

Economic Indicators of AAOIFI Internal Audit Project

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Abstract

The rapid development of crisis phenomena and the decline in basic economic indicators, both at the level of states and individual organizations, led to the need to strengthen internal control measures and to search for sources of more reliable and timely information. Recently, the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI) has developed a draft standard "Sharia internal audit". This paper discloses the most significant provisions of the presented standard. Aspects are considered in detail regarding the basic principles of the activity of Sharia internal auditors, the scope of audits, organizational independence and objectivity, and quality control of audit procedures. The analysis of the requirements for the level of qualification of Sharia internal auditors is conducted. In conclusion, the standard proposed by AAOIFI can turn into a solid methodological and administrative reason for Sharia interior review, which thusly cannot just ensure the premiums of Sharia-delicate accomplices, yet additionally increment market trust in IFIs in the midst of emergency, since its extension covers a lot more extensive parts of strict, financial and moral norms.

Keywords: Sharia internal audit, Islamic financial institutions, AAOIFI standards, Islamic banking, internal audit standards.

I. INTRODUCTION

Currently, many countries are experiencing serious economic problems associated with the pandemic of a new coronavirus infection. A large number of long-established patterns overnight became insolvent, and the need for conceptual changes became apparent not only to leading economists and business analysts, but also to representatives of small and medium-sized businesses.

According to A. Kudrin, the fall in Russia's GDP amid the economic crisis in 2020 could be from three to five per cents, and in the case of a negative scenario, up to 8%. Based on the World Bank, rate of economic growth of Southeast Asian countries, including China, will decrease from 5.8 to 2.1%, and in a negative scenario, generally, to minus 0.5%. According to the forecast of Euler Hermes, the decline in economic growth in the Middle East region will reach 2.5% in 2020.

In the context of a large-scale degradation of the economy based on the principles of capitalism, opinions about the possible partial or complete replacement of the existing economic model with alternative options began to be expressed more and more. Some experts propose such models as based on the principles of socialism or the Islamic economy. According to experts, the abolition of the principle of "develop for development" and the minimization of loan interest will be important in the formation of a new model. In our opinion, special attention should be paid in this regard to Islamic banking, which is a specific segment of the financial industry and has a number of features, such as the prohibition of loan interest and transactions with excessive uncertainty, etc. It is based on operations with real assets, and not with money as such.

Taking into account the latest trends in the Russian economy, especially in socially significant sectors, such as construction, agriculture, and the production of essential goods, a reorientation to minimize the application of loan interest and the introduction of alternative financing methods is highly relevant. Another important aspect of needs is the forced decrease in risk appetite and the share of transactions with uncertainty made by these companies, which is primarily due to the high level of volatility in a crisis in almost all areas, a rapid change in legislation and a general economic trend towards preventive control of risk levels.

Total assets of IFI for 2018 estimated at \$ 2.5 trillion; according to optimistic forecasts, by 2025 they should have amounted to \$ 7 trillion. However, the on-going negative events in the world significantly adjusted this forecast. In Russia, Islamic banking was in its infancy even before the crisis and, according to some estimates, amounted to only 1.5 billion roubles. Of course, in the conditions of a general economic recession, these indicators will decrease significantly, but against the background of the clearly manifested shortcomings of the existing economic system, it becomes possible to integrate Islamic principles of financing into the current economy.

To ensure such integration, it is necessary to carefully study the regulatory framework of Islamic financial institutions and to borrow the best experience to improve the activities of those Russian companies that would like to work on the basis of the Islamic principles of entrepreneurship.

Conducting activities in full compliance with Islamic principles of financing is difficult in the current Russian

legislation, which leads to a rise in the cost of Islamic financial instruments and a decrease in their demand. Nevertheless, from the point of view of social policy, the partial integration of the Islamic financial system into the most significant sectors could significantly reduce risk levels, stabilize investment flows and increase the level of business social responsibility in these sectors of the economy.

The relative stability of the Islamic financial system is primarily due to the fact that there is a clear idea of acceptable financial transactions, the global goals of IFIs and methods for achieving them. The basis of corporate governance is the concept of social equality and justice. However, to date, experts have noted the lack of clear regulatory regulation of the IFI. The initiator in this direction was the Accounting and Auditing Organization of Islamic Financial Institutions (AAOIFI).

AAOIFI is an independent international non-profit organization founded in 1991 and located in Bahrain. The main activity of the organization is the development and promotion of standards in the field of accounting, audit, management, ethics and sharia (Islamic law) for the IFI and other participants in the Islamic finance industry. To date, AAOIFI has issued more than 100 standards, and the organization's activities are supported by regulatory bodies and experts in more than 45 countries.

II. METHODS

When writing the paper, methods of analysis and synthesis of information were used, as well as a method of comparison and generalization. The steps and procedures for conducting a Sharia internal audit are similar to those of traditional internal auditors; however, a significant difference lies in the scope of the audited operations. Checking the observance of ethical and social norms comes to the forefront; this becomes especially relevant for many organizations around the world in the context of the economic and social crisis. The effectiveness of Sharia internal audit is assessed by checking the means of internal control, risk management and corporate governance in general, based on the ability to ensure confidence in compliance with the principles and rules of Sharia.

III. RESULTS AND DISCUSSION

In May 2019, AAOIFI experts demonstrated the draft of the new standard "Sharia internal audit" in the city of Kazan, at the Kazan Summit site. This standard is of particular interest in light of the fact that the scope of the Sharia internal audit is much wider than the internal audit conducted according to traditional rules. Given the specifics of the IFI activities, the audit should not only be an economic and legal assessment of business processes, but also have a more comprehensive and balanced nature, taking into account the ethical and technological aspects of the companies.

The main objective of this standard is the development and provision of guidelines and practical procedures for the implementation and functioning of Sharia internal audit (ISA) in organizations that conduct their activities in accordance

with the principles and rules of Sharia. The draft standard spells out compliance with the law, the need for quality control and ethical requirements, describes in detail the goals and organizational structure, as well as professional requirements regarding the basic procedures, documentation and reporting of the Sharia internal audit.

According to the AAOIFI interpretation, "Sharia internal audit is a function independent of management that is part of the governing bodies of the IFI; its main purpose is to ensure the confidence of those in charge of governance and the Sharia Supervisory (Steering) Council regarding compliance by the IFI with principles and rules of Sharia. Sharia internal auditors are those who perform the functions of the Sharia internal audit" [2].

It is noteworthy that, as in the International Auditing Standards (ISAs) of the International Federation of Accountants (IFAC), the glossary of the draft standard defines the basic terms related to Sharia internal audit. In the context of the possible introduction of Islamic principles of financing into the current economic system, depth wording of the basic concepts and a detailed description of the procedures being carried out can significantly improve the work of Sharia internal auditors and the activities of the IFI as a whole, taking into account the specifics of the activity. This is especially important when attracting a significant number of people who do not profess Islam to this area of government.

The draft standard notes that Sharia internal audit, as well as internal audit in its traditional sense is carried out focusing in three directions:

- Assessment of corporate governance processes for the proper functioning of the IFI
- Assessment of the effectiveness of the internal control system
- Checking the adequacy of the evaluation criteria and risk management mechanisms.

The main purpose of the Sharia internal audit is to provide guarantees regarding compliance by the IFI with the principles and rules of Sharia determined in accordance with the following hierarchy of regulatory documents:

1. Sharia standards published by AAOIFI;
2. Normative acts issued by the regulatory body of the relevant jurisdiction, since they entail regulatory requirements of Sharia;
3. Decisions of the Central Sharia Council of the relevant jurisdiction;
4. The requirements of the applicable financial reporting standards issued by AAOIFI, if they are related to the requirements of Sharia;
5. Recommendations and resolutions given by the Sharia Supervisory (Steering) Council of the IFI" [2].

As can be seen from the above hierarchy, the provisions of the standards issued by AAOIFI are of predominant importance and in those states, where Sharia principles are laid down at

the legislative level the laws of these states are of predominant importance, too.

For Russia, in the absence of an appropriate regulatory framework for regulating the financial and economic activities of organizations that rely on Islamic principles in their activities, it would be constructive, in our opinion, to create Sharia Supervisory Councils of various jurisdictions and to bring financial legislation to the maximum contradictions to the listed norms.

Nevertheless, in the current conditions of the absence of an appropriate legislative base and relatively high costs of ensuring full compliance with Sharia principles and rules, a phased integration of the main elements of the Islamic economy into the financial systems of the Russian organizations under consideration is possible.

A significant place in the draft standard is occupied by the organizational structure of the Sharia internal audit. AAOIFI recommends the creation of a separate independent Sharia internal audit unit. This will allow achieving the highest level of independence and objectivity of Sharia internal auditors; it will be possible to attract highly specialized personnel to consider atypical facts of economic activity. As an alternative, the draft interpreted standard provides for the possibility of creating a Sharia internal audit unit within the traditional internal audit department or outsourcing the activities of the Sharia internal audit to a professional firm. At the same time, the department of traditional internal audit (outsourcing company) should have sufficient capabilities (both in quantitative and qualitative respects).

Regardless of the form of organizational structure chosen by the IFI, special attention should be paid to the independence and objectivity of Sharia internal auditors, as well as to the quality control of the procedures.

In their activities, Sharia internal auditors should be based first of all on the provisions of the Koran and the Sunnah; it is necessary to be very careful in their conclusions and to be critical of any disputed situations. The independence and objectivity of Sharia internal auditors is of particular importance in the absence of an appropriate regulatory framework and the incompatibility of the level of training of specialists in the field of Islamic finance with the high requirements declared by AAOIFI. It is emphasized that Sharia internal auditors should be independent of the executive management, but not necessarily independent of the organization. The management, in turn, should provide unlimited access to all documents, reports and systems to Sharia internal auditors (as well as to any internal auditors). To achieve maximum independence and objectivity, Sharia internal auditors should not carry out any operational or managerial activities, including activities to comply with Sharia.

A special place in the draft standard is occupied by the issue of quality control of the activities performed by Sharia internal auditors. The need to fulfil the requirements of the Program to ensure and improve the quality of internal audit, as well as other professional and regulatory requirements, is noted. According to the draft standard, a clear mechanism is needed

to assess the quality and improve the performance of Sharia internal auditors using independent assessments by team members at the level of colleagues or at a higher level. In carrying out such assessments, they are guided by documented principles that take into account the frequency and extent of independent evaluations, as well as the qualifications of the persons responsible for their conduct.

The draft AAOIFI standard enshrines a significant amount of requirements for Sharia internal auditors and emphasizes the need for continuous development and self-education. It is recommended that multidisciplinary teams be established consisting of experts in the field of Sharia, audit, internal control and regulatory compliance. In addition, for effective performance of their duties, all employees need an understanding of the general principles, products and processes of Islamic finance.

This provision of the standard is very significant for organizations wishing to conduct their activities in accordance with Islamic principles of the economy, but operating in different economic and cultural conditions. For example, Russia is characterized by a shortage of specialists with an appropriate level of knowledge of audit, internal control, and corporate governance on Islamic principles, which greatly complicates the introduction and use of Islamic financial products.

In order to form and maintain a high level of professional competence of their employees and according to the draft standard, IFIs should ensure the continuous education and training of Sharia internal auditors, mainly in the field of audit and Sharia knowledge, with an emphasis on fiqh al-Muammalat norms (the branch of Islamic jurisprudence regulating relations related to trading and other transactions). The standard has special requirements for the head of the Sharia internal audit unit, such as: to have a higher education or relevant professional qualifications; understand the operations and functions of Islamic banking and finance, the relevant principles and rules of Sharia, and also understand fiqh al-Muammalat; have 5 years of experience in the relevant field; be approved by the Sharia Supervisory Board.

Based on a detailed analysis of the provisions of the draft standard, it can be summarized that knowledge of fiqh al-Muammalat is mandatory for Sharia internal auditors. First of all, this is due to the large scale of negative reputation consequences of violation of fiqh provisions for IFIs in comparison with violation of secular legislation.

Given the growing negative economic and social consequences of the crisis, as well as the rapid and not always consistent changes in the regulatory framework of many states, the requirement for specialists to know the legislative framework (including in the monitoring mode) may become one of the prerequisites for conducting business only for Islamic financial institutions, but also organizations operating according to traditional principles of the economy.

IV. SUMMARY

A detailed study of the provisions of the proposed draft standard "Sharia internal audit" shows that the AAOIFI experts developed the stages and procedures of Sharia internal audit in detail, presented the main parameters of the organizational structure, and clearly defined qualification requirements for Sharia internal auditors. The steps and procedures for conducting a Sharia internal audit are similar to those of traditional internal auditors; however, a significant difference lies in the scope of the audited operations. Checking the observance of ethical and social norms comes to the forefront; this becomes especially relevant for many organizations around the world in the context of the economic and social crisis. The effectiveness of Sharia internal audit should be assessed by checking the means of internal control, risk management and corporate governance in general, based on the ability to ensure confidence in compliance with the principles and rules of Sharia.

V. CONCLUSIONS

In the current economic situation, many countries and individual organizations are faced with the need to review their policies in the field of economics and finance. One of the alternative economic systems that are most oriented towards social and ethical standards is the Islamic finance system. The presented standard undoubtedly helps to increase the efficiency of using Islamic financial instruments. A proper Sharia internal audit should timely identify and promptly eliminate any problems of non-compliance with Sharia principles and rules. The standard proposed by AAOIFI can become a reliable methodological and regulatory basis for Sharia internal audit, which in turn can not only protect the interests of Sharia-sensitive partners, but also increase market confidence in IFIs in times of crisis, since its scope covers much broader aspects of religious, economic and ethical standards.

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