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The Adoption of Accounting Base in External Shariah Audit Report

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Abstract

Shariah compliance is the industry's core value proposition and the cornerstone of the worldwide Islamic financial sector. To ensure compliance and uphold the legitimacy of Islamic finance among stakeholders, a number of efforts are being implemented in various countries. One such approach that offers greater independence than others in providing Shariah assurance is external Shariah audit. External Shariah auditors of IFIs carry out financial audit tests in addition to testing for adherence to the Shariah Advisory Council's (SAC) norms and regulations for Islamic Financial Institutions (IFIs). The Malaysian Accounting Standards Board (MASB) anticipates creating unique standards for Malaysian IFI in the future. This study aim to examine the need of adoption accounting base in external Shariah audit report. This study is a conceptual paper which base on the discussion of literature review and library research. The research offers practical implication to authority body in accounting to formulate special accounting standard for external Shariah audit report among IFI.

Keyword: Accounting, Audit Standard, Shariah Audit, External Shariah Audit, Audit Report

INTRODUCTION

According to the ACCA and KPMG report from 2010, the different ways that Islamic banks around the world apply accounting standards whether IFRSs or local accounting standard in the preparation of financial statements may pose a problem for accounting practices, accountant understanding, and Islamic bank compliance levels. Although many believed the International Financial Reporting Standards (IFRS) to be the fundamental rules, The IFIs are committed to safeguarding Islamic principles, which makes them stand apart from conventional financial institutions, services and products. The role of auditing is crucial in ensuring that economies are transparent and accountable while delivering shariah-compliant goods to customers and investors. Even though Malaysia as a global leader in the Islamic finance sector, Shariah audit still requires solid administration and guidance to fully realize its potential. Along with numerous other organizations whose rules and regulations have been modified to suit shariah requirements, the Central Bank of Malaysia (BNM) is the primary regulator of Malaysian IFIs and Shariah audit practices.

Nur Laili et al. (2019) discovered that the internal Shariah auditors from commercial banks and Development Financial Institutions argued that if certain IFIs appoint external auditors to perform this particular scope, there is usually a problem with the Shariah audit scope of financial statements. The situation typically arises in commercial banks' Islamic divisions when IFIs lack the necessary knowledge to execute full-scope Shariah audits of financial statements. The respondents emphasised that when the Shariah audit scope is carried out by the external auditors, it is difficult for IFIs to assess the efficacy of internal audit functions. BNM Shariah governance permits each IFI to designate external auditors to undertake a Shariah audit on its individual Islamic financial activities (BNM, 2019). In Malaysia, there are no legal requirements for external auditors to perform Shariah audit at IFIs. Then, from Malaysia's standpoint, the shariah review officer is supposed to conduct daily shariah compliance monitoring, while the internal auditor is expected to provide assurance that the IFIs' controls are sufficient to handle shariah compliance issues and principles (Nur Laili et al. 2019) .

Shariah advisor is sometimes referred to as the Shariah Committee or Shariah Supervisory Council (SSC) in Malaysia. The Bank Negara Malaysia (BNM) directive known as GP8-i is the foundation upon which the Shariah audit report is prepared. The Shariah governance framework, which was made public in 2011, has had a significant impact on the governance system, particularly on Islamic institutions. The framework's primary goal is to give the board, Shariah committee, and management of Islamic Financial Institutions full direction in carrying out their responsibilities in regard to Shariah. In Pakistan, their Shariah advisor is known as a Shariah Advisor (SA), and the guidelines utilised in generating a Shariah audit report are based on the requirements set forth by the State Bank of Pakistan and some AAOIFI requirements. In Bahrain, the Shariah advisor is known as the Shariah Supervisory Board (SSB), and they rigorously adhere to AAOIFI's requirements when compiling the Shariah audit report. (Noor Aimi, Nurauliani, Siti Norwahida & Nurul Jaliah, 2015). The Shariah guidelines and compliance should be the basis for the proper execution of all procedures used to examine and assess IFI transactions and commercial activities. The procedures involve organising review procedures, carrying out review procedures, creating and reviewing working papers, documenting conclusions, and creating the Shariah Audit Report (SAR). To properly inform the shareholders about the IFI's adherence to Shariah law in conducting commercial activities, all of those procedures should be reported in SAR. Most of the discussion on Shariah audit in Malaysia context relate with the scopes and practices of internal Shariah audit for IFI. There are lack of study regarding Shariah audit specifically in the scope of external auditing. Even though BNM Shariah governance (2019) give the option to IFI to conduct external Shariah audit, but that not compulsory as mandatory and regulation need. Therefore, this study aim to discuss the need of accounting base in external Shariah audit especially in prepare SAR

SHARIAH AUDIT PRACTICE FOR MALAYSIAN IFI

The term "Shariah audit" refers to a function that provides an independent assessment on the quality and effectiveness of the IFI's internal control, risk management systems, governance processes as well as the overall compliance of the IFI's operations, business, affairs and activities with Shariah. The Shariah audit function, at minimum, must (a) establish an audit methodology to assess the risk profile and vulnerabilities of each auditable area; (b) generate an audit plan for the assignments to be performed; (c) establish clear documented audit programs that provide guidance to the internal auditors in gathering information, auditing procedures and audit assessment; and (d) communicate results to the board and Shariah committee through an audit report, detailing the audit findings and recommendations for rectification measures, as well as the auditee's responses and action plans (BNM, 2019). Examples of Shariah audit processes include risk assessment, internal control assessment, contract review pertaining to business activities, review of business activities policies and procedures, examination of the process flow of the activities, follow-up, communication of results to auditee, and others. Additionally, the structured framework should have an audit programme that takes into account the SOPs, which include accounting (for example, MASB and AAOIFI), regulatory requirements (BNM), and other needs Yazkhiruni, Haslida, Nurmazilah & Joni Tamkin (2016).

In Malaysia IFI context, in order to provide assurance of Shariah compliance in Islamic financial activities and operations, the practise of Shariah audit is closely similar to internal auditing. The IFIs' financial and Shariah information is examined via a Shariah audit. Instead of performing the financial statement audit as it is done by the external auditors, the internal Shariah auditors analyse the financial statements to ensure that they are free of any Shariah non-compliance issues and unrecognised profits (Ab Ghani & Abdul Rahman, 2015). An effort was undertaken to create the Exposure Draft of the Internal Shariah Audit Framework (ISAF), which has not yet been developed by Bank Negara Malaysia as the regulator The ISAF Exposure Draft outlined the precise rules pertaining to Shariah audit practises, including the Shariah audit scope, Shariah audit objectives, Shariah audit and governance, Shariah audit charter, the competence of internal Shariah auditors, the Shariah audit process, and reporting requirements. When combined with other Shariah governance processes like Shariah risk management, Shariah review, and the Shariah research function, this Exposure Draft of ISAF offers a systematic and guided method for IFIs to implement effective Shariah audit (International Shariah Research Academy (ISRA), 2011).

The Shariah audit process should be carried out in accordance with the established Shariah criteria, which include the written opinions of the Shariah Advisory Council (SAC), the Shariah guidelines provided by Bank Negara Malaysia, the written opinions of the Shariah Committee members, and the product manuals of the IFIs (Abdul Rahman, 2011). Internal Shariah auditors should have complete access to the audit evidence in IFIs in order to implement an effective Shariah audit process, and the auditable areas should include assessments of internal control systems for Shariah compliance, risks of non-compliance, and audits of product information and reporting (International Shariah Research Academy (ISRA), 2011). Internal auditors must inform the appropriate parties of their findings after executing the audit process. The view of a successful internal control system, recommendations, and ideas for any corrective actions should all be included in the internal audit engagement. Internal audit reporting needs to be accurate and able to meet stakeholder expectations (The International Institute of Internal Auditors (IIA), 2011). In addition, Abdul Rahman (2011) emphasized that internal Shariah audit reports should be approved by the Board Audit Committee and include any findings of Shariah non-compliance, an evaluation of the frequency of non-compliance, timelines for correction, and an opinion on the effectiveness of internal control systems for Shariah compliance.

DIFFERENT BETWEEN INTERNAL AND EXTERNAL SHARIAH AUDIT

International Standard on Auditing (ISA) deals with the external auditor's responsibilities if using the work of internal auditors. This includes (a) using the work of the internal audit function in obtaining audit evidence and (b) using internal auditors to provide direct assistance under the direction, supervision and review of the external auditor (ISA, 2020). According to International Standards for the Professional Practice of Internal Auditing issued by the Institute of Internal Auditors (IIA) defined internal audit as "an independent, objective assurance and consulting activity designed to add value and improve an organization's operations. It helps an organization accomplish its objectives by bringing a systematic, disciplined approach to evaluate and improve the effectiveness of risk management, control and governance processes." (IIA, 2012). According to AAOIFI (2010) the internal Shariah audit shall be carried out by an independent division/department or part of the internal audit department, depending on the size of the IFI. It shall be established within an IFI to examine and evaluate the extent of compliance with Islamic Shariah rules and principles, fatwas, guidelines, and instructions issued by the IFIs Shariah supervisory board (SSB); hereafter referred to as Shariah rules and principles.

The main goal of the internal Shariah audit is to make sure that an IFI fulfils its obligations with regard to the application of the Shariah laws and principles as specified by the IFI's SSB. An IFI's internal Shariah audit functions in accordance with the guidelines set forth by the IFI and is a crucial component of its Shariah governance. It must include a statement of intent, authority, and accountability (charter). The management draughts the charter, which must adhere to Islamic Shariah laws and principles. The IFI's SSB must approve the charter before it can be released by the board of directors and it must be revised on a regular basis (AAOIFI, 2010). The internal Shariah audit will first plan each review assignment and the supporting documents. The internal Shariah audit department is very important to an IFI. Internal Shariah audit is regarded as the key element in the application of accounting systems which in turn, helps to evaluate the work of the department. The internal Shariah audit is considered as the backbone of business accounting as it is the section that records all business transactions related to the sector. It is about advising entities how to achieve their objectives by managing risks and improving internal control. Even though internal Shariah audit is useful to all types of IFIs, much of it is required by the public sector where its objectives are usually broad, complex and not easy to measure.

External Shariah audit is an independent assurance engagement to provide reasonable assurance that an IFI complies with the Shariah principles and rules applicable to its financial arrangements, contracts and transactions during a specific based on a specific set of Shariah principles and rules' contained in the criteria (AAOIFI, 2018). There is an obvious relationship between the internal and external auditors based on the international standards of an audit which are controlled by a set of guidelines, which includes the following (Latifah, Syed Musa, Soualhi & Omar, 2019):

- The external auditor and internal auditor should frequently meet to discuss the matters, which are in common and those that influence the external auditor's job.
- The external auditor should assess the internal auditor's work in relation to the scope that the internal auditor is supposed to work on.
- The external auditor should be familiar with the internal auditing activities so that the external auditor can examine the financial statement and ensure that it is free from material misstatements.

- The external auditor should ensure that the internal auditing function is planned and performed efficiently so that during meetings the plans and procedures of internal auditing can be improved.

THE DEVELOPMENT OF ACCOUNTING STANDARD IN THE SHARIAH AUDIT

It is crucial for IFIs to provide high-quality financial statements because they play a crucial role in fostering economic development as a foundation for social stability where people live with decent values and religious faith (Vinnicombe, 2010). A strong financial statement is a crucial tool for IFIs to thrive in a market where consumers are assured that the goods adhere to Shariah rules (Archer and Abdel Karim, 2007). For IFIs operating in a competitive and dynamic market, this problem of effective oversight and regulation has emerged as their biggest difficulty (El Qorchi, 2005). Even while IFRSs are a tool for regulatory oversight, applying the same accounting standards as traditional banks indicates that the goods provided by IFIs are identical to those provided by traditional financial institutions. Despite the existence of Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) as accounting standard for IFIs, several nations now apply IFRSs to IFIs in their entirety when reporting their operations. Despite the legitimacy of such a method, some people are of opinion that IFIs have such pronounced variations in their goals and operations, their transactions should be recorded in a different way.

IFIs aspire to be distinct from traditional financial institutions in terms of their goals, operations, beliefs and practises by adhering to Shariah (Abdul Rasid, Abdul Rahim & Wan Ismail, 2011). Nevertheless, IFIs operate in a dynamic, competitive business that is dominated by the West, necessitating regulatory oversight similar to that of Western institutions (Islam, 2003). The financial statements of IFIs may not be comparable due to the various approaches used by their supervising authorities (Kamla, 2009). In light of this, the IFIs sector demands a sound accounting and reporting system that complies with Shariah criteria and applicable to real-world use (Abdul Rahman, 2003). According to Abdul Rahman (2011), Shariah auditors should be capable of applying internal auditing standards, accounting principles, comprehending management principles, using relevant Shariah audit tests, and having good interpersonal communication skills. The same competence requirements, which are crucial to ensuring the successful performance of the Shariah audit role in IFIs, were also laid forth by the International Shariah Research Academy (ISRA). The competency components include the adequate knowledge and skills to apply auditing standards, accounting principles and relevant Shariah audit tests. Shariah audit shall be performed according to the Shariah risk based audit approach which requires Shariah auditors to be trained in the risk management areas as well.

IFIs have been operating in Malaysia since the 1970s, although there are no official Islamic accounting rules in place. Although the Malaysian Accounting Standards Board (MASB) made an attempt to create specific standards for IFIs, it appears that over time, the reporting position has changed and now indicates that IFI procedures closely resemble those of conventional banks. The global tend in the reporting environment have been observed as the IFI contracts and products have been developed rapidly. The Malaysian regulatory body, the MASB, has modified its position on the necessity of a set of accounting rules specifically for IFIs as a result of changes in reporting. To simplify IFI reporting, the MASB actively worked to develop Islamic accounting standards in the early 2000s. The MASB claims that the lack of appropriate IFI accounting standards made it impossible to compare individual bank financial performance across time and between periods. The MASB consequently believed that the absence of specific rules would impede the growth of Islamic investment vehicles as well as a healthy Islamic capital market. The MASB has taken the AAOIFI accounting standards into consideration while creating new IFI standards since it thinks that having a unique set will increase openness and foster the growth of these institutions. Islamic accounting standards are necessary in order to fulfill Muslims' desire to incorporate Islamic principles into every part of their lives, including their banking activities. This includes the development of accounting standards for IFIs. (Nor Farizal, Fadzlina & Ashaari, 2019).

ADOPTION ACCOUNTING BASE IN EXTERNAL SHARIAH AUDIT REPORT

In contrast to the Shariah audit scope on financial statements, external auditors often deal with financial statement audit. The goal of a shariah audit on financial statements is to ensure that the components, such as the recognition, distribution, and purification of income and expenses, including the computation of zakat, are free from issues of not adhering to Shariah (Abdul Rahman, 2011; International Sharīʿah Research Academy (ISRA), 2011). The study also recommended that IFIs develop an additional strategy to assess the scope of an effective internal Sharia audit in comparison to the Sharia audit scope when it is contracted out to external auditors. IFIs must ensurethat external auditors create a methodical approach to carry out the Shariah audit function that is comparable to the one carried out by the internal Shariah auditors within the IFIs. For the external auditors to be able to guarantee that the financial statements comply with Shariah, it is also crucial that they look for any Shariah non-compliance issues.

The scope of the Shariah audit function also covers any special Shariah audit assignments requested by the Board or the Shariah Committee. These Shariah matters relate to the financial statements in IFIs, such as the recognition of income and expenses and zakat computation, the effectiveness of the Shariah internal control system, reviewing the Shariah non-compliance risks management function, and any special Shariah audit assignments (Abdul Rahman, 2011). Islamic banking subsidiaries lack the practise of performing a Sharah audit of financial statements because the subsidiaries view the scope as falling outside the purview of the external auditors who typically carry out the financial statement audit (Ab Ghani & Abdul Rahman, 2015). Hence, accounting transactions may also contain issues with non-compliance with Shariah and non-recognized profit earnings. Thus, there may be expose to the risk of Shariah non-compliance in Islamic financial activities, and internal Shariah audit functions within IFIs may not be effective. In addition to auditing the financial statements, the external auditor of an IFI also performs a test of shariah compliance, which is one of their special duties. The audit process consists of a structured, documented plan with a number of steps, starting with audit planning and concluding with an external audit report that expresses an opinion on whether the financial statements were prepared in accordance with relevant national accounting standards and practises in the country where the IFI operates and the fatwa (religious opinions), rulings, and guidelines issued by the SSB of the IFI.

The Shariah auditor must gather sufficient and pertinent audit evidence in order to reasonably assure that the IFI complied with the SSB's determined shariah rules and principles. The auditor shall depend on the fatawa, rulings, and guidance issued by the SSB as guidance in determining whether the financial accounts of the IFI have been produced in compliance with Shariah rules and principles. However, the auditor is not expected to interpret the Shariah laws and principles (Haniffa, 2010). Therefore, the auditor will include processes in his or her examination when directing the audit to ensure that all new fatawa, rulings, and guidance, as well as adjustments to existing fatawa, rulings, and guidance, are

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recognised and reviewed for each period under investigation. To confirm that all product types sold by the IFI have been subjected to a review by the SSB, the auditor will look over the reports the SSB sent to the IFI about Shariah compliance as well as the SSB's meeting minutes. The results of every internal review conducted by the IFI's management, as well as the internal audit and the report of the internal shariah review, must all be examined by the auditor. The Shariah auditor will send the SSB a draft of his or her draft report along with any conclusions regarding Shariah compliance. If the SSB's draft report reveals that compliance is deficient, the auditor may modify the report while adequately outlining the nature of and justifications for the modification. The Shariah 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 (Agus Arwani, 2018).

The terminologies used in Islamic financing contracts need to be presented in the financial reports in a consistent manner. This is fundamental to the financial accounting objective of ensuring contractual rights and obligations of the parties involved in Islamic finance transactions so that they are properly documented and reported in the financial statements of Islamic financial institutions. In the general purpose of financial statements, the elements of the financial statements as well as the financial reporting process of recognition, measurement, presentation, and disclosure are the key factors that influence the financial reports of various reporting institutions. In case of Islamic financial institutions, the elements of financial statements such as the balance sheet and income statement involve financial activities that are unique to specific contracts. These Shariah based contracts require a different accounting treatement than conventional contracts, for example productive assetsin the balance sheet are represented by financings and investments. These are based on different contracts such as mudarabah, musharakah, murabahah, bay' al-muajjal, salam, istisna', ijarah and others.

The reporting process for each contract may differ from one to the other. For instance, the recognition and measurement of mudarabah and musharakah are influnced by the capital contribution and perticipation of the IFI as well. Thus, they have to be reported differently. Similarly, in the murabahah and ijarah contracts, the asset is financed and the beneficial use of the asset is acquired and hence needs to be accounted for differently. In another example, an investment account which is neither a liability nor equity, but rather a special form of equity, needs to be classified and reported differently. Income recognized for financing assets differs in term of the appropriate recognition tests of sale, payment, delivery or lapse of time. Each of these recognition criteria is different for different types of contracts. When gross margin needs to be distributed as income to investment account holders, a separate line item needs to be identified to present and disclose this distribution. The distribution is not an expense and is not to be treated as similar to other outflows. Hence, it is pertinent that the terminologies identified by the Shariah requirements are adopted and used in financial reporting according to a uniform or similar standard.

Statement of Financial Position	Note	20X1 RM'000	20X0 RM'000
Assets			
Cash and short term funds		xxx	xxx
Deposits and placements with financial institutions		xxx	xxx
Investment accounts placement - financing		xxx	xxx
Financial assets		xxx	xxx
Financing and advances		xxx	xxx
Statutory deposits with Bank Negara Malaysia		xxx	xxx
Investment in subsidiaries		xxx	xxx
Investment in associates		xxx	xxx
Property, plant and equipment		xxx	xxx
Total assets		xxx	xxx
Liabilities			
Islamic deposits from customers		xxx	xxx
Investment accounts of customers		xxx	xxx
Deposits and placements of banks and other financial institutions		xxx	xxx
Investment accounts due to designated financial institutions		xxx	xxx
Financial liabilities		xxx	xxx
Provision for zakat and taxation		xxx	xxx
Total liabilities		xxx	xxx
Shareholder's equity			
Share capital		xxx	xxx
Reserves		xxx	xxx
Total shareholder's equity		xxx	xxx
Total liabilities and shareholder's equity		xxx	xxx
Restricted investment accounts		xxx	xxx
Total Islamic banking asset		xxx	xxx
Commitment & contingencies		xxx	xxx

Diagram 1: Illustrative statements of financial position of an Islamic bank
Source: Bank Negara Malaysia (BNM) policy document

Statement of Comprehensive Income	Note	20X1 RM'000	20X0 RM'000
Income derived from investment of depositors' funds		xxx	xxx
Income derived from investment of investment account funds		xxx	xxx
Income derived from investment of shareholders' funds		xxx	xxx
Impairment loss on investments		(xxx)	(xxx)
Total distributable income		xxx	xxx
Profit share/*wakalah* fees income from investment accounts[33]		xxx	xxx
Profit/hibah distributed to depositors		(xxx)	(xxx)
Profit distributed to investment account holders		(xxx)	(xxx)
Total net income		xxx	xxx
Personnel expenses		xxx	xxx
Other overhead expenses		xxx	xxx
Profit before zakat and taxation		xxx	xxx
Zakat		xxx	xxx
Taxation		xxx	xxx
Profit for the year		xxx	xxx
Earnings per share (sen)		xxx	xxx

Diagram 2: Illustrative statements of comprehensive income of an Islamic bank
Source: BNM policy document on Financial Reporting of Islamic Banking Institutions 2018

An Audit report usually consist of a few lines and is, therefore very brief. Someone with no background in auditing may view it as a mere legal formality because of its brevity. This is quite paradoxical in the sense that these few lines of report is the outcome of great care, tremendous amount time and skills and due diligence coupled with proper process and planning. However, this is the nature of the external audit report wherein the report users do not to spend time in prolonged debate but more concerned with ultimate outcome; detailed accounting and auditing issues are addressed in another separate long-form audit report (Hayes, 2005). The Shariah auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statement. The basic elements of the auditor's reports are as follows (Ahcene, 2016):

a) Title
b) Addressee
c) Opening or introductory paragraph
d) Scope paragraph
e) Reference to Auditing Standards for Islamic Financial Institutions (ASIFI) or relevent national standards.
f) Description of the work the auditor performed
g) Opinion paragraph
h) Date of report
i) Auditor's address
j) Auditor's signature

In the opinion paragraph of the auditor report, the report should clearly state the auditor's opinion as to whether the financial statements give a 'true and fair view' in accordance with the Shariah rules and principles as determined by SSB of IFI, AAOIFI financial reporting framework and accounting standard as well as relevent accounting standards and statutory requirements.

Types of Audit Opinion	Circumtances
Unqualified opinion	The financial statement give a true and fair view in accordance with the identified financial reporting framework.
Qualified Opinion	Effect of disagreement with management and limitation on scope is not material and pervasive to require disclaimer or adverse opinion.
Disclaimer of Opinion	Effect of disagreement with management and limitation on scope is material and pervasive that auditor is not able to obtain sufficient appropriate audit evidence.
Adverse Opinion	Effect of disagreement with management and limitation on scope is material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statement.

CONCLUSION

External Shariah audit framework integrated with accounting base has a vital role in monitoring and maintaining the objectives of IFIs by mitigating the Shariah non-compliance risks that can be found in products, activities and operations. There is a need for an education and training program which provides relevant basic knowledge in Shariah accounting and auditing; but most Shariah auditors do not possess both qualifications. Kasim and Sanusi (2013), suggested that Shariah auditors should have specialized qualifications both in Shariah and accounting. One of their recommendations was that university to include Shariah auditing courses in its syllabus or introduces a double-major in accounting and Shariah so that future accountants or auditors have the necessary skills and knowledge of Shariah audit.

This study contribute to the regulator and authority body to enhance external Shariah audit as main part of effective IFI Shariah governance. In future, it is hoped that IFIs will offer Shariah-compliant products in substance and form and for the reporting to be based on the Islamic reporting conceptual framework. Appropriate standards and proper guidelines are needed for external Shariah audit conduct effectively base on Shariah and accounting principle.

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