

Halal Assurance for Islamic Capital Market: The Accountability of Shariah Auditors

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Abstract

The large potential of the halal business and the continuous unique position and strength of the halal hubs demand more from an audit function for halal assurance. Hence there is a need for a properly in place monitoring and controlling system to be in tandem with the drastic development of the industry. This paper examines the role of *Shariah* auditors in discharging their accountability towards halal assurance. The paper attempts to relate the concept of accountability to the reality of a *Shariah* auditor by referring to the concept of "*Taklif*" in Al-Quran through its *Surah Al-Baqarah* (2:282). Further, the role of the *Shariah* auditor for halal assurance is argued to be in defects without the criteria of having the Islamic identity, being knowledgeable in *Shariah Islamiah* and having the value of integrity embedded in him/her which relates to the characteristics of independence, objectivity, honesty and sincerity. The paper concludes that the accountability of a *Shariah* auditor in halal assurance is believed to result in achieving the conformity with the objectives of the *Shariah Islamiah* as a whole.

Keywords: Halal assurance; Halal hub; *Shariah* auditor

Introduction

Auditing, in particular the theoretical aspects, have not been much discussed in halal related discourses and conferences. It is frequently represented that auditing is a practical subject, with the inference that auditing is what auditors do, and that it does not have any theoretical content [1]. Traditionally auditing only performed a stewardship function. It informed the members of an entity whether management of that entity, to whom their capital had been entrusted, had invested it as planned. Later, the users of financial statements became more sophisticated. They started to demand more from an audit function than a mere attestation that their investments could still be accounted for. Voluminous additional data accompany published financial statements and auditors need to comment on these on top of basic accounts. Hence auditing expanded from its stewardship role to the growing awareness towards social audits. It is expected to grow and adapt as the demands of the users of the profession change with time.

However, lately audit as a social phenomenon has been lacking in the literature as well as in practice despite the assumption that good quality attestation of social reporting is essential to an organization's reliability and ability to fulfill its required role in developing transparency and accountability [2]. This is more so for a Halal Hub. Realizing the large potential of the halal business and the continuous unique position and strength, Malaysia has positioned itself to become the Global Halal Hub. To spearhead and coordinate the overall of the halal industry, the government has established the Halal Industry Development Corporation (HDC). Hence there is a need for a properly in place monitoring system for halal assurance to be in tandem with the development and the aspiration of becoming a one-stop center of the hub. Further, to have a complete controlling and monitoring process chain, an extension to expressing opinion on the financial reporting of an organization, the issues of social, environmental and sustainability reporting and how they impact the halal industry should also be addressed.

Islamic capital market is under the supervision of Securities Commission Malaysia. Shari'ah Advisory Council (SAC) of the Securities Commission has the solely authority to decide and to classify the listed companies whether they are Shari'ah compliant or not. The

list is updated two times a year. The objectives of the list of the Shari'ah approved companies are to facilitate the investors who are interested to invest in Shari'ah compliant stocks, to centralize the Shari'ah decisions domestically, to enhance the transparency and disclosure quality of the information, to promote the development of Islamic capital market (ICM) and to encourage the development of the Islamic instruments [3].

In the progress of Shari'ah screening, the first stage is examining the core activities of the companies. If the core activities are related to financial services based on *riba* (interest), gaming and gambling, manufacture or sale of non-halal products or related products, conventional insurance, entertainment activities that are non-permissible according to Shari'ah, manufacture or sale of tobacco-based products or related products, stock broking or share trading on Shari'ah non-compliant securities or other activities deemed non-permissible according to Shari'ah, the companies will not be categorized as Shari'ah approved companies. If the companies are not related to the above stated core activities, these companies will be assessed in the second stage. In the second stage, for companies which have incomes from both permissible and non-permissible activities, the SAC measures level of mixed contributions from permissible and non-permissible activities towards turnover and profit before tax of the companies. The SAC uses benchmarks based on *Ijtihad* (Shari'ah based reasoning). In this stage, some financial ratios, for instance, the ratio of liquid assets to illiquid assets, are computed to compare with the benchmark. Where the contributions of non-permissible activities exceed the benchmark, the securities shall be classified as Shari'ah

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non-compliant. Moreover, public image and the contribution of the companies towards the society are the additional criteria that SAC is looking for in assessing the companies. Currently more than 80% of the listed companies are Shari'ah approved companies [4].

This paper examines the role of *Shariah* auditors in discharging their accountability towards halal assurance. The following section briefly discusses the need of auditing for halal assurance. Next, the paper attempts to relate the concept of accountability to the reality of a *Shariah* auditor for halal assurance. The paper argues that *al-Quran* through its *Surah Al-Baqarah* (2:282) has embedded the key concept of accountability as a framework to guide accountants with Islamic values. The final section concludes.

The Need of Auditing For Halal Assurance

Before examining the auditors' accountability for halal assurance and how observance of *shariah* will affect them, it is worth reviewing the Western literature in order to understand how auditing has developed over the years. This may help readers to appreciate comparison to the development of *shariah* audit practice for halal assurance in particular.

One would expect that the *shariah* auditing function is likely to be different from that of the West because the environment is different, the issues are different and the influential groups are different. Examining the available Western literature may also provide a background to a discussion on how *shariah* auditing may be improved from the limitations of conventional auditing, if there is any.

Auditing is a profession, and just like any other profession, it is dynamic not static. It will grow and adapt as the demands of the users of that profession change with time. According to Tricker [5], in exploring the precedents on auditing, two theses are advanced; first, that external expectations of the audit function evolve, and the practice of auditing develops, in response to changing demands for accountability in society. Second, that demands for accountability emerge as a response to perceived corporate collapse, crises or other problems of social regulation. In other words, corporate crises may lead to new expectations of and requirements for accountability, which in turn lead to new demands on the audit function.

Globally, the growing amount of Islamic financial assets is encouraging, as are efforts in creating new halal products and services. The ability to build an Islamic economy will depend on its success in bringing together the fragmented sharia-compliant sectors. The ability to develop an Islamic economy will depend on how successful it will be in bringing together the fragmented sharia-compliant, halal and Muslim-friendly sectors. Cooperation with other Islamic hubs is a major factor that will need to be addressed during the creation of a cohesive Islamic economy. One of the most pressing issues is the establishment of Islamic standards and a legal framework that leaves no room for confusion. While regulatory bodies do exist, there is not much trickle-down to the actual markets. On a national level, that could be addressed by creating specific departments or experts dedicated to Islamic industries. For companies operating in halal production, it is also about credibility. Presenting a halal choice to Muslim consumers will not automatically mean they will choose it over a conventional product. They will need to be able to trust the brand is truly halal and that the product is of comparable quality. All these elements will require much time and effort to develop *shariah* auditors with proper qualification and competency.

Auditors are accountable in expressing their opinion on the accounts; and to some stakeholders it is not an assurance of the future

viability of an entity or an assurance that there has been no fraud or other irregularities. Thus, in addition to higher competency levels expected from the auditors, the scope of auditing for halal assurance must change. For example, as an extension to expressing opinion on the halal certification, the issues of social, environmental and sustainability reporting should also be addressed.

Muslim *Shariah* law uses the word halal to refer to something permitted or lawful. The law strictly prohibits consumption of pork and drinks that contain alcohol. It forbids the use of utensils or food that come into contact with other non-halal foodstuffs either directly or indirectly. The law presses charges to offenders of this rule and may force people to even pay interest among other penalties. The *Sharia* rule is so particular to an extent that it sometimes contradicts other rules for companies and businesses. Due to this ambiguity, there are only few halal-certified establishments in non-Muslim nations.

Obtaining the halal certification does not allow the establishments to tamper with quality. Regular inspections of businesses that have already received the documents are done in order to uphold quality. The inspections in non-Muslim countries such as Japan are usually carried out by halal organizations in Muslim countries such as Malaysia Halal Corporation which is an internal halal auditor recognized by both Indonesian and Malaysian governments' associated bodies.

Power [6] argues that the world is experiencing "the explosion of an idea" and a movement along a continuum from a society that trusts everything and audits nothing to a society that trusts nothing and audits everything. It is clear that the role of auditing has evolved and the relevance of auditing is established through its historical precedents from detecting fraud and errors to enhancing the stakeholders' confidence through audit opinion. Auditors are not only required to enhance the credibility of financial statements or halal certification in this case, but they are also expected to provide value-added services, such as reporting on irregularities, identifying business risks and advising management on internal control weaknesses. The paradigm of auditing can be argued to be shifting, and the auditors' role is being redefined [7].

In the near future, more establishments are likely to offer halal-certified services for Muslims. This might mean that there would be increased Muslim-friendly businesses around the world including non-Muslim countries such as the United Kingdom, Australia, China and Japan. The world's total Muslim population stands at around 1.6 billion which translates to about 25% of all the people in the world. With the new achievement, to have halal assurance auditing framework should be one of the critical agendas for halal hubs.

The Role of Shariah Auditors for Halal Assurance

The audit function in an Islamic state is important and mandatory as it reflects the accountability of the auditor not only to the users of the financial statements, but more important, to the Creator, Allah SWT. This is because Muslims believe that one's actions and thoughts are always being watched by Allah (*Muraqabah*). Fundamental to Islam is the edict that "...surely Allah takes careful account of all things" (*Quran*, 4:86). It is to be noted that these references are to "account" in its generic sense, reference to one's obligation to "account" to God on all matters pertaining to human endeavor for which every Muslim is "accountable" [8].

In Islamic history, the institution of *Hisba* and the role of the *Muhtasib* – to monitor, control and prevent fraudulent exploitations on consumers in the market place goes back to the time of Prophet

Muhammad (pbuh) and the first four Caliphs. The function was linked to Quranic verses that urge Muslims to promote right and prevent wrong. For instance in Surah Ali-‘Imran, verse 104:

“Let there arise out of you, a band of people, inviting to all that is good, enjoining what is right, and forbidding what is wrong: They are the ones, to attain felicity.”

The prohibition of interest (riba) in Islam and the aspiration of Muslims to make this prohibition a practical reality in their economies, has led to the establishment of a number of Islamic financial institutions around the world [9] and the development of Islamic capital market. Religious or *shariah* audit evolved in parallel to the development of Islamic institutions in the Muslim world. Over the past two decades, the development of Islamic banks has increased immensely and a large number of Islamic banks have been established around the world. As part of the Islamic business institutions, the Islamic banks are obliged to perform *Shariah* compliance activities in their operations [10]. Starting from the Islamic banking system, the *shariah* compliance activities later on were applied to other financial sectors such as insurance and capital market. With the drastic development of the Islamic financial system operating in the Islamic and non-Islamic countries, automatically the Islamic accounting and auditing will be important issues under discussion. Al-Qur’an impliedly mentions the importance of auditing:

“O you who believe! If a wicked person comes to you with any news, ascertain the truth, lest you harm people unwittingly, and afterwards become full of repentance for what you have done (49:6).”

Further, in Quran 2:282 (*Al-Baqarah*, verse 282), writing and dictation of contracts, presence of the witnesses and specification of date of payment are considered to be critical steps in ensuring validity of a contract. Every single part of the contract will support each other and provide strong evidence in case any doubt or confusion arises in future. There is less chance for any party to cheat or take advantage of the other party’s weaknesses. Most scholars agreed that the presence of the witnesses was only a recommendation [11]. It would be very pertinent and helpful if this recommendation is applied as to avoid any dissatisfaction or false claim that may arise.

The Halal industry is another new growth sector not only in Malaysia but has become the fastest growing global business across the world. It is also an emerging market force that is attracting non-Muslims with its wholesome, hygienic and contamination-free principles in food production. The global value for trade of Halal foods and non-food products is estimated at USD2.1 trillion annually. To serve the growing global consumer demands for Halal products and services and to increase the confidence level of the users, halal assurance activities should go hand-in hand with the promotion of halal products and services.

Questions may then arise as to who should be responsible to conduct the check and balance on *shariah* matters which is not covered by the external auditors. Is there a need for a special category of shariah auditors for halal assurance purposes? Or is it enough to have a shared resource with the headquarters for the auditing purposes, if it happens that the halal assurance is part of the whole business? If so, which auditing framework do the auditors need to follow?

Shariah auditors do not have a mandatory regulated professional code to follow; instead they follow the Islamic *shariah* principles [12]. Although AAOIFI [13] has come up with the code of ethics for auditors of Islamic financial institutions, the framework/standards within which to formulate their task as *shariah* auditors has not so far been

defined. The fact that they are guided by their moral beliefs [14] and they are distinguished and knowledgeable *shariah* scholars [15] makes it difficult to know whether they are competent to perform their duty or not as *shariah* auditors, even though their position is comparable to the auditors of the IFIs [16]. It is eventually an empirical question as to who is a qualified *shariah* auditing expert, and what the boundaries of certified knowledge? Further, which body should take charge of ensuring the needs for auditors of halal assurance.

It is easy to show that a halal entity can comply with all rules and regulations without adding any value or achieving the objective of *Maqasid Ash-Shariah* for which its formation is based. The accountability of the *shariah* audit function carried out by the shariah auditor is thus checked only to the extent of its adherence to rules and procedures. Thus it may be assumed that the function makes no contribution to assessing the achievement of the objectives specifically on the socio-economic objectives. Different from the capitalist environment, in an Islamic society with a very heavy social and ethical agenda, the current practice of halal assurance may need to be extended to auditing the overall achievement of the socio-economic objectives of the entity.

Is the current profession qualified to undertake this extension of duty? By right the auditor giving opinion on halal assurance is religiously responsible and he is duty bound to acquire knowledge of *shariah* and his duty emanates from the principles of Islam and from the general standards of his profession. Therefore, it is the duty of the auditor to do his best in the capacity of a professional by acquiring related knowledge as the profession requires the auditor to certify that the overall operation and business transactions of the institution which they audit comply with the objective of the institution. Accordingly, if the objective of the organization is to conduct business in accordance with *shariah* principles, the auditors have the responsibility to ensure *shariah* compliance in every aspect by virtue of taking the audit assignment [17].

Zaid [18] discussed the mandatory requirements of *Al-Kateb* (accountants/auditors) in a Muslim society. The most important criteria is the *Islamic identity*. The appointed person must be able to apply, explain, and interpret related issues with reference to the Islamic law. This criteria is relevant for halal assurance in particular which demands the responsible person to be a practicing Muslim who is committed and capable of competently discharging the expected technical tasks within the requirements of the *Shariah*.

Being *knowledgeable in Shariah Islamiah* should be another fundamental requirement as the *Shariah Islamiah* (Islamic law) is the guiding foundation that *Al-Kateb* needs in carrying out his work, without which he cannot justify his actions and rationalize his judgments. Further, Zaid [18] stressed on the criteria of *integrity* which according to him, one that cannot be ignored when discussing the role to be played by a *Shariah* auditor. This eventually relates to characteristics of independence, objectivity, honesty and sincerity.

In view of the elements discussed above and together with the understanding of Quran 2:282, the concept of “*Taklif*” or the accountability of a *Shariah* auditor in halal assurance is believed to result in achieving the conformity with the objectives of the *Shariah Islamiah*.

Conclusion

Islam has developed its own concept of accountability, which is the concept of “*taklif*” where everyone is accountable for his responsibility

which entails reward or punishment, each of which would come in this world or in the Hereafter or both [19]. This means that the people must accept the duties and liabilities as well as the benefits of any ownership or responsibility, though they have no control over the final decisions of their actions.

This is the reason why the injunctions of *shariah* is aimed to educate individuals including the *shariah* auditors and inspire them with faith and instill in them the qualities of being trustworthiness and righteous [20]. It is through grooming the individuals with accountability that Islam aims at achieving its socio-economic goals.

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