# Shariah Audit for Islamic Finance Industry in Revolution Industry 4.0: A Part of Religious Confession

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Abstract: A key component of Revolution Industry 4.0 is the internet which is characterized by connected devices. Not only does this help internal operations, but through the use of the cloud environment where data is stored, equipment and operations can be optimized by leveraging the insights of others using the same equipment or to allow smaller enterprises access to technology they wouldn't be able to on their own. Shariah auditing has a key importance as there is a growing awareness among Islamic institutions that every such institution should contribute towards achieving Maq'asid Al-Shariah or the objectives of the Islamic law. 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. Confession is a specific form of testimony, involving oneself and it is used as a form of proof in judicial matters. Confession has been recognized as a source of conclusive proof of a right and a crime by Islamic textual sources. There are accusations that Islamic financial industry doesn't Shariah-compliance. By the existence of Shariah audit in the industry it will prove the industry that it is in the real track of Islamic teaching. The paper uses qualitative approach, desk-research study in which it uses the existing literature. At the end, the research found that the industry still minimizes the Shariah auditing role though it is a confession proof as required in Islamic teachings. Among the objectives and aims of this paper are: (1) To understand the importance of Shariah compliance and Shariah governance in Islamic banking and comprehend Shariah audit, (2) To analyze the Shariah audit area in facing Revolution Industry 4.0, (3) To relate the importance of Shariah audit in Islamic Financial Institutions to admission as proof that IFIs are Shariah-compliance. The methodology followed in this study is mainly of library work, basically it was based on related literatures written in conventional and Islamic perspective. Some information is taken from the practitioners' of many organizations through a primary data collection. The paper found that Shariah audit is considered as a confession to defense the allegation that IFIs are not in accordance with Islamic teachings.

## 1 INTRODUCTION

Abdul Karim Zaidan as quoted by Kamali (1996, p. 17) said: "In its capacity as the vicegerent of God, the Muslim community is entrusted with the authority to implement the *Shariah*, to administer justice and to take all necessary measures in the interest of good government. The sovereignty of the people, if the use of the word 'sovereignty' is at all appropriate, is a delegated, or executive sovereignty (*sultan tanfidhi*) only.

Theoretically one can argue that there cannot be any financial institution like banks in Islamic economics paradigm as the real sense of existing banking practice contradict with the fundamental Islamic finance principles. The debate on whether Islamic banks ever be Islamic has been going on since the inception of the first Islamic bank in Egypt, Mit Ghamr. So, what's the current position among academics and practitioners after 5 decades of tremendous development in Islamic finance industry.

Shariah compliance and review is the third important pillar of the Shariah Governance Model. Shariah review and assessment of adequacy of internal controls is a regular feature of the Shariah compliance. For this purpose, an internal Shariah audit department, under the internal audit committee of any Islamic financial industry, is to be established with the objectives to ensure compliance and to



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develop a Shariah non-compliance risk awareness culture in the organization.

However, due to various reasons, the internal audit is not considered a sufficient and reliable tool by the external users. Therefore, to give greater confidence to stakeholders of IFIs, an independent external Shariah audit is to be conducted by the statutory auditors, for which they are required to build up their capacity by engaging qualified Shariah auditors in their teams.

Till the time the audit firms develop a reliable Shariah audit system, Shariah review of the operations and transactions of IFIs may be conducted by their in-house Shariah board or Advisor on periodical basis (Haqqi, 2014).

Yaacob (2012) wrote: "Modern Islamic banking and financial institutions (IFIs) have been in existence for more than forty years. The first recorded institution was the Mit Ghamr Savings Bank in Egypt which was led by one Ahmad Elnaggar, established in the year of 1962. The bank was later absorbed by the Nasr Social Bank in 1972 (El-Hawary, Grais and Iqbal, 2004). Then the Pilgrims' Savings Fund Board was formed in Malaysia in 1963. It still exists until today (Haniffa and Hudaib, 2010). Haniffa and Hudaib (2010) provide an interesting analysis of the stages in the modern Islamic finance history from the 1940s to present time. They argued that somehow the sacred intentions became *"perplexed with the secular goals of modernity"* Although it is argued that the establishment of IFIs had started as early as the development of Islam in Makkah and Madinah (Haron and Azmi, 2009).

The Islamic financial industry instantly expanded over the past few decades and in 2011, Dubai Islamic Bank argues that Islamic banking and finance is one of the fastest growing economics sectors of the world today. However, compared to conventional banking and finance, Islamic banking and finance system is still in its very early stage. The conventional banking and finance system was first started in the 16th century when the merchants in Venice established the Banco Della Pizza at Rialto in Venice, Italy (Haron and Azmi, 2009, pp.43-44)

This paper discusses the importance of Shariah audit in Islamic financial institutions and it is regarded as a confession by the institutions that all its operational activities are in accordance with Islamic teachings. This is importance to keep the institutions are accountable and trustworthy in the eyes of public as stakeholders.

## 2 LITERATURE REVIEW

In "Emerging issues for auditing in Islamic Financial Institutions: Empirical evidence from Malaysia", (2013) the authors examine the perspective of practitioners who are involved directly and/or indirectly with the process of Shariah compliance/auditing from Islamic financial institutions (IFIs) in Malaysia on the issues of standards for Shariah auditing, auditor qualifications and independence. They examine 77 self-developed questionnaires applicable to the main issues focused by this study. The survey questionnaires are distributed by mail or delivered in person to 85 respondents in 21 Malaysian Islamic financial institutions. They found that Malaysian IFIs are in need of properly guided Shariah standards for Shariah auditing practices.

This paper discusses the relation between Shariah audit and the way to prove a fact or deny it before the court in order to highlight that Shariah audit in IFIs is needed to prove that IFIs are Shariah complince.

Nor Fadilah and Nuzul Akhtar (2016) in "Shariah Governance Framework: The Roles of Shariah Review and Shariah Auditing" highlight the roles of Shariah Review and Shariah Auditing and discuss on the issues and challenges related to Shariah review and Shariah Audit in Islamic Financial Institution (IFIs). They said that the growth of the Islamic finance industry around the world is due to the unique features of Islamic Financial institutions (IFIs) that emphasize on the fairness and justice in their operations. Al Quran and As-sunnah be the main rules to be followed. The IFIs are responsible to ensure they comply with the Shariah principles in its products, instruments, operations, practices, management, etc. As for that reason, Shariah governance is another component that is peculiar exclusively to IFIs.

This paper relates the need to Shariah audit by IFIs to admission as one of method to prove the fact before Shariah courts.

Nawal, Shahul and Maliah in "Shariah Auditing in Islamic financial institutions: Exploring the gap between the "desired" and the "actual" discuss "what ought to be" Shariah auditing and the current practice of Shariah audit in IFIs in Malaysia. Their paper aims to explore empirically the gap between "the desired" and "the actual" practice of Shariah auditing in IFIs in Malaysia. They found that there exists a gap between the two concepts in terms of certain issues discussed in this study.

This paper does not touch the desire and the actual practice of Shariah auditing but only discuss the relation between Shariah audit and confession in Islamic law of evidence.

A paper titled "Post Implementation of Shariah Governance Framework: The Impact of Shariah Audit Function Towards the Role of Shariah Committee" written by Zurina Shafii, Ahmad Zainal Abidin, Supiah Salleh, Kamaruzaman Jusoff and Nawal Kasim (2013) states that recent issuance of Shariah Governance Framework by Bank Negara Malaysia has shown a significant impact towards the establishment of the Shariah audit and consequently, towards the role of the Shariah Committee. Hence the paper studies on the impact of the Shariah audit function towards the role of Shariah Committee with regards to the post implementation of the Shariah Governance Framework and found that from in depth interviews reveal that the Shariah audit function has an added value in ensuring the compliance towards the Shariah principles.

This study elaborates the importance of Shariah audit in IFIs and its connection with admission in Shariah court for proving the fact.

Nor Aishah and Zurina (2014) claim in "The Undergraduates' Perspective on Shariah Audit in Islamic Banks: An Insight to the Future Shariah Auditor Labour Market in Malaysia" that despite the importance of Shariah audit, there is little understanding on how to implement an effective and efficient Shariah audit from the human capital perspective, particularly in terms of Shariah audit education. This study purports to explore the perception of the undergraduates on Shariah audit in the Islamic Banks in Malaysia using questionnaire survey in Malaysia. It found that there is significant difference between students who are exposed to Shariah audit course and those who are not.

This paper discusses the proof of confession is practiced by IFIs through their Shariah auditing institutions.

On the other side, Lutz Sommer (2015) in "Industrial Revolution - Industry 4.0: Are German Manufacturing SMEs the First Victims of this Revolution?" writes that industry 4.0 represents a special challenge for businesses in general and for SMEs in particular. The study at hand will examine companies´ awareness, readiness and capability to meet this challenge taking into account the special role of SMEs.

This paper confirms the importance of Shariah auditing in IFIs as its admission of Shariah-compliance in this challenging era of Revolution Industry 4.0.

A Othman (1996) in *An Introduction to Islamic Law of Evidence* said: "*Iqrar* [admission] is therefore a form of admission for the purpose of proving a fact in order to establish a right or interest of another person against the maker of the admission himself". The book is about Islamic law of evidence as a discipline of knowledge.

This paper aims at proving that Shariah audit is considered as confession that IFIs are on the tract of fulfilling the need to prove that they are in accordance with Shariah rules.

# 3 DISCUSSION

## 3.1 Shariah Audit Defined

Shariah audit consists two words 'shariah' and 'audit'. Shariah, also spelled Sharia, the fundamental religious concept of Islam—namely, its law. The religious law of Islam is seen as the expression of God's command for Muslims and, in application, constitutes a system of duties that are incumbent upon all Muslims by virtue of their religious belief. Known as the Sharīʿah (literally, "the path leading to the watering place"), the law represents a divinely ordained path of conduct that guides Muslims toward a practical expression of religious conviction in this world and the goal of divine favour in the world to come (Ahmed El Shamsy, N.J Coulson, *Britannica*).

On the other hand, audit is the examination or inspection of various books of accounts by an auditor followed by physical checking of inventory to make sure that all departments are following documented system of recording transactions. It is done to ascertain the accuracy of financial statements provided by the organization.

Audit can be done internally by employees or heads of a particular department and externally by an outside firm or an independent auditor. The idea is to check and verify the accounts by an independent authority to ensure that all books of accounts are done in a fair manner and there is no misrepresentation or fraud that is being conducted.

Auditing is "a systematic process of objectively obtaining and evaluating evidence regarding assertions about economic actions and events to ascertain the degree of correspondence between those assertions and established criteria and communicating the results to interested users" (Committee on Basic Auditing Concepts [COBAC], 1972: 2)

Having discussed the two words i.e 'shariah' and 'audit' above, then Shariah audit refers to the periodical assessment conducted from time to time. This is to provide an independent assessment and objective assurance designed to add and improve the degree of compliance in relation to the Islamic financial institution IFI's business operation, with the main objective of ensuring a sound and effective internal control system for Shariah compliance. In other words, it is to prevent instances of Shariah non-compliance which is a peculiar risk to all institutions operating under an Islamic worldview domain (Rauf, n.d).

AOIFI's Governance Standard No. 2 states: "Shariah review is an examination of the extent of an IFI's compliance, in all its activities, with the Shariah. This examination includes contracts, agreements, policies, products, transactions, memorandum and articles of association, financial statements, reports (especially internal and central bank inspection), circulars, etc." (AAOIFI, 2004).

Kamaruddin and Hanifah (2017) "Currently, there is no standardized definition of Shariah audit issued by the regulated bodies as the IFIs industry is still growing. However, there are few descriptions regarding Shariah audit that can be used in identifying Shariah audit. For instance, Bank Negara Malaysia (BNM) in Shariah Governance Framework (SGF) refers Shariah audit as: "The periodical assessment conducted from time to time, to provide an independent assessment and objective assurance designed to add value and improve the degree of compliance in relation to the IFI's operations, with the main objective of ensuring a sound and effective internal control system for Shariah compliance. (BNM, 2010, p. 10)

Before the issuance of SGF in 2010, several scholars have defined Shariah audit based on their understanding and experience. This includes a definition of Shariah audit by Prof Dr Abdul Rahim Abdul Rahman which is: "the accumulation and evaluation of evidence to determine and report on the degree of correspondence between information and established criteria for Shariah compliance purposes" (Abdul Rahman, 2008, p. 9).

Another Shariah audit definition by Associate Prof Dr Nawal Kasim is as follows: "a systematic process of obtaining sufficient and appropriate evidence to form an opinion as to whether the subject matter correspondence with Shariah rules and principles in broadly accepted by stakeholders and society at large" (Kasim, Ibrahim, & Sulaiman, 2009, p. 1).

The above Shariah audit definitions are also in line with the scope for internal Shariah review by Accounting and Auditing Organization for Islamic Financial Institutions Governance Standard (AAOIFI, 2010) for IFIs (GSIFI-3) No. 3 which is to ensure that the management of an IFI discharge their responsibilities in relation to the implementation of the Shariah rules and principles as determined by the IFI's Shariah Supervisory Board (SSB).

Another related description regarding internal Shariah audit is put forward by Dr Asyraf Wajdi Dusuki in defining Shariah audit as: A systematic process of obtaining and evaluating, sufficient and reliable evidence by an internal Shariah auditor, as a basis to form an opinion, as to whether the operations and activities of the entity being audited is incompliance with established Shariah criteria and reporting the opinion hereon to the appropriate authority. (Dusuki, 2011, p. 3)

Last but not least, the latest Shariah Governance Exposure Draft issued by BNM on November 2, 2017 also re-defines the Shariah audit as: "a function that provides an independent assessment on the quality and effectiveness of the IFIs internal control, risk management systems, governance processes as well as the overall compliance of the IFIs operations, business, affairs and activities with Shariah" (BNM, 2017, p. 18).

Based on all above definitions regarding Shariah audit, it can be said in general that Shariah audit is considered as tools or procedures to give assurance to the stakeholders that an organization's operations are in accordance with Shariah laws and principles. Although there are a lot of descriptions regarding Shariah audit, yet it still lacks in terms of detailing the scope of Shariah audit itself. As a result, Shariah audit practices by each IFI currently are different each other."

## 3.2 Revolution Industry 4.0

To some, it will seem too soon to talk about the next industrial revolution, i.e., the fourth industrial revolution, but the adoption of digital technology has reached a point where we are ready for another radical change, the digital transformation of the industry or what we call industry 4.0.

The change is based on the adoption of new technologies for the progressive automation of the production process. It is about innovative technologies whose application to the industry will be developed day by day

Bernard Marr, "We're in the midst of a significant transformation regarding the way we produce products thanks to the digitization of manufacturing. This transition is so compelling that it is being called Industry 4.0 to represent the fourth revolution that has occurred in manufacturing. From the first industrial revolution (mechanization through water and steam power) to the mass production and assembly lines using electricity in the second, the fourth industrial revolution will take what was started in the third with the adoption of computers and automation and enhance it with smart and autonomous systems fueled by data and machine learning.

## 3.3 Allegation against Islamic Financial Institutions

Understanding the underlying wisdom of the origin of Muamalat could clear some misconceptions towards Islamic banks in Malaysia. These misconceptions arise when we talk about transformation from conventional bank to Islamic bank. The development process of Islamic banking and the services offered by Islamic banks may be similar to those of conventional banks with some exception that include general banking principles (Eddy Yusuf, 2008).

Nawal and Sanusi (2013) wrote: "New regulations have been imposed to restore confidence in the corporate governance system and the oversight role in this system. The effect on the presence of a code of ethics for instance, appears to have an impact on the quality of auditors‟ judgments [8]. Hence, the introduction of Islamic laws into Islamic financial institutions has resulted in great changes; especially in the way the institutions do their business. This has also affected the audit of these institutions. Accordingly, the normal audit objective has been changed to agree with the Islamic law even though the normal conventional auditing is unable to cater for the values of shariah Islamiah. Conventional auditing is based on a system which is value-free and does not take into consideration the moral and ethical values laid down by Islam, despite the fact that standard setters believe that the ethical environment is an important factor in improving audit quality."

Yasoa, Wan Abdullah and Endut observed "On the contrary, if the Islamic banks fail to monitor the internal control and strengthen the lines of defense in the organisation, the probability of Shariah non-compliance activities or events to occur is very high. The existence of the Shariah non-compliance activities can damage the Islamic banks' reputation and may reduce the confidence of depositors, shareholders, customers, and other stakeholders towards the institutions. Hence, any income earned from non-compliant transactions should be channelled to charitable organisations and should not be recorded as normal income from operation."

Siddiqui (2018) "Fatwas given are according to Islamic principles which are not followed by bankers working in Islamic banks. Ulama are on board in advisory capacity only while those involve in execution are bankers. Many learned scholars who are in favor of Islamic banking have also shown their concerns over what was prescribed by them and what is in actual in practise Islamic banks are following.

In March 2009, Sheikh Muhammad Taqi Usmani of the Accounting and Auditing Organization for Islamic Finance Institutions (AAOIFI), a Bahrain-based regulatory institution that sets standards for the global Islamic Banking industry, declared that 85% of Sukuk, or Islamic bonds, were "un-Islamic". Usmani has been called "the granddaddy of modern-day Islamic finance".

According to another veteran of Islamic economics, Muhammad Akram Khan, criticizes Islamic banking as professing to have "put its business on a basis other than interest" but in practice devising "a whole host of ruses and subterfuges to conceal interest."

Mahmoud Amin El-Gamal, a professor of economics at Rice University (United States), has described modern Islamic finance as "Sharia arbitrage" -- i.e. what is prohibited in conventional finance becomes permissible when deemed "Shari'a compliant" despite having similar, if not the same, economic substance

Islamic economist Muhammad Akram Khan said Islamic banking has evolved toward convergence with conventional banking "imitating conventional banks in product development" rather than establishing "a different type of banking which was aligned to fairness, equitable income distribution, and ethical modes of investment."

The above allegations shall be faced by IFIs in order to keep themselves as Shariah compliance industry in all their concept, activities, procedures and management.

## 3.4 The Need to Shariah Audit

The Guidelines on Internal Syariah Audit Framework of Brunei Darussalam are intended to provide guidance on the Notice No. IFAU/N/2/2018. These Guidelines are designed to meet the following objectives:

(i) To set out the expectations of the Authority on the Financial Institutions and Banks to establish institutional arrangements and recommendations to facilitate the effective implementation of internal Syariah audit as an integral component of the Syariah Governance Framework; and
(ii) To provide guidance for the Financial Institutions and Banks in specifying the scope of internal Syariah audit, internal Syariah audit objectives, internal Syariah audit governance, internal Syariah audit charter, competency of internal Syariah auditors, internal Syariah audit process and reporting for internal Syariah audit.

Shariah audit system must be in place to forensically examine the institution’s performance on a regular basis and identify incidences of incorrect or incomplete transactional flows, with the aim of rectifying and improving performance in a continual and sustainable manner, and following the necessary Shariah, governance, and ethical, financial and regulatory standards.

The shariah audit shares similar functions to the company audit but they focused more on the compliance of IFIs to shariah precepts and requirement (Sultan, 2007). Haniffa (2010, p.45) stresses that*”the conventional financial audit is inadequate to fulfill the needs of the stakeholders of IFIs”.* This is true as the International Standards on Auditing (ISAs) did not take into accounts the shariah aspects. The International Auditing and Assurance Standard Board (IAASB) only sets the international standards for auditing, quality control, review and other assurance and related services that serves mostly the shareholders interest. Sometimes the ISAs are catered for specific country or environment needs. Only recently we can see the growing awareness of IFIs to implement shariah audit which is one the core key elements of good corporate and shariah governance to achieve the objectives of the shariah (Kasim, Ibrahim and Sulaiman, 2009).

Shariah audit is the examination of an IFIs compliance with the shariah, in all of its activities, particularly the financial statements and other operational components of the IFIs that are subjected to the risk of compliance including but not limited to products, technology supporting the operations, operational processes, the people involved in the key areas of risk, documentations and contracts, policies and procedures and other activities that require adherence to sharia principles” (Haniffa, 2010). The shariah audit should ensure that the IFIs have sound and effective internal control systems to comply with the shariah.

## 3.5 Confession a Proof of Accountability

Under Islamic law, disputes are mediated before a judge or *Qadi*. Similar to common law principles, the burden of proof is on the plaintiff or accuser who must present clear and convincing evidence to support his claim. A defendant has the presumption of innocence and any doubts in the dispute are resolved in his favor. A judge's decision, which is final and binding on the parties, must be consistent with both the evidence presented and Islamic law.

Generally, only the oral testimony of a witness is permitted as evidence. A witness is required to testify that he had direct and personal knowledge of the act and is certain that his testimony is true. A witness who testifies untruthfully is subject to punishment. Documentary or circumstantial evidence may be permitted only if its reliability is proven. Both the plaintiff and the defendant are allowed to present evidence at trial.

Confession is regarded as useful evidence in a dispute. A confession occurs when a defendant swears that they are guilty prior to trial. Confession must be done according to specific procedures before it can be regarded as admissible. A confession, for example, must be done without coercion before a notary. Once admissible, a judge may use either as proof of a defendant's innocence or guilt.

Confession is a specific form of testimony, involving oneself and it is used as a form of proof in judicial matters. This aspect concerning moral guilt has been carried on in various legislative codes in which a criminal is considered worse if he does not confess to his crimes. *Al-Iqrar* is the Arabic word for confession. It literally refers to an admission or confession.

However, under Islamic law, admission or confession is one of the ways in which cases are proof. A confession as a statement oral or written made by a person accused of an offence, stating that he has committed that offence. Confession has been recognized as a source of conclusive proof of a right and a crime by the Holy Quran and the Sunnah of the prophet (PHUH) and he implemented *Hadd* (offences with prescribed punishment) merely on the confession of the accused.

However, a confession must be clear and devoid of ambiguity. It must be subject to one and same interpretations at all times and were an admission (its wording and context) is clear; it is binding on the court to act upon it. On the other hand, confession could be described as admitting liability in the issue or issues before a court of law. It could be oral or written. It is a trite law that a confession of crime by a sane, adult, which is made freely without any element of compulsion, binds the maker.

Allegations against the operation of Islamic financial institutions as mentioned in the previous point must be solved including by means of confession by the industry in order to maintain the confident of the customers of the industry.

## 3.6 Shariah Audit: A Solution

Helal Uddin, Md. Musharof Hossain (2013) Auditing standards are the norms of auditing policies and practices issued by the authority for the guidance of their members regarding the examination of the items and making the audit report for satisfaction of the intended users. The International Standard of Auditing which is currently practiced was developed interest based western socio-economic culture and environment. But Islamic organizations established and operated based on Islamic Shariah to achieve legitimate objectives, work in different environment using different financial instruments and perform some transactions which are unknown to the western world. Hence, The Accounting and Auditing organization for Islamic financial institutions (AAOIFI) is an Islamic International autonomous not-for-profit corporate body that was established in Bahrain to prepare accounting, auditing, governance, ethics and shariah standards for Islamic financial institutions and the industry on 26th February, 1990 to attain the following objectives:

1) to develop accounting and auditing thoughts relevant to Islamic financial institutions;
2) to broadcast accounting and auditing thoughts relevant to Islamic financial institutions and its applications through training, seminars, publications of periodical newsletters, carrying out and commissioning of research and other means;
3) to prepare, promulgate and interpret accounting and auditing standards for Islamic financial institutions; and
4) to review and amend accounting and auditing standards for Islamic financial institutions.

Islamic financial institutions need Shariah auditing because the Shariah has basic principles to be observed in any operation. Such basic principles are:

a. Integrity
b. Objectivity
c. Confidentiality
d. Neutrality
e. Competency
f. Continuity
g. Disclosure
h. Giddiness
i. Orienting
j. Planning
k. Legality
l. Committed to Ethics, and
m. Committed to Religion.

In addition, Audit engagement indicates, to do the audit work in a particular time, according to Islamic auditing view point the engagement will occur among the parties by considering following standards:

a. Believable standards,
b. Moral standards,
c. Behavioral standards,
d. Educational standards,
e. Practical Standards.

According to Helal Uddin, Md. Musharof Hossain. (2013), Role of Auditor in Islamic Auditing are:

a) Auditor's liability towards Outside financiers: The auditor's liability to outside financiers in the Islamic framework is enhanced by specific institutional setup of the economy. In the Islamic economy interest- bearing finance is not available to the business. All finance is risk capital in the form of equity capital or *mudarabah* capital for different maturities. The outside financiers who provide capital on *mudarabah* on the basis of profit loss sharing will need an extended assurance from an independent agency that the profit (or loss) declared by the management is true or correct. In the absence of such an assurance, the outside finance shall be extremely bashful. It would simply make the operation of interest-free financing impossible. In these circumstances who could be looked up for reliance other that the auditor? In the capitalist framework the interest of outside financiers is protected by predetermined interest charge. The auditor makes sure that the final figure of profit (or loss) is arrived at after providing for interest on all loans and financial obligations. With the absence of interest, the determination of true profit (or loss) becomes crucial for the outside financiers as well. It is to them that the auditor will owe a responsibility. Determination of profit or loss is a subjective and value-laden area in a business organization. The ultimate figure of profit depends on a number of decisions such as rates of depreciation on different assets, valuation policies of stocks, amortization of intangible assets, charging to deferred payments to current operational income, apportionment of profit into reserves and dividends, etc. In the capitalist framework these questions are decided by the management and the auditor reports compliance on them. But in the Islamic framework standards may have to be devised for the determination of profit or loss for different categories of trade and industry. Due care would be taken to arrive at a judicious and consistent figure of profit (or loss) so that interest of outside financier are also protected. In the absence of fixed predetermined rate of interest, the financiers may be left at the mercy of the management to declare a profit (or loss) in the manner they like. The prevalent standards of morality and integrity in Muslim countries suggest that the auditor would have to operate in an extended field to verify an accurate figure of profit (or loss), which may not be a strict compliance of the management policies. It would be an outsider's view-a third party opinion on the operations of the business organization. If the Islamic framework does not provide for such a role of the auditor, it would not fetch necessary confidence and support of the masses.

b) Assessment of management practices: As stated above the business firms would acquire outside finance on the basis of *shirkah* or *mudarabah*. The financiers would also require an assurance that the firms acquiring these funds would manage them with due regard for economy, efficiency and effectiveness. In the absence of such an assurance the financiers may not be willing to provide capital for fear of gross mismanagement. The funds provided on the basis of *shirkah* or *mudarabah* do not have any predetermined cost in the form of interest. As a result the likelihood of miss utilization of these resources increases. Part of which the financiers can have proper management of these resources will come through an independent examination of the business processes and practices. Such an independent examination will be made by the auditor. It is, therefore important that the auditor in the framework would extend his examination to the management of resources as well. The audit criteria for such an examination would be derived from the generally accepted management practices. Of course, in the Islamic economy these practices would also undergo certain change in the light of Shariah law and values.

As a corollary, it is implied that such an examination would require exposition of standards for business management in the Islamic framework. These standards would be utilized by the auditor for his examination. As stated earlier, traditionally it is not part of the statutory responsibility of the auditor to examine and report on the management of resources. Only recently, various shades of 'value for money' auditing have emerged, which have expanded the scope of auditing considerably. The expansion in the scope of auditing is taking place in the capitalist framework as well. In the Islamic economy the basic framework would undergo a change although the concept of expansion in the scope may be similar to the one being evolved in the capitalist framework. It may be added that the 'value for money' auditing is being applied, mainly to public sector organizations where the ownership of resources is impersonal as compared to business firms where the owners exercise direct control on the management. But in the Islamic framework, the outside financiers of business firms would have direct control over management. Therefore, they would require an independent examination of the management processes and practices to satisfy themselves that their funds are not being squandered away willfully or handled negligently. Thus, the auditor's role in the Islamic economy would expand to include assessment of resource management even in the private sector.

c) *Bakhs*: The auditor would be required to report on the extent of *bakhs* practiced by the auditee. *Bakhs* literally means to decrease; to diminish; to reduce. But the Qur'an has used this term to indicate any voluntary effort to diminish or decrease the value of the product being sold. The Qur'an has admonished the people of the Prophet Shu'aib*Alaihissalam* for *bakhs* since they caused a loss to the buyer by reducing the value of the merchandise (Surah al-A'raf: 85). *Bakhs* would, therefore, include adulterations in food, changes in specifications of ingredient and raw-material or modification in the production formulate that may result into decrease in the quality of the product.

d) *Tatfif*: The auditor would investigate into the extent of *tatfif* exercised by the clients. *Tatfif* is Qur'anic term which stands for causing damage to the other party in weight and measures (Surah al-Mutaffifin: 1-2). It suggests taking-in an excess measure and giving –out a short measure. They would report on the extent the organization adhered to the Shariah injunction of *'awful mikyalwalmizan* (give a full measure and weight). He would check the accuracy of the weights and measures and in case of packed material would testify, to as far an extent as possible, that these package weigh and measure the quantity stated on them.

e) *Uqud*: The auditor would investigate into the extent the business firm kept to its *uqud* (contracts). Keeping of contracts has been emphasized in the Qur'an at a number of places (Surah al-Maidah: 1). The auditor would look into various contractual commitments of the clients towards customers, suppliers, debtors, creditors and the state. His report would point out areas of neglect and non-fulfillment of obligations.

f) *Ihtikar*: The auditor would check the extent of *ihtikar* (hoarding) practiced by an organization. Hoarding of foodstuffs has been prohibited by prophet (peace be upon him), explicitly. By analogy to foodstuffs, hoarding of other article with the intension of causing scarcity and bidding up prices artificially may also be treated as *ihtikar*. The auditor would express his opinion on the extent an organization practiced *ihtikar*.

g) *Khiyanah*: The auditor would point out area of *khiyanah* in the affairs of the organization. It does not include merely embezzlement of funds but also falsification of accounts, bogus insurance claim, tax evasions, window dressings, and miss-statement of accounts.

h) *Israf*: another area of auditor's investigation would be the extent of *israf* (extravagance) which an organization practiced. Israf has been condemned by the Qur'an as an undesirable behavior for individuals (Surah al-Maidah: 41). This can be extended to cover the behavior of firms as well. *Israf* is a socially determinate concept.

The state and other institutions (such as chamber of commerce and industry) may lay down desirable scales of office furnishing, business banquets and social functions. These would be guidelines for the auditor to comment on the propriety of expenditure by an organization.

i) *Speculation*: While auditing the accounts of financial institutions, the auditor would report on the extent of credit extended by these organizations for speculative purposes. He would also examine and report on disguised riba. He would try to unveil all such malpractices which the shariah has banned in the *bai'alsarf* (exchange of money for money).

j) Determination and payment of zakat: Payment of Zakat is an obligation on those who own wealth beyond the exemption limit *(nisab).* Thus, the obligation of Zakat on the rich is because of their wealth. On the basis of this general rule it is agreed that business firms are also subject to Zakat, although the exact method of its calculation needs reconsideration. It will be one of the responsibilities of the auditor in the Islamic economy to report that Zakat has been calculated correctly and paid into the public Zakat fund or spent properly on one of the eight heads of account specified in the Holy Qur'an (Surah al-Taubah: 60).Thus the auditor would watch the interest of the poor people in the society. Knowledge requirement for a Muslim auditor: The auditor would have to play an extended role in the Islamic economy. He would be operating in the wider social orbit advising management on efficiency, helping state in *Amar bilma'rufwanahy'anil' munkar* and protecting the interests of third parties such as customers and suppliers.

k) The Auditor's report: Socio – economic values of the Islamic economy include ihsan. Ihsan in turn, is a cluster of various values such as *amanah* (honesty), *ithar* (sacrifice), *ta'awun* (cooperation), *sabr* (patience), *shukr* (thanks giving), *tawakkul* (trust), *infaq* (spending), and *silaturrahm* (joining of kinship ties), etc. Business organization undertakes philanthropic and socio-cultural activities even in capitalist economies. In an Islamic economy, the adoption and promotion of ihsan is one of the requirements of the shariah. Auditor in the Islamic framework would report on the extent an organization adhered to these concepts and propagated them over and above its principal operations. Following subject matter must consider for formulating final report,
   - o The scope of the report,
   - o The auditing standards are committed,

- The shariah rules be committed,
- The main remarks and Errors,
- The main recommendations,
- The date of the report,
- The signature of the Auditor.

# 4 CONCLUSION

Shariah compliance is the backbone of Islamic finance institutions (IFI) in which they operate. Therefore, ensuring Shariah compliant aspect is paramount to maintain the confident level and public at large. Inadequate attention to the whole process of Shariah compliant aspect triggers negative repercussion to the IFIs, such as massive withdrawal and financial loss. In this regard it is essential to have a comprehensive, robust and well-functioning Shariah control mechanism to ensure the beginning-to-end Shariah compliant in the day-to-day business operations. As such, a sound Shariah audit and review have to be in place to assess the level of Shariah compliance aspect on a regular basis, to identify any potential Shariah compliant incidences as to provide with the proper rectification mechanism.

The findings basically reveal that the Shariah audit function has an added value towards the Shariah compliance of the operation of the IFIs, particularly on the implementation process of the product in the organization and the internal control that should be imposed. In addition, the function facilitates IFIs to identify possible Shariah breach of contracts (if any), prior as well as after the implementation of the product. This is vital for IFIs to provide preventive and corrective measures before greater issues really happen.

## 4.1 Recommendation

Compliance to Shariah is vital to enhance the confidence of the stakeholders of IFIs. This is one of the reasons for any regulatory body in a jurisdiction to issue the Shariah Governance Framework for implementation by the IFIs. It is the objective of this paper to examine the impact of the Shariah audit function as a confession to extract confidence from stakeholders of the industry.

Hence, Shariah auditing is a must in the industry because it's a proof that the industry runs its operations in accordance to Shariah compliance.

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