

# **Shariah Auditing in Islamic financial institutions: Exploring the gap between the “desired” and the “actual”**

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*Persistently high expectations from the operations of Islamic financial institutions (IFIs) appears to give way for a gap to exist between “what ought to be” shariah auditing and the current practice of shariah audit in IFIs in Malaysia. Sulaiman (2005) mentioned that “what ought to be desired (the desirable)” may not coincide with “what is actually desired (the desired)” and in consequent “what is actually desired” may not be the same as “the actual” practice. This paper aims to explore empirically the gap between “the desired” and “the actual” practice of shariah auditing in IFIs in Malaysia. It is found that there exists a gap between the two concepts in terms of certain issues discussed in this study. Even though this paper cannot hope to bridge the gap that exists, it nevertheless shows that shariah audit function has not seriously taken an impact in IFIs in Malaysia despite its potential as a monitoring tool for shariah compliance.*

Field of Research: Auditing in the Islamic perspective, Islamic Financial Institutions (IFIs).

## **1. 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 suggested 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 (Syed Alwi, 2007). There is a need to develop a useful *shariah* audit framework to ensure effectiveness of the goals of *shariah* compliance in IFIs which in turn can contribute positively to the ummah (society) at large. This paper attempts to examine what is the current practice of shariah auditing in IFIs in Malaysia and compare with what is the “desired” auditing in the Islamic perspective. Sulaiman (2005) found that “what ought to be desired” (the desirable) may not coincide with “what is actually desired” (the desired) and in consequent “what is actually desired” may not be the same as “the actual” practice. Therefore, to determine if there exists a gap between the “desirable” and the “actual”, the gap to be examined should

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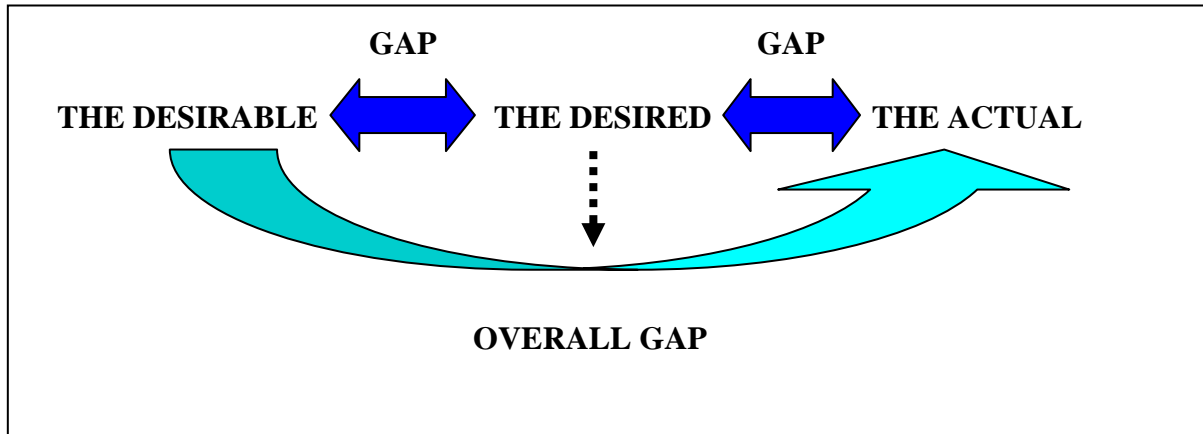
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look into two aspects: 1) between “the desirable” and “the desired”, and 2) between “the desired” and “the actual” practice. Figure 1 below shows the components of the overall gap between the ‘desirable’ and the ‘actual’ practice of *shariah* auditing in IFIs in Malaysia. However, this paper, which is part of a larger project, focuses on the gap between the “desired” and the “actual” practice.

**Figure 1: The process of determining the gap**



Section 2 briefly discusses the literature review. This is followed by section 3 which outlines the methodology used in this study. Next, the paper continues with the main findings derived from the study discussed in section 4. Finally section 5 concludes.

## 2. Literature review

Critical comments on auditing and demands for wider responsibility, visibility and accountability of companies have led many to debate on what ought to be the ideal audit function (e.g. Houck, 2003, Humphrey, 2000, Ball et al., 1998, Napier, 1997, Blair, 1990). Further, people have started to re-evaluate the level of trust they put on audit to provide assurance for investment and financial information, and the trend of solely depending on audit as the best source of credibility for such information may have now become defunct (Humphrey, 2000). The profession’s problems started after high-flying Enron Corporation suddenly declared bankruptcy, followed by a few more giant conglomerates. Consequently, auditors became regular features in front-page news stories and banner headlines (Houck, 2003). 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 (Ball et al., 1998).

Realizing the consequences of adopting the conventional auditing framework which is limited in scope, the auditing practice in Islamic institutions should be of a different perspective. The existence of these institutions is based on the Islamic principles with the main objective of achieving the ‘*maslahah to the ummah*’ (benefit to the people) through socio-economic justice. In view of the drastic growth of Islamic institutions all over the world, in particular, the IFIs, this paper examines whether the current practice of *shariah* auditing in IFIs is in line with what is desired by Muslims.

It is argued that the role of a *shariah* auditor in an IFI is different and wider than his/her role in the conventional organizations (Banaga et al., 1994). This is because it has been extended to cover the compliance with the *shariah*<sup>i</sup>. Further, auditing in Islam has been derived from the basic values of Islamic society; from conventional concept of “attest and assurance” to meeting the *Maq’asid Asy-Shariah* (Khan, 2001). It is also argued that since Islamic organizations are supposed to be operating under the Islamic worldview, they may need a different type of accounting (Shahul, 2000) and auditing system (Khan, 2001). They are expected to serve the needs of the Islamic society whose focus and priorities are different from other worldviews. As any other organizations, managers of IFIs seem to be held accountable not only for the manner in which appropriated funds are disposed, but also for the efficiency and effectiveness with which they use those funds. Further, to be in line with the broad scope of the *shariah*, efforts to propagate universal virtues of Islam should be undertaken in terms of products, processes, systems, personnel, marketing, investments etc.<sup>ii</sup> Specifically, this paper argues that differences in roles and operating environments of IFIs, which have the capacity to affect the auditing framework needed to assess the performance of the IFIs and discharge accountability, were ignored. In fact IFIs have to depend on the conventional auditing framework for audit purposes which is limited in scope, despite the obligation to meet the objectives of the *shariah*.

### **3. Methodology**

The purpose of this study is basically to examine the expectations and the actual practice of *shariah* audit function in Islamic financial institutions (IFIs) in Malaysia. As discussed previously, a proper ‘check and balance’ mechanism should be in place in IFIs to assure the activities of the organizations are in line with the Islamic principles and to protect the confidence and faith of the stakeholders of Islamic organizations.

In the course of achieving the objective, this study surveys different groups of respondents who are involved directly or indirectly, with the process of *shariah* compliance/auditing in IFIs in Malaysia, using questionnaires and interviews. This is to obtain insight into the existing practices as well as what is expected by the respondents or ‘what ought to be’ the *shariah* auditing in the IFIs. The methodology for this specific research derives from previous studies examining *shariah* advisors’ responsibilities and power in Islamic banks (e.g. Abdul Rahim et al., 2004; Banaga et al., 1994). Its significance and contribution to the body of knowledge are based on a need to examine an understudied linkage between the theory and practice of *shariah* auditing. This exploratory analysis of the scope of *shariah* auditing looks at the four aspects of *shariah* compliance structure and how the current scope can be expanded. Even though extant literatures are lacking, few attempts have been made to analyze the power and responsibilities of *shariah* advisors in Islamic banks in particular.

### **4. Discussions of Findings**

There are four main issues related to *shariah* auditing practice in IFIs in Malaysia highlighted in this study. They are the framework, the scope, the qualification and the issue of independence. Table 1 below outlines the results from ‘the desired’ and the

actual practice and subsequently the gap between the two. Seventy-seven questions were presented in the questionnaire. Since this paper is part of a bigger project, not all the questions are relevant to the topic under discussion.<sup>iii</sup> Out of the 155 distributed questionnaires, 85 responses were usable. The aggregate means of the responses are recorded, the differences are calculated and finally the significance of the difference between the desired and the actual is determined on the three areas of interest i.e. framework, scope, and independence. The issue of qualification is tested using a test of proportion. All the three areas of interest (framework, scope, and independence) show significant difference in mean variance between the two concepts (the 'desired' and the 'actual'). Similarly, 'qualification' also shows significance between the proportions. This indicates that overall there is a gap between what is 'desired' and the 'actual' practice of *shariah* auditing in IFIs in Malaysia.

**Table 1: The gap analysis between the 'desired' and the actual practice of *shariah* auditing.**

FRAMEWORK						
THE 'DESIRED'	'E'	THE 'ACTUALS'	'A'	THE GAP (E-A)	Significant test	INTERVIEWS
The theoretical framework of <i>shariah</i> auditing should differ from conventional auditing framework.  (Part II: 1, 2)	Agg mean: 4.06	Despite the fact that the theoretical framework of <i>shariah</i> audit should differ from conventional audit, IFIs use AAOIFI standards since there is no <i>shariah</i> audit framework in IFIs in Malaysia.  (Part III: Q48-51)	Agg mean: 3.05	1.01	p=0.000*	Theoretical framework should be different from conventional, however currently, no difference from conventional as procedures and processes are the same.
SCOPE						
THE 'DESIRED'	'E'	THE 'ACTUALS'	'A'	THE GAP (E-A)	Significant test	INTERVIEWS
The scope of <i>shariah</i> auditing should be broader than the conventional audit.  (Part II: 4, 6, 9)	Agg mean: 3.95	The scope of <i>shariah</i> auditing practices in IFIs in Malaysia is limited to financial statements audit.  (Part III: Sections 1-6)	Agg mean: 3.49	0.46	p=0.006*	Most IFIs audit compliance of products only. Cost consideration of extending scope, New entrants and therefore need to compete by developing new products, need to educate staff before scope expansion, Perceived to be difficult.  Not in favour of social and environmental or performance audit as considered not within scope, lack of awareness as workload may increase without adequate resources, profit motivated.

QUALIFICATION						
THE 'DESIRED'	'E'	THE 'ACTUALS'	'A'	THE GAP (E-A)		INTERVIEWS
A <i>shariah</i> auditor should be specialized in <i>shariah</i> and accounting qualifications.	Proportion of those who are directly involved in <i>shariah</i> audit practice in this study: 59/85=0.69	Practitioners of <i>shariah</i> auditing are qualified in both <i>shariah</i> and accounting	Proportion of those who are qualified in both accounting and <i>shariah</i> in this study: 5/85=0.059	0.631	p= 0.000*	<p><u>Mixed opinion on the 'desired':</u>  <i>Internal auditors:</i> Dealing with <i>shariah</i> matters including <i>shariah</i> audit should be done by <i>shariah</i> qualified people. <i>External auditors:</i>  <i>Shariah</i> audit is an internal matter. Should not involve external auditors.  <u>Actual practice:</u>  Internal auditors with both qualifications- only one.  Mgt of <i>shariah</i> unit- majority with <i>shariah</i> qualification only.  Teamwork of internal auditors &amp; <i>shariah</i> unit- a few.  Internal audit dept. doing <i>shariah</i> audit alone -none.  External auditor doing <i>shariah</i> audit-none</p>
INDEPENDENCE						
THE 'DESIRED'	'E'	THE 'ACTUALS'	'A'	THE GAP (E-A)	Significant test	INTERVIEWS
A <i>shariah</i> auditor should be independent from the organization he/she is working in.  Part IV: Q7 and 13	Agg mean: 3.99	Practitioners of <i>shariah</i> auditing practices in IFIs in Malaysia are independent from the organizations they are working in. Part III: Q52-55	Agg mean: 2.00	1.99	p=0.000*	There seems to be overdependence on the <i>shariah</i> secretariat to do <i>shariah</i> audit as ShC members are part timers, mostly academics. Hence independence is questionable.

\* significant at 5%

From the results in Table 1, it is obviously shown that there is a gap between the 'desired' and the current practice of *shariah* auditing. The results for the test indicate that the 'actual' is unable to meet the requirements of the 'desired'. Using t-tests to analyze the significant difference in means and test of proportions, it is found that the four aspects (the framework, the scope, the qualification and the independence) indicate significance in the difference.

#### **4.1 Framework**

Regarding the framework of *shariah* auditing, the selection of one technique over another to get more favorable decision, according to the circumstances, also affects the consistency and predictability of many fiqh rulings (Vernados, 2005). Bearing in mind that the IFIs began with the purpose of benefiting all society, conflicts arise when a country has been greatly influenced by the Western legal systems either in the usage of accounting standards or civil and commercial codes. The absence of recognized guidelines and *shariah* auditing standards is a major problem facing the current *shariah* auditing framework. AAOIFI and IFSB are both involved in addressing these issues. However, for Malaysia, AAOIFI standards are not mandatory. Auditors are required, professionally, to follow standards, however as at the moment *shariah* auditing standards are still lacking. In promulgating the standards and guidance, it is important that the standard-making process of *shariah* auditing to be dynamic and progressive. The result in Table 1 clearly shows that a gap does exist between the 'desired' and the 'actual' practice. Most IFIs are using conventional framework of auditing because of the non-availability of *shariah* auditing framework even though the majority of respondents perceived that there is a need for *shariah* auditing to be different from conventional framework.

#### **4.2 Scope**

With regards to the scope, there is evidence of public concern about what is being achieved in the audit of accounting and financial statements [Arens and Loebbecke (1998), Blair (1990), Houck (2003)]. There are also pressures from some quarters for a different kind of audit [Flint (1988), Gray et al. (1996), Harahap (2002), Humphrey (2000), Batra (1996)]. This involves increasing support for the claims of those who would demand 'a social audit' to report on the social behavior and performance of organizations in all their relationships with society, individuals and other organizations. While this helps in the search for a theoretical starting point, it also poses a problem. By demonstrating the desire to extend the scope of *shariah* auditing, the lack of expertise, specification and definition on the scope of *shariah* auditing practice concerns the respondents of the questionnaires survey for this study. This appears to be the reason for the gap. With the capitalistic mentality by certain quarters and lack of awareness on widening the scope into social and environmental as well as performance audits by others are some of the reasons for not favoring to extend the scope. Thus a gap exist between the 'desired' and the 'actual'.

### 4.3 Qualification

Relating to qualification of *shariah* auditors, the finding shows that there is a difference between the desired and the actual qualification of *shariah* auditors as the proportion of those respondents who qualified in both *shariah* and accounting is only 5.9% as compared to those respondents who practice *shariah* auditing in IFIs in Malaysia (69%). This is an indication that the practice lacks people of both qualifications as indirectly they are important in determining the vision and mission of Islam is preserved within the IFIs. *Shariah* auditors are expected to reflect their responsibility and accountability not only to the management and stakeholders, but more important to the God. This will promote the foundations for building public confidence and assurance that the IFIs are *shariah*-compliant in all of their activities.

In addition to the result in Table 1, Table 2 shows that there is a significant negative weak correlation between those with accounting and *shariah* qualifications. This indicates that those with accounting qualifications often tend not to have *shariah* qualifications at the same time (the higher the qualification in accounting the lower is the qualification in *shariah*).

**Table 2: Correlation between those with Accounting and *Shariah* qualifications**

		Accounting/Auditing qualification	<i>Shariah</i> qualification
Accounting/Auditing qualification	Correlation Coefficient	1.000	-.303**
	p-value	.	.005
	N	85	85
<i>Shariah</i> qualification	Correlation Coefficient	-.303**	1.000
	p-value	.005	.
	N	85	85

\*\* . Significant at .05

However, there are mixed responses from interviewees in terms of the desired qualification. What is actually desired coincides with the actual existence of the proper qualification. Some prefer *shariah* auditing practices to be carried out by the *shariah* people who are qualified in *shariah* only while others point out that the task is an internal matter indicating that it should be the responsibility of the internal auditors or *shariah* committee members. Similarly, in actual practice, only one interviewee has both qualification and a few works as a team consisting of internal auditors and management of the *shariah*. Working in a team is seen as threatening the principle of independence. None is carried out by either internal auditors alone or external auditors by themselves. Therefore what is desired clearly does not coincide with the actual practice, resulting in the existence of a gap.

#### **4.4 Independence**

In the case of independence, the integrity of the *shariah* auditors are further enhanced by the expectations of those who have interest in the IFIs for the *shariah* auditors to be independent enough to give opinions on the positions of the IFIs in terms of being *shariah*-compliant in all aspects. In situations where the responsibility and social significance of the audit are at their greatest, the criteria of independence must be applied with the greatest rigor (Flint, 1988). It is the social function of the audit in IFIs for the benefits of the *ummah* which creates the need for independence among the *shariah* auditors in IFIs. The full potential of an audit cannot be realized if they are not wholly and truly independent, as the social purpose will be frustrated. The result shows a significant difference between the desired and the actual practice. This is also reflected in the interview results whereby in actual practice, a heavy dependence on the internal people such as the management of the *shariah* unit is placed to carry out *shariah* audit in IFIs. Self-review threats may occur as no separation of duties is clearly determined. Thus, even though respondents are clear on what is actually desired of independence, but in actual fact they cannot avoid to be relaxed on the principle of independence due to unavoidable circumstances. Therefore a gap does exist between the 'desired' and the 'actual' practice.

#### **5. Conclusion**

All the four pertinent issues of discussion within this paper show adverse effect which result in a gap because what is actually desired does not coincide with the actual practice. This unexpected scenario indicates that the practice of *shariah* auditing has not seriously taken an impact in IFIs in Malaysia despite it being a crucial monitoring tool for *shariah* compliance. All the areas tested in the questionnaire and interviews pose a certain magnitude of gaps. 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 agenda of the IFIs if they are to survive for a long time.

Both the results of questionnaire survey and interviews reveal the relevance of developing a framework for *shariah* auditing in IFIs in Malaysia. The results are interesting and useful, but at the same time reflect evidence that the *shariah* audit process is still a highly unstructured task. Apparently, the *shariah* audit practitioners themselves are somehow unable to respond to the *Maq'asid-Ash-Shariah* agenda despite their apparent willingness to do so. So one important policy implication of this study is that the Malaysian Institute of Accountants (MIA) 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 Malaysia.

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<sup>i</sup> The word *Shariah* literally means the road to the watering place, the straight path to be followed (Laldin, 2006, p.2). It is a doctrine of duties, a code of obligations needed to regulate all human actions for the purpose of establishing human order (Ibn Ashur, 2006, p.1)

<sup>ii</sup> See for example, the objectives of financial accounting as enunciated in Statement of Financial Accounting 1 by AAOIFI (AAOIFI, 2005).

<sup>iii</sup> The full set of questionnaire is available upon request.

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