of historical financial statements by the auditor, the criteria are usually financial report standards (FRS).

Harahap explains that the process of sharia audit services, the criteria can be developed based on the written opinion of the Shariah Supervisory Agency (SSA), product manual and operating procedures standard. Instructions or evidence in sharia audits include: oral testimonies from auditors, written communication with outside parties, observations by auditors, and electronic data transactions. Sharia audits will develop a systematic and comprehensive audit program (Harahap, 2007).

Shariah audit programs also need to be written in a language that can be easily understood by potential shareholders. Three phases of Shariah Audit, namely (Harahap, 2002):

First, planning. The auditor must understand the business of Islamic financial institutions including the nature of the contract used for various types of Islamic financial services. Then, the sharia auditor needs to identify the right technique, resources and scope to develop an audit program. The audit program will then identify the main activities to be carried out, the objectives of each activity and technique to be used, including sampling techniques in order to achieve audit objectives. Among the techniques that can be used include examination of papers, interviews, benchmarking, surveys, case studies, flowcharts, etc.

Second, inspection. Appropriate audit techniques need to be identified and explained. The right technique is needed to gather the evidence needed both quality and quantity to reach reasonable conclusions in accordance with sharia compliance. The main aspects of inspection in the field require sampling techniques. A more detailed examination of the documentation will be needed whether or not a sampling methodology is used. Working papers and audit records are the two most important things in the examination phase. The purpose of the working paper is to provide a systematic record of work performed during the audit and is an information record and facts obtained to support the findings and conclusions.

Third, report. The results of the audit implementation, including the preparation of a sharia audit report, which is good communication from the auditor to the users or readers. Generally the report will be different, but all must inform the reader about the level of suitability between the information and the criteria that have been set.

Islamic audits are needed to complement the current government program in the Islamic financial services industry. AAOIFI audit standards in the Islamic banking system are the standards used for the most comprehensive audit method, namely by

emphasizing that the subject of sharia compliance as the main and mandatory search object (AAOIFI, 1998).

The standards that can support the audit process are made by AAOIFI is as follows (AAOIFI, 2017):

First, Objective and Principles of Auditing (Objectives and Principles of Audit). The main objective of the IFI audit lies in the statement of opinion about whether the financial statements are prepared in all material respects in accordance with the Sharia Principles Rules and accounting standards of AAOIFI and are relevant to national accounting standards and practices in the countries where financial institutions operate. This is done so that the auditor provides a correct and fair view of the financial statements. The auditor must comply with the code and ethics as a professional accountant published by AAOIFI and the International Federation of accountants that do not conflict with Islamic rules and principles. The ethical principles governing the auditor's professional responsibilities include: truth, integrity, trust, justice, honesty, independent, objectivity, professional competence, due care, confidentiality, professional behavior and technical standard

Second, Auditor's Report. The auditor must review and assess conclusions drawn from audit evidence obtained as a basis for expressing opinions on the financial statements. The basic elements of the Auditor's report are as follows: Title, Address to be addressed, opening or introducing paragraphs, paragraphs of scope, references to relevant and relevant national standards, auditor job descriptions, paragraphs of opinion, date of report, address of auditor, and signature of auditor

Third, the auditor's responsibility to consider fraud and errors in financial statement audits. This standard provides guidance on the characteristics of fraud and errors and the auditor's responsibilities in establishing minimum procedures relating to fraud and errors. The auditor's responsibility lies in the statement of opinion about whether the financial statements are prepared in all material respects, in accordance with Islamic rules and Sharia principles, accounting standards of AAOIFI and relevant national standards and statutory requirements.

Fourth, Continuous Audit Procedure. There are several methodologies important steps that must be taken to have Audit Results Standard from Islamic Financial Institutions. The methodology must be preceded by preliminary considerations because preliminary consideration is a very important consideration in maintaining good corporate governance and ensuring sharia compliance.

These initial considerations are as follows(AAOIFI, 1998):

First, continuous of monitoring and auditing. This monitoring will help ensure that policies, procedures and business processes operate effectively and help management assess the effectiveness of internal controls. This usually involves automated testing of system activities in the business processes provided against control rules and frequencies based on the underlying business cycle. While continuous auditing is an automatic performance control and risk assessment every day continuously.

Second, Meta Control is an extra level of control as a warning system, for example: if Islamic Bank financing facilities have increased without proper management authorization, the Internal Control Department can help remind management.

Third, independent and objectivity. The audit process may need to be re-conceptualized before implementing continuous auditing. This is because continuous

audit activities differ from those that occur during audits in general which often place auditors in the middle of the audit process. In a continuous audit, the auditor must be notified if the transaction is stopped after certain audit requests are met. This is important for the auditor to ensure that the audit process continues to have a system of checks and balances to maintain the objectivity of their work during the audit.

Earnings management is the possible outcome of some degree of flexibility and discretion the companies' managers have in reporting their financial performance. Furthermore, the judgments in financial reporting and structuring transactions to alter financial reports to either mislead some stakeholders about the principal economic performance of the company or to influence the contractual outcomes that depend on reported accounting numbers is referred to commonly as earnings management (Healy and Wahlen, 1998). In this context, Schipper (1989) defines this practice as "purposeful intervention in the external financial reporting process, with the intent of obtaining some private gain" (Schipper, 1989). The literature has provided an evidence for the expected economic influences that can explain the motivations behind the earnings management practices worldwide. Firstly, managers with accounting-based bonus plans have an incentive to report higher earnings in order to maximize their rewards (the management compensation plan hypothesis). Secondly, managers in companies of high financial leverage have the motivation to report higher earnings to avoid the breach of debt covenant restrictions (the debt/equity hypothesis). Thirdly, managers of large politically visible companies have the motivation to report lower earnings to minimize the possibility of wealth (the political cost hypothesis) (Rahman, 2005). Similarly, Dechow et al., (1995) have argued that managers engage in earnings manipulation in order to attract capital and in order to avoid violation of contracts (Dechow, Sloan, 1995).

Currently, the responsibility of carrying out the shariah audit function is impliedly enforced on the Shariah Supervisory Board (SSB) 2. Even though the regulators realize the need to have shariah audits for IFIs, there is no mention of the appointment and responsibilities of a shariah auditor per se, nor a specific definition of a shariah audit, in any related acts or regulations. Section 3 (5) (b) of the Islamic Banking Act (IBA) 1983 does mention indirectly on the responsibility of a shariah auditor, but this section is related to the requirement to establish an SSB which includes among others the responsibility of producing an endorsement of a shariah report. The latest Shariah Governance Framework (SGF) issued by the Central Bank discussed on the function of shariah audit as part of the governance structure, hence very limited in scope. Questions may then arise as to who is responsible to conduct the check and balance (in other words, doing the auditing) on shariah matters which is not covered by the external auditors, particularly (Kasim et al., 2009). Research conducted by Hood and Bucheery showed that financial (external) auditors were reluctant to undertake the responsibility of confirming shariah compliance. IBA 1983, BAFIA 1989, BNM (Bank Negara Malaysia) / GPS (Global Position System) 1, SGF and AAOIFI seem to put the responsibility of forming and expressing an opinion on the extent of an IFI's compliance with shariah (in other words doing the shariah audit e.g. GSIFI 2) on the SSB (Hood and Bucheery, 1999). In addition, both the AAOIFI standards and the Central Bank's guidelines also give the responsibility of advising, planning, and monitoring of the activities of the IFIs (e.g. BNM (Bank Negara Malaysia)/GPS (Global Position System) 1 and SGF) on the SSB. This, however, leads to questions of independence which is a fundamental concept in auditing, as auditors cannot audit or

examine their own work. Due to the faith-based nature of the business, it is evident that the SSB will review most aspects of the business even though the involvement could vary and focused on approval of basic structure of products and other special activities rather than interfering in the day-to-day operations of business (Besar, Sukor, Muthalib, and Gunawa, 2009).

Furthermore, SSB does not have a mandatory regulated professional code to follow; instead, they follow the Islamic Shariah principles (Banaga, A., Ray, G. and Tomkins, 1994). Whereas investors of shariah approved companies depend on the SSB‟s scholarship and expertise in making decisions on evaluating and selecting optimal investment portfolio (Mohd Dali, Mudasir. and Abdul, 2008). Although AAOIFI has come up with the code of ethics for auditors of IFIs, the framework/standards within which to formulate their task as shariah auditors have not so far been defined. The fact that they are guided by their moral beliefs (Karim, 1990) and they are distinguished and knowledgeable shariah scholars (Rahim, A. R., Bakar, and Syafie, 2004) makes it difficult to know whether they are competent to perform their duty or not as shariah auditors, even though their position is comparable to the auditors of the IFIs (Besar, Sukor, Muthalib, and Gunawa, 2009). It is eventually an empirical question as to who is qualified shariah auditing expert, and what are the boundaries of certified knowledge are. Should the auditor be the staff who is within the organization but independent of the areas being audited and reporting directly to management – the classic formulation of the duties of an internal auditor as suggested by Maltby for an environmental auditor (Maltby, 1995).

The 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 Shariah 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 (Masruki & Shafii, 2013)."

Unlike conventional legal 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, the auditing of IFIs is not only confined to the legal financial audit but also to what is known as the shariah review, which is the reason d'être for IFIs (Sarea & Hanefah, 2013).

Hence, auditing of IFIs can be defined as a systematic process of objectively obtaining and evaluating evidence regarding assertions about religious and socio-economic 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 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 (Hanefah, Shafii, 2012).

The corporate governance and its characteristics such as the board of directors and audit committee have received great attention in the recent years by accounting and finance researchers. In this context, many countries around the world have reformed their own corporate governance systems in order to protect the rights of the shareholders. The audit committee as one of the corporate governance characteristics can enhance the quality of financial reporting throughout open and candid communication and good working relationships between the companies' board of directors, audit committee, internal auditors and external auditors (Mustafa Mohd Hanefah, Zurina Shafii, 2012).

The uniqueness of corporate governance for IFIs stems from two principal elements: (i) faith-based approach that mandates conduct of the business in accordance with shariah principles; and (ii) profit-motive that recognizes business and investment transactions and maximization of shareholders wealth etc. At times these elements could be perceived to be in conflict with each other and as such corporate governance framework for IFIs has to treat these tensions effectively, while providing an enabling framework that allows ample opportunities of growth and strength of the system (Haniffa, 2010).

These times compliance standards vary across jurisdictions (see Attachment) since, in absence of a well-conceptualized framework, countries evolved their own framework drawing from their own needs and experiences. At the same time, IFIs encouraged product innovation which moves away from fixed-interest (*riba*) loan transaction to promoting a contractual arrangement for profit sharing in businesses. The inherent risks of exposures (legal, credit, market, etc.) in financial instruments are very different from risks associated with loans. An appropriate corporate governance framework would need to recognize these elements and identify risks and challenges associated with the different Islamic contractual arrangements and instruments. IFIs reputation is highly dependent on the perception of customers with respect to shariah compliance and issues surrounding investor's protection given the traditional reliance on the deposit products etc (El-Gamal, 2006).

Characteristics of the audit of IFIs

The task of key players in the audit

The current role of the SSB focuses on compliance with rules and procedures and completeness of paperwork. It is easy to show that an IFI can comply with all rules and regulations without adding any value or achieving the objective of the shariah for which its formation is based. The accountability of the shariah audit function carried out by the SSB is thus checked only to the extent of its conformity to rules and procedures. Thus, it may be assumed that the function makes no contribution to assessing the achievement of the objectives (Haniffa, 2010)

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 (Sultan, 2007).

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 Shariah Supervisory Board specifically on the socio-economic objectives. Different from the capitalist environment, in an Islamic society with a very heavy social and ethical program, the current practice may be considered inadequate. On the other hand, the role of the external auditor in an IFI is different and wider than his role in the traditional organizations (Banaga, Ray, and Tomkins, 1994).

This is because it should be extended to cover the compliance with the shariah and auditing in Islam has been derived from the basic values of Islamic society; from the traditional concept of "attest and authority" to meeting the socio-economic objectives of the Islamic law (Khan, 2001). Is the current profession qualified to undertake this extension of duty? By right the auditor auditing IFIs is religiously responsible and his duty is bound to acquire knowledge of shariah and his duty emanates from the principles of Islam and from the general standards of his profession.

Therefore, it is the duty of the auditor to do his best in the capacity of a professional by acquiring related knowledge as the profession requires the auditor to certify that the transactions of the institution which they audit to comply with the objective of the institution. Accordingly, if the objective of the IFI is to conduct business in accordance with shariah principles, the auditors of the institution have a responsibility to ensure shariah compliance by virtue of taking the audit assignment. However, as mentioned above, research conducted by Hood and Bucheery (Hood, and Bucheery, 1999) indicated that external auditors were reluctant to undertake the responsibility of ensuring shariah compliance mainly due to the lack of expertise. Further, Simpson and Willing (Simpson, and Willing, 2000) argued that the role of external auditors in the IFIs was seen to be complex due largely to the lack of experience of most external auditors on the Shariah principles. Besar et.al suggested that in ensuring the success of shariah compliance review framework, IFIs need to promote the involvement of the external auditors in order to enhance the independence and transparency of the industry (Besar, Sukor, Muthalib, and Gunawa, 2009).

In line with these issues, the present study seeks to examine whether there are sufficient standards for shariah auditing practices for IFIs in Indonesia. Besides that, this study also investigates whether the practitioners of shariah auditing practices in IFIs in Indonesia qualified in both shariah and auditing/accounting related subjects. Finally, this study seeks to observe the issue of independence between the practitioners of shariah auditing practices in IFIs and the organizations they attached. This research offers several practical and theoretical imperative for regulators, IFIs and the public as a whole. The audit function in an Islamic state is important and mandatory as it reflects the accountability of the auditor not only to the users of the financial statements but more important, to the Creator, Allah S.W.T. Muslims believe that one's actions and thoughts are always being watched and it is to be noted that one has the obligation to "account" to God on all matters pertaining to human endeavor for which every Muslim is "accountable" (Askary and Clark, 1997).

The effectiveness of the audit committee

There is no specific scientific precise definition for the audit committee, but it differs by the different professional environment, as well as interests. It was defined by the Bank of Britain as "a subcommittee of the board of directors that is responsible to follow-up financial matters in the company and to assist the board in making financial decisions, in which the board may not have the time and expertise to know its details. The size of the audit committee is referred to as the number of directors appointed to be members of the audit committee, in this regard there could be small, medium and large audit committee. These recommendations reflect the assumption that size is a very important attribute of the effective audit committees. Although the size of the audit committee is affected mainly by the size of the company and its board of directors, a larger audit committee may not necessarily cause in more effective functioning as a larger audit committee may lead to unnecessary debates and delay the decisions (Lin, 2008). According to Abdellatif (2009), the larger size of the audit committee can mitigate effectively asymmetric information during the seasoned equity offerings. Since by earnings management managers aim to mislead users of financial statements by providing them with false information about a company's true financial position and operating performance, the larger audit committee may play a vital role in constraining the occurrence of earnings management (Abdellatif, 2009).

External auditor

One of the unique tasks 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 fatwa (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 a judgment as to whether the financial statements of the IFI have been prepared accordance with shariah rules and principles, the auditor will rely on the fatawa, rulings and guidance issued by the SSB. However, the auditor is not expected to provide interpretation of the shariah rules and principles (Haniffa, 2010).

Hence, when guidancing 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 an 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 (AAOIFI, 2017). 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 the 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 the internal shariah review, who will then discuss the conclusions and recommendations with appropriate levels of management before issuing the final written report (Haniffa, 2010).

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 (Sultan, 2007).

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 (Lahsasna & Saba, 2014).

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 fatawa, whereas in fact, they should be making an independent judgment on the issue of compliance (Zakaria, Nurazalia, Ariffin, 2016).

Third, the independence of the SSB has been questioned as they are involved in making fatawa and in setting up the guidelines on shariah compliance as well as in conducting a shariah review or audit of the IFI concerned (Haniffa, 2010).

These challenges are inter-linked and mutually reinforcing and range from (Akhtar, 2006): Reputational risk arising out of any uncertainty on shariah compliance. The success of an Islamic financial system is based on stakeholders believe that the system is Shariah Compliant. This single factor intensifies the role of good corporate

governance to ensure that the faith of stakeholders is not compromised and the system sustains and grows smoothly. The reputational risk factor i.e. loss of faith has to be managed right from the inception of an IFI and the Shariah Advisor/Board are assigned to perform their duties.

First, the commitment of dedicated. Qualified directors who understand and can assess shariah compliance would facilitate effective oversight and protect the industry from overall reputation risks. Qualifications/experience of shariah advisors is the key to judge and support the development of shariah-compliant financial services. In absence of this, there is a risk that for short-term profits/gains the shareholders/BOD may become willing to compromise on the shariah principles. The presence of shariah literate directors would discourage precedence of profit motive over shariah compliance. From the regulatory point of view, the licensing stage is of particular importance whereby the licensing authority should demand a clear demonstration of sponsors' commitment to Islamic banking.

Second, demarcation of responsibility and accountability between Board, Management, and Shariah Advisor. Akin to the demarcation issue in a conventional bank between Board of Directors and the Management; is the demarcation essential between the role and functions of Shariah Advisor or a special Shariah Board (as the case may be) as distinct from the Management/BOD. Due to faith-based nature of the business, it is evident that the Shariah Advisor will review most aspect of the businesses but the involvement could vary and focused on approval of basic structure of products and other special activities rather than interfering in day-to-day operations of businesses. Notwithstanding, the Shariah Advisor has to be more mainstream than an advisor in a conventional bank. To perform their functions effectively, there is need to enhance the pool and capacities of Shariah Scholars in financial business as currently the most experienced Shariah Scholars are represented on Shariah Boards of different institutions. State Bank of Indonesian has taken a lead in this direction by requiring that the banks appoint one Shariah Scholar for a single bank only, according to the fit and proper criteria, as a result of which, all the 18 licensed Islamic banking institutions have appointed their own Shariah Advisors and new institutions are appointing Shariah Advisors. This policy also ensures full-time availability of these advisors to guide and monitor the banks on daily basis.

Third, investment policy to comply with shariah criteria. An IFI can not invest, whether through financing or share purchase, in the companies which are engaged in non-halal businesses. This adds a new dimension to corporate governance which the Board and the Management of the IFIs have to fulfill. The investment policy, which has to be consistent with shariah, is a part of the encompassing corporate strategy to be approved by the Board.

Fourth, investors' protection. Under the principle of Mudaraba, Investment Account Holder (IAH) as Rabb-ul-Mal bears the risk of capital invested by the IFI as Mudarib. This equates the IAHs' investment risk with the shareholders of IFI who bears the risk of losing their capital as investors in the IFI. Given the IAH would be more risk averse than owners of IFIs, the supervisory authorities should play a role in protecting the interests of the IAH vis-à-vis the shareholders of IFIs with regard to their rights and be safeguarding against commingling of funds and/or conflict of interest of shareholders.' A way for central banks offering Deposit Insurance schemes would be to devise Shariah-compliant-Deposit insurance schemes for depositors of IFIs to provide a safety net while ensuring stability in the financial system.

Fifth, on the financing side. If the funds are invested on Musharaka or Mudaraba basis (Arwani, 2016), the safety of the funds invested would depend on the governance of the borrowing enterprise. The IFIs should be expected to conduct active monitoring of enterprises they invest in under Musharaka or Mudaraba. IFIs relationship with such enterprises ought to be of long-term nature with active involvement in governance in contrast to a short-term, transactional relationship. Among others, some expertise about the business of such enterprises would be prerequisite for IFIs for them to assess appropriately business risk and to effectively monitor their operations.

Sixth, disclosure and transparency. Transparency and disclosure of a structure of the product and its strengths and weaknesses are critical and IFIs should be mandated to this discipline. IFIs should further conform to the highest international standards and practices for financial and non-financial reporting and disclosure. Moreover, IFIs should be transparent in the adoption and application of Shariah rules and principles issued by its Shariah Scholars. These should be made publicly available through appropriate channels. In line with the IAHs' rights of monitoring the performance of their investments, they should be entitled to be informed of the methods of profit calculation, asset allocation, investment strategies and mechanics of smoothing the returns (if any) in respect of their investment accounts.

Seventh, corporate governance framework should ensure. In order to provide relevant information for investors' decisions, that the disclosure is timely and accurate on all material matters, is in accordance with high-quality standards of accounting and disclosure and the audit and review of these disclosures by independent, competent and qualified auditors is carried out. The external auditors of Islamic financial institutions also need to develop the expertise to conduct Shariah Compliance Audit and report on their findings to the shareholders and the general public.

Eighth, harmonization of shariah rulings. One of the issues faced by the Islamic financial industry is lack of standardization of shariah rulings within the same jurisdictions and among various regions. The diversity provided by different schools of thoughts on same issues at times creates confusion in the minds of the general public, but if properly harmonized across the globe, can become a great strength for the Islamic financial services industry thereby providing different options suitable to the varying needs of customers. AAOIFI 3 has taken a lead by preparing shariah standards approved by 14 renowned Shariah Scholars across the world. Some countries have recognized these standards in their regulatory framework, and the adoption of these standards in other countries will pave the way not only for shariah-compliance but also product innovation. In addition, the central banks/regulatory agencies monitoring the performance of Islamic financial institutions also need to establish their own Shariah Board for guiding them in the formulation of policies and rules as well as for resolution of conflicting shariah opinions.

Ninth, vigilance and oversight of the Supervisor. As in any conventional bank, the role of the supervisor is critical in ensuring the smooth functioning of the institutions. The key element of shariah supervision is the existence of a mechanism that ensures that the Islamic financial system continues to remain viable and growing without compromising the principles of shariah. This leads me to share with you the experience of Indonesian in the area of Islamic banking.

CONCLUSIONS, LIMITATION, AND SUGGESTION

Conclusions

Generally, there are still few uncompleted issues in shariah audit in terms of standard for shariah auditing practices, shariah auditors qualification and their independence. If these remain unresolved, specifically in terms of lacking in a properly guided and comprehensive framework of shariah auditing and the shortage of expertise, the smooth development of the Islamic banking and finance industry will be distorted. They should be completed immediately as this may have an impact on the confidence of the stakeholders on the validity of the shariah compliance of the Islamic financial institution's products and service on its operations and activities.

Limitation

This study also argues that shariah audit, as a social function, is a very important assurance tool to achieve the maqosid as shariah (objectives of the Islamic law). As far as Indonesian is concerned, it can be concluded that the practice of shariah auditing is still considered to be an insignificant program for IFIs in Indonesian despite the fact that Indonesian is in the process of becoming a one-stop center for Islamic banking and finance. In fact, the standards and guidelines used to cater for shariah auditing are still underdeveloped with only a small portion of it is included in the latest Shariah governance framework issued by the Central Bank of Indonesian. In the absence of generally accepted criteria of shariah auditing, this research finds that people who are directly or indirectly involved with shariah auditing in IFIs in Indonesian judge shariah auditing function are evolving and having a proper framework of shariah auditing would be part of their main program in the future undertaking. It has a significant impact on their current shariah audit practice. It is reasonable to infer, therefore, that in addition to having a framework of shariah auditing in IFIs in Indonesian, shariah auditors also examine the framework to be different and distinct from the normal conventional auditing framework.

Suggestion

One important policy implication of this study is that the Indonesian Institute of Accountants (IAI) or the regulatory body in charge of IFIs, should be assigned to take the responsibility of identifying and implementing a comprehensive and integrated shariah auditing framework in order to cater for the ever-increasing number of IFIs in Indonesian. Hence, the program of having a properly guided shariah compliance assurance process in the form of implementing a shariah audit framework for IFIs need to be in the list of priorities for the development of the industry as a whole. There is also proof to suggest that shariah auditors are likely to be a different group of auditors with specialized qualifications both in shariah and accounting areas of study. In fact, one policy inference from this study is that it would be beneficial for a CPA firm who audits IFIs to establish specific policies to ensure that its partners and audit staffs who are bounded in shariah auditing are qualified in shariah on top of the technical accounting qualifications they have. In consequence, university accounting departments may find it rewarding to include shariah auditing courses in their syllabus or producing graduates with double majors in accounting and shariah. A related policy implication to this is for the profession and the CPA firms to encourage closer interaction between the practitioners and accounting academics for field research and funding the research.

Realizing the importance of shariah auditing framework to have its own criteria and methodology to be in parallel with the Maq'asid Ash-Shariah, the bridging of the gap that exists should be the priority in the program of the IFIs if they are to survive for a long time.

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