Auditing Standard No. (1)

Objective and Principles of Auditing

Contents

Objective and Principles of Auditing

Introduction

1. The purpose of this Auditing Standard for Islamic Financial Institutions (ASIFI) is to establish standards and provide guidance on the objective and general principles governing an audit of financial statements prepared by a financial institution which conducts business in conformity with Shari'a Rules and Principles.

Objective of an Audit

2. The objective of an audit of financial statements is to enable the auditor to express an opinion as to whether the financial statements are prepared, in all material respects, in accordance with the Shari'a Rules and Principles, the accounting standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and relevant national accounting standards and practices in the country in which the financial institution operates. The phrase used to express the auditor's opinion is "give a true and fair view".

3. Although the auditor's opinion enhances the credibility of the financial statements, the user cannot assume that the opinion is an assurance as to the future viability of the financial institution or as to the efficiency or effectiveness with which management has conducted the affairs of the financial institution.

General Principles of an Audit

4. The auditor should comply with the "Code of Ethics for Professional Accountants" issued by the AAOIFI, and the International Federation of Accountants which do not contravene Islamic Rules and Principles. Ethical principles governing the auditor's professional responsibilities include:

a) Righteousness,
b) Integrity,
c) Trustworthiness,
d) Fairness,
e) Honesty,
f) Independence,
g) Objectivity,
h) Professional Competence,
i) Due Care,
j) Confidentiality,
k) Professional Behaviour, and
l) Technical Standards.

5. The auditor should conduct an audit in accordance with ASIFIs, which are auditing standards approved by the Accounting and Auditing Organization for Islamic Financial Institutions. These contain basic principles and essential procedures together with related guidance in the form of explanatory and other material.

6. The auditor should plan and perform the audit with professional competence and due care recognizing that circumstances may exist which cause the financial statements to be materially misstated. For example, the auditor would usually expect to find evidence to support management representations and not automatically assume that they are necessarily correct.

Scope of an Audit

7. The term "scope of an audit" refers to the audit procedures deemed necessary by the auditor in the circumstances to achieve the objective of the audit. The procedures required to conduct an audit in accordance with ASIFIs should be determined by the auditor having regard to the requirements of appropriate Islamic Rules and Principles, ASIFIs, relevant professional bodies, legislations, regulations which do not contravene Islamic Rules and Principles, and, where appropriate, the terms of the audit engagement and reporting requirements. International Standards on Auditing (ISAs) shall apply in respect of matters not covered in

detail by ASIFIs providing these do not contravene Islamic Rules and Principles.

Reasonable Assurance

8. An audit is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement. Reasonable assurance is a concept relating to the accumulation of the audit evidence necessary for the auditor to conclude that there are no material misstatements in the financial statements taken as a whole. Reasonable assurance relates to the whole audit process.
9. Reasonable assurance also means that the auditor has satisfied himself that the transactions he examined during his audit comply with Shari'a Rules and Principles as determined by the Shari'a Board of the financial institution.
10. However, there are inherent limitations in an audit that affect the auditor's ability to detect material misstatements. These limitations result from factors such as:
    a) The use of sampling while testing transactions and balances.
    b) The inherent limitations of any accounting and internal control system (including, for example, the possibility of collusion).
    c) The fact that most audit evidence is persuasive rather than conclusive.
11. Also the work undertaken by the auditor to form an opinion is based on judgement, regarding in particular:
    a) The gathering of audit evidence, for example, in deciding the nature, timing and extent of audit procedures, and
    b) The drawing of conclusions based on the audit evidence gathered, for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.
12. Further, other limitations may affect the persuasiveness of audit evidence available from which to draw conclusions on aspects of the financial statements (for example, transactions between related parties). In these cases certain ASIFIs identify specified procedures which may, because of the nature of these aspects, provide sufficient appropriate audit evidence in the absence of:

a) Unusual circumstances which increase the risk of material misstatement beyond that which would ordinarily be expected, or
b) Any indication that material misstatement exists.

Responsibility for the Financial Statements

13. While the auditor is responsible for forming and expressing an opinion on the financial statements, the responsibility for preparing and presenting the financial statements in compliance with Shari'a Rules and Principles and relevant legislation and regulations is that of the management of the financial institution. (Consideration should be given to the definition of management in relevant national legislation and regulations.) The audit of the financial statements does not relieve the management of the financial institution of this responsibility.

Effective Date

14. This Standard shall be effective for financial statements for the financial periods beginning 1 Muharram 1418 A.H. or 1 January 1998 A.D.

Adoption of the Standard

The Standard of Objective and Principles of Auditing was adopted by the Board in its meeting No. (11) held on 2-3 Muharram 1417 A.H., corresponding to 19-20 May 1996 A.D.

Auditing Standard No. (2)

Auditor's Report

Contents

Auditor’s Report

Introduction

1. The purpose of this Auditing Standard for Islamic Financial Institutions (ASIFI) is to establish standards and provide guidance on the form and content of the auditor’s report issued as a result of an audit performed by an independent auditor of the financial statements of a financial institution which conducts business in conformity with Shari’a Principles. Much of the guidance provided can be adapted to auditor’s reports on financial information other than financial statements.

2. The auditor should review and assess the conclusions drawn from the audit evidence obtained as the basis for the expression of an opinion on the financial statements.

3. This review and assessment involves considering whether the financial statements have been prepared in accordance with the accounting standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI) and relevant national standards or practices. It will also be necessary to consider whether the financial statements comply with statutory requirements.

4. The auditor’s report should contain a clear written expression of opinion on the financial statements taken as a whole.

Basic Elements of the Auditor’s Report

5. The auditor’s report includes the following basic elements:
   a) Title,
   b) Addressee,
   c) Opening or introductory paragraph,
   d) Scope paragraph (describing the nature of the audit),
   e) A Reference to the ASIFIs and relevant national standards or practices,
   f) A Description of the work the auditor performed,

g) Opinion paragraph containing an expression of opinion on the financial statements,
h) Date of report,
i) Auditor's address, and
j) Auditor's signature.

A measure of uniformity in the form and content of the auditor's report is desirable because it helps to promote the reader's understanding and to identify unusual circumstances when they occur.

Title

6. The auditor's report should have an appropriate title.

Addressee

7. The auditor's report should be appropriately addressed as required by the circumstances of the engagement and local laws and regulations.

Opening or introductory paragraph

8. The auditor's report should identify the financial statements of the financial institution that have been audited, including the date of and period covered by the financial statements.

9. The report should include a statement that the financial statements and the financial institution's undertaking to operate in accordance with Shari'a Rules and Principles are the responsibility of the financial institution's management, and a statement that the responsibility of the auditor is to express an opinion on the financial statements based on the audit. (Consideration should be given to the definition of management in relevant national legislation and regulations.)

10. Financial statements are the representations of management. The preparation of such statements requires management to make significant accounting estimates and judgments, as well as to determine the appropriate accounting principles and methods used in preparation of the financial statements. In contrast, the auditor's responsibility is to audit these financial statements in order to express an opinion thereon.

11. An illustration of these matters in an opening (introductory) paragraph is:

"We have audited the accompanying statement of financial position of the Example Islamic Financial Institution as of ……… (end of financial period) and the related statements of income and cash flows (and the other financial statements specified in Financial Accounting Standard No. (1): General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions) for the period then ended. These financial statements and the financial institution's undertaking to operate in accordance with Shari'a Rules and Principles are the responsibility of the financial institution's management. Our responsibility is to express an opinion on these financial statements based on our audit."

Scope paragraph

12. The auditor's report should describe the scope of the audit by stating that the audit was conducted in accordance with ASIFIs and relevant national standards or practices as appropriate which do not contravene the Shari'a Rules and Principles. "Scope" refers to the auditor's ability to perform audit procedures deemed necessary in the circumstances. This assures the reader that the audit has been carried out in accordance with established standards or practices. Unless otherwise stated, the national auditing standards or practices followed are presumed to be those of the country indicated by the auditor's address.

13. The report should include a statement that the audit was planned and performed to obtain reasonable assurance about whether the financial statements are free of material misstatements.

14. The auditor's report should describe the audit as including:
    a) Examining, on a test basis, evidence to support the financial statement amounts and disclosures
    b) Assessing the accounting principles used in the preparation of the financial statements
    c) Assessing the significant estimates made by management in the preparation of the financial statements, and
    d) Evaluating the overall financial statement presentation.

15. The report should include a statement by the auditor that the audit provides a reasonable basis for the opinion.

16. An illustration of these matters in a scope paragraph is:

    “We conducted our audit in accordance with Auditing Standards for Islamic Financial Institutions (and refer to relevant national legislation, regulations and standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.”

Opinion paragraph

17. The auditor’s report should clearly state the auditor’s opinion as to whether the financial statements give a true and fair view in accordance with the Shari’a Rules and Principles as determined by the Shari’a Supervisory Board of the Islamic financial institution and the financial reporting framework and, where appropriate, whether the financial statements comply with statutory requirements.

18. The term used to express the auditor’s opinion is “give a true and fair view”. This term indicates, amongst other things, that the auditor considers only those matters that are material to the financial statements.

19. The financial reporting framework is determined by the AAOIFI, statutory requirements, rules issued by professional bodies, and the development of general practice within a country, with an appropriate consideration of fairness and the financial institution’s undertaking to operate in conformity with Shari’a Rules and Principles. To advise the reader of the context in which “fairness” is expressed, the auditor’s opinion will indicate the framework upon which the financial statements are based by using words such as “in accordance with

(indicate accounting standards of the AAOIFIs and relevant national legislation, regulations and standards or practices)".

20. In addition to an opinion on the true and fair view, the auditor's report may need to include an opinion as to whether the financial statements comply with other requirements specified by relevant statues or law.

21. An illustration of these matters in an opinion paragraph is:

    "In our opinion, the financial statements give a true and fair view of the financial position of the Example Islamic Financial Institution as of … (end of financial period) and of the results of its operations and its cash flows (and state also the opinion on the other financial statements) for the financial period then ended in accordance with the Shari'a Rules and Principles (as determined by the Shari'a Board of the Financial Institution) and in accordance with the accounting standards of the AAOIFI … (and comply with …)"

22. In any situation where it is not evident which country's accounting principles have been used, the country should be stated. When reporting on financial statements that are distributed extensively outside the country of origin, it is recommended that the auditor refer to the standards of the country of origin in the auditor's report, such as:

    "… in accordance with accounting principles established by the AAOIFI and generally accepted in country …"

    This designation will help the user to better understand which accounting principles were used in preparing the financial statements. When reporting on financial statements that are prepared specifically for use in another country (for example, where the statements have been translated into the language and currency of another country in a cross-border financing), the auditor will consider the need to refer to the accounting principles of the country of origin where prepared, and will consider whether appropriate disclosure has been made in the statements.

Date of report

23. The auditor should date the report as of the completion date of the audit. This informs the reader that the auditor has considered the effect on the financial statements and on the report of the events and transactions of which the auditor became aware and that occurred up to that date.

24. Since the auditor's responsibility is to report on the financial statements as prepared and presented by management, the auditor should not date the report earlier than the date on which the financial statements are signed or approved by management.

Auditor's address

25. The report should name a specific location, which is ordinarily the city where the auditor maintains the office that has responsibility for the audit.

Auditor's signature

26. The report should be signed either in the name of the audit firm, the personal name of the auditor or both, as appropriate.

Auditor's Report

27. An unqualified opinion should be expressed when the auditor concludes that the financial statements give a true and fair view in accordance with the identified financial reporting framework. An unqualified opinion also indicates implicitly that any changes in accounting principles or in the method of their application, and the effects thereof, have been properly determined and disclosed in the financial statements.

28. The following is an illustration of the entire auditor's report incorporating the basic elements set forth and illustrated above. This report illustrates the expression of an unqualified opinion.

Auditor's Report

(Appropriate Addressee)

We have audited the accompanying statement of financial position of the Example Islamic Financial Institution as of … (end of financial period) and the related statements of income, and cash flows (and the other financial statements specified in Financial Accounting Standard No. (1): General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions) for the financial period then ended. These financial statements and the Financial Institution's undertaking to operate in accordance with Shari'a are the responsibility of the Financial Institution's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with the Auditing Standards for Islamic Financial Institutions (and refer to relevant national legislation, regulations and standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the financial statements give a true and fair view of the financial position of the Example Islamic Financial Institution as of … (end of financial period) and of the results of its operations and its cash flows (and state also the opinion on the other financial statements) for the financial period then ended in accordance with the Shari'a Rules and Principles as determined by the Shari'a Board of the Financial Institution and the accounting standards of the AAOIFI … (and comply with …).

Auditor

Date

Address

Modified Reports

29. An auditor's report is considered to be modified in the following situations:

   1. Matters that do not affect the auditor's opinion:

   Emphasis of a matter

   2. Matters that do affect the auditor's opinion:

   a) Qualified opinion,
   b) Disclaimer of opinion, or
   c) Adverse opinion.

   Uniformity in the form and content of each type of modified report will increase the user's understanding of such reports. Accordingly, this ASIFI includes suggested wording to express an unqualified opinion as well as examples of modifying phrases for use when issuing modified reports.

Matters That Do Not Affect the Auditor's Opinion

30. In certain circumstances, an auditor's report may be modified by adding an emphasis of matter paragraph to highlight a matter affecting the financial statements which is included in a note to the financial statements that more extensively discusses the matter. The addition of such an emphasis of matter paragraph does not affect the auditor's opinion. The paragraph would preferably be included after the opinion paragraph and would ordinarily refer to the fact the auditor's opinion is not qualified in this respect.

31. The auditor should modify the auditor's report by adding a paragraph to highlight a material matter regarding a going concern problem.

32. The auditor should consider modifying the auditor's report by adding a paragraph if there is a significant uncertainty (other than a going concern problem) the resolution of which is dependent upon future events and which may affect the financial statements. An uncertainty is a matter whose outcome depends on future actions or events not under the direct control of the financial institution but that may affect the financial statements.

33. An illustration of an emphasis of matter paragraph for a significant uncertainty in an auditor's report follows:

"In our opinion … (remaining words are the same as illustrated in the opinion paragraph 28 above).

Without qualifying our opinion we draw attention to Note (X) to the financial statements. The Financial Institution is the defendant in a lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The Financial Institution has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the matter cannot presently be determined, and no provision for any liability that may result has been made in the financial statements."

34. The addition of a paragraph emphasizing a going concern problem or significant uncertainty is usually adequate to meet the auditor's reporting responsibilities regarding such matters. However, in extreme cases, such as situations involving multiple uncertainties that are significant to the financial statements, the auditor may consider it appropriate to express a disclaimer of opinion instead of adding an emphasis of matter paragraph.

35. In addition to the use of an emphasis of matter paragraph for matters that affect the financial statements, the auditor may also modify the auditor's report by using an emphasis of matter paragraph, preferably after the opinion paragraph, to report on matters other than those affecting the financial statements. For example, if an amendment is necessary to other information in a document containing audited financial statements and the financial institution refuses to make the amendment, the auditor would consider including in the auditor's report an emphasis of matter paragraph describing the material inconsistency. An emphasis of matter paragraph may also be used when there are additional statutory reporting responsibilities.

Matters That Do Affect The Auditor's Opinion

36. An auditor may not be able to express an unqualified opinion when either of the following circumstances exists and in the auditor's judgement the effect of the matter is or may be material to the financial statements:

a) There is a limitation on the scope of the auditor's work, or
b) There is a disagreement with management regarding the implementation of Shari'a Rules and Principles as determined by the Shari'a Board of the financial institution, the acceptability of the accounting policies selected, the method of their application or the adequacy of financial statement disclosures.

The circumstances described in (a) could lead to a qualified opinion or a disclaimer of opinion. The circumstances described in (b) could lead to a qualified opinion or an adverse opinion. These circumstances are discussed more fully in paragraphs (41–46).

37. A qualified opinion should be expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation on scope is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion. A qualified opinion should be expressed as being "except for" the effects of the matter to which the qualification relates.

38. A disclaimer of opinion should be expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements.

39. An adverse opinion should be expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

40. Whenever the auditor expresses an opinion that is other than unqualified, a clear description of all the substantive reasons should be included in the report and, unless impracticable, a quantification of the possible effect(s) on the financial statements. Usually, this information will be set out in a separate paragraph preceding the opinion or disclaimer of opinion and may include a reference to a more extensive discussion, if any, in a note to the financial statements.

Circumstances That May Result in Other Than an Unqualified Opinion

Limitation on Scope

41. A limitation on the scope of the auditor's work may sometimes be imposed by the financial institution (for example, when the terms of the engagement specify that the auditor will not carry out an audit procedure that he believes is necessary, or that he should not carry out an audit of the compliance of the financial institution with the Shari'a Rules and Principles). However, when the limitation in the terms of a proposed engagement is such that the auditor believes the need to express a disclaimer of opinion exists, the auditor would usually not accept such a limited engagement as an audit engagement unless required by statute. Also, a statutory auditor would not accept such an audit engagement when the limitation infringes on the auditor's statutory duties.

42. A scope limitation may be imposed by circumstances (for example, when the timing of the auditor's appointment is such that the auditor is unable to observe the counting of physical inventories). It may also arise when in the opinion of the auditor the financial institution's accounting records are inadequate or when the auditor is unable to carry out an audit procedure believed to be desirable. In these circumstances the auditor would attempt to carry out reasonable alternative procedures to obtain sufficient appropriate audit evidence to support an unqualified opinion.

43. When there is a limitation on the scope of the auditor's work that requires expression of a qualified opinion or a disclaimer of opinion, the auditor's report should describe the limitation and indicate the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed.

44. Illustrations of these matters are set out below.

Limitation on scope-qualified opinion

"We have audited … (remaining words are the same as illustrated in the introductory paragraph (28) above).

Except as discussed in the following paragraph, we conducted our audit in accordance with … (remaining words are the same as illustrated in the scope paragraph (28) above).

We were unable to obtain independent confirmation in respect of a … transaction amounting to (xx). In addition, the original documentation relating to the … contract was not made available to us. There were no other satisfactory audit procedures that we could adopt to confirm that the amount is recoverable.

In our opinion, except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to the recoverability of the … amount, the financial statements give a true and fair view … (remaining words are the same as illustrated in the opinion paragraph (28) above)."

Limitation on scope-disclaimer of opinion

"We were engaged to audit the accompanying statement of financial postion of the Example Islamic financial institution as of … (end of financial period) and the related statements of income, and cash flows (and the other financial statements specified in Financial Accounting Standard No. (1): General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions) for the financial period then ended. These financial statements and the financial institution's undertaking to operate in accordance with Shari'a are the responsibility of the financial institution's management. (Omit the sentence stating the responsibility of the auditor).

(The paragraph discussing the scope of the audit should be amended according to the circumstances.)

(Add a paragraph discussing the scope limitations as follows:)

We were unable to obtain independent confirmation in respect of a … transaction amounting to (xx). In addition, the original documentation relating to the … contract was not made available to us. There were no other satisfactory audit procedures that we could adopt to confirm that the amount is recoverable.

Because of the significance of the matters discussed in the preceding paragraph, we are unable to express an opinion on the financial statements."

Disagreement with management

45. The auditor may disagree with management about matters such as the acceptability of accounting policies selected, the method of their application, or the adequacy of disclosures in the financial statements. If such disagreements are material to the financial statements, the auditor should express a qualified or an adverse opinion.

46. Illustrations of these matters are set out below.

Disagreement on accounting policies-inappropriate accounting method-qualified oinion

"We have audited … (remaining words are the same as illustrated in the introductory paragraph (28) above).

We conducted our audit in accordance with … (remaining words are the same as illustrated in the scope paragraph (28) above).

As discussed in Note (X) to the financial statements, no depreciation has been provided in the financial statements, a practice which, in our opinion, is not in accordance with AAOIFI's standards. The provision for the year ended … (end of financial period) should be xxx based on the straight-line method of depreciation using annual rates of 5% for the building and 20% for the equipment. Accordingly, the fixed assets should be reduced by accumulated depreciation of (xxx) and the loss for the year and the accumulated deficit should be increased by (xxx) and (xxx), respectively.

In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements give a true and fair view … (remaining words are the same as illustrated in the opinion paragraph (28) above)."

Disagreement on accounting policies-inadequate disclosure-qualified opinion

"We have audited … (remaining words are the same as illustrated in the introductory paragraph (28) above).

We conducted our audit in accordance with … (remaining words are the same as illustrated in the scope paragraph (28) above).

On … the Islamic Financial Institution entered in to … contracts amounting to (xx) for the purposes of financing commodities. The agreements limit the payment of future cash dividends to earnings arising after … (end of year). In our opinion, disclosure of this information is required by …

In our opinion, except for the omission of the information included in the preceding paragraph, the financial statements give a true and fair view … (remaining words are the same as illustrated in the opinion paragraph (28) above)."

Disagreement on accounting policies-inadequate disclosure-adverse opinion

"We have audited … (remaining words are the same as illustrated in the introductory paragraph (28) above).

We conducted our audit in accordance with … (remaining words are the same as illustrated in the scope paragraph (28) above).

(Paragraph(s) discussing the disagreement).

In our opinion, because of the effects of the matters discussed in the preceding paragraph(s), the financial statements do not give a true and fair view of the financial position of the Islamic Financial Institution as of … (end of financial period) and of the results of its operations and its cash flows (and state also the opinion on the other financial statements) for the financial period then ended in accordance with … (and do not comply with …)."

Effective Date

47. This standard shall be effective for financial statements for the financial periods beginning 1 Muharram 1418 A.H. or 1 January 1998 A.D.

Adoption of the Standard

The standard of The Auditor's Report was adopted by the Board in its meeting No. (11) held on 2–3 Muharram 1417 A.H., corresponding to 19–20 May 1996 A.D.

Auditing Standard No. (3)

Terms of Audit Engagement

Contents

Terms of Audit Engagement

Introduction

1. The purpose of this Auditing Standard for Islamic Financial Institutions (ASIFI) is to establish standards and provide guidance on the appointment of an auditor to audit the financial statements of a financial institution which conducts business in conformity with Shari'a Rules and Principles.

   The main points are:

   a) Agreeing the terms of the engagement with the Islamic financial institution (client);
   b) The auditor's response to a request by a client to change the terms of an engagement to one that provides a lower level of assurance.

2. The auditor and the client should agree on the terms of the engagement. The agreed terms would need to be recorded in an audit engagement letter or other suitable form of contract.

3. This ASIFI is intended to assist the auditor in the preparation of engagement letters relating to audits of Islamic financial institutions' financial statements. The standard is also applicable to related services. When other services such as tax, accounting, or management advisory services are to be provided, separate letters may be appropriate to distinguish clearly the statutory audit from other services.

4. In some countries, the objectives and scope of an audit and the auditor's responsibilities are established by law. Even in those situations the auditor may still find audit engagement letters informative for their clients.

Audit Engagement Letters

5. It is in the interest of both client and auditor that the auditor should send an engagement letter, preferably before the commencement of the engagement, to help in avoiding misunderstandings with respect to the engagement.

Basic contents of the engagement letter

6. The engagement letter documents and confirms the auditor's acceptance of the appointment, the objectives and scope of the audit, the extent of the auditor's responsibilities to the client and the form of any reports to be provided by the auditor.

Objective of the audit of the financial statements

7. The objective of an audit of financial statements is to enable the auditor to express an opinion as to whether the financial statements are prepared, in all material respects, in accordance with the fatwas, rulings and guidelines issued by the Shari'a supervisory board of the Islamic financial institution, the accounting standards of the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), national accounting standards and practices, and relevant legislation and regulations applied in the country in which the Islamic financial institution operates. The phrase used to express the auditor's opinion is whether the financial statements "give a true and fair view" in accordance with the above.

Management's responsibility for the financial statements

8. The financial statements are the responsibility of the management of the Islamic financial institution, which is also responsible for maintaining an effective internal control system, for properly recording transactions in the accounting records, for safeguarding assets, and for the overall true and fair presentation of the financial statements.

9. The audit report should include a statement to the effect that the financial statements and the Islamic financial institution's undertaking to operate in accordance with the Shari'a Rules and Principles are the responsibility of the Islamic financial institution's management. The auditor is responsible for attesting as to whether the management has adhered to the fatwas, rulings and guidelines issued by the Shari'a supervisory board of the Islamic financial institution.

10. The management of the Islamic financial institution should provide the auditor with all the fatwas, rulings and guidelines issued by its

Shari'a supervisory board, and other relevant documents, e.g., reports of the Shari'a supervisory board.

Management's representation

11. The auditor will make specific inquiries of management about the representations contained in the financial statements and the operation of the internal control over the financial reporting process. The auditor should obtain representation letters from the client about oral representations made to him. The auditor would expect management to provide him with complete, accurate, and timely information.

Scope of an Audit

12. The scope of the audit includes reference to ASIFIs and applicable national standards or practices and a description of the work the auditor would perform. Matters to which the engagement letter ordinarily makes reference include the following:
    - The audit is to be conducted in accordance with ASIFIs. International Standards on Auditing and national standards shall apply in respect of matters not covered by ASIFIs providing International Standards on Auditing and the national standards do not contravene Shari'a Rules and Principles.
    - The auditor needs to obtain an understanding of the accounting system in order to assess its adequacy as a basis for the preparation of financial statements.
    - The auditor needs to obtain relevant and reliable evidence sufficient to enable them to draw reasonable conclusions therefrom.
    - The nature and extent of the auditor's procedures vary according to his assessment of the internal control system.
    - The auditor shall endeavour to plan his audit so that he has a reasonable expectation of detecting material misstatement in the financial statements or accounting records resulting from fraud, instances of non-compliance or errors which may exist.
    - Due to the test nature and other inherent limitations of an audit, together with the inherent limitation of any accounting and internal control system, there is an unavoidable risk that even some material misstatement may remain undetected.

Form of Reports

13. The engagement letter shall refer to the form of reports or other communications of results of the engagement to be issued by the auditor in addition to the statutory reports to the equity holders, such as a report to management on any identified material weaknesses in, or observations on, the accounting and internal control systems.

14. The engagement letter shall state that the auditor must have unrestricted access to whatever records, documentation and other information requested in connection with the audit. The engagement letter should also state the auditor's expectations of receiving from management written confirmation concerning representations made in connection with the audit.

Fees

15. The engagement letter should state the basis on which fees are computed and any billing arrangements.

Agreement of the Terms of Engagement

16. The engagement letter should request the client to confirm the terms of the engagement by acknowledging receipt of the engagement letter.

Other Matters

17. The auditor may also wish to include in the letter, inter alia:
    a) Arrangements regarding the planning of the audit.
    b) Description of any other letters or reports the auditor expects to issue to the client.
    c) The arrangements regarding consultation with the client's Shari'a supervisory board.
    d) When relevant, the following points could also be made:
        - Arrangements concerning the involvement of other auditors and experts in some aspects of the audit.
        - Arrangements concerning the involvement of other auditors and other client staff.
        - Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit.

- Any restrictions of the auditor's liability when such possibility exists.
- A reference to any further arrangements between the auditor and the client.

An example of an audit engagement letter is set out in Appendix (1).

Audit of components

18. When the auditor of a parent Islamic financial institution is also the auditor of its subsidiary, branch or division (component), the factors that influence the decision whether to send a separate engagement letter to the component include:
    - Who appoints the auditor of the component.
    - Whether a separate audit report is to be issued on the component.
    - Legal requirements.
    - The extent of any work performed by other auditors.
    - Degree of ownership by parent.
    - Degree of independence of the component's management.

Recurring Audits

19. On recurring audits, the auditor should consider whether circumstances require the terms of the engagement to be revised and whether there is a need to remind the client of the existing terms of the engagement.

20. The auditor may decide not to send a new engagement letter each period. However, the following factors may make it appropriate to send a new letter:
    - Any indication that the client misunderstands the objective and scope of the audit.
    - Any revised or special terms of the engagement.
    - A recent change of senior management, equity holders, members of the board of directors or in ownership, such as in a new holding Islamic financial institution.
    - A significant change in nature or size of the client's business.
    - Legal requirements.

Acceptance of a Change in Engagement

21. An auditor who, before the completion of the engagement, is requested to change the engagement to one which provides a lower level of assurance, should consider the appropriateness of doing so.

22. A request from the client for the auditor to change the terms of engagement prior to completion may result from:
    - A change in circumstances affecting the need for the service.
    - A misunderstanding as to the nature of an audit or of the related service originally requested.
    - A restriction on the scope of the engagement, whether imposed by management or caused by circumstances.

    The auditor would consider carefully the reason given for the request, particularly the implications of a restriction on the scope of the engagement.

23. A change in circumstances that affects the Islamic financial institution's requirements or a misunderstanding concerning the nature of the service originally requested would ordinarily be considered a reasonable basis for the client requesting a change in the terms of engagement. In contrast, a request for a change by the client would not be considered reasonable if it appeared that the change related to information provided by the client that is incorrect, incomplete or otherwise unsatisfactory.

24. Before agreeing to change an audit engagement to a related service (such as a review), an auditor who was engaged to perform an audit in accordance with ASIFIs would consider, in addition to the above matters, any legal or contractual implications of the change.

25. If the auditor concludes that there is a reasonable justification for changing the terms of engagement and the audit work performed complies with ASIFIs applicable to the changed terms of engagement, the report issued would be that appropriate for the revised terms of engagement. In order to avoid confusing the reader, the report would not include reference to:

- The original engagement; or
- Any procedures that may have been performed in the original engagement, except where the engagement is changed to an engagement to undertake agreed-upon procedures and thus reference to the procedures performed is a normal part of the report.

26. Where the terms of the engagement are changed the auditor and the client should agree on the new terms.

27. The auditor should not agree to change of the terms of engagement where there is no reasonable justification for doing so. An example might be an audit engagement where the auditor is unable to obtain sufficient appropriate audit evidence regarding receivables and the client asks for the engagement to be changed to a review engagement to avoid a qualified audit opinion or a disclaimer of opinion.

28. If the auditor is unable to agree to a change of the terms of engagement and is not permitted to continue the original engagement, the auditor should withdraw and consider whether there is any obligation, either contractual or otherwise, to report to other parties, such as the board of directors or equity holders, the circumstances necessitating the withdrawal.

Effective Date

This standard shall be effective for financial statements for the financial periods beginning 1 Muharram 1419 A.H. or 1 January 1999 A.D.

Adoption of the standard

The standard of Terms of Audit Engagement was adopted by the Accounting and Auditing Standards Board in its meeting No. (13) held on 10-11 Safar 1418 A.H., corresponding to 15-16 June 1997 A.D.

Appendix (A)
Example of an Audit Engagement Letter

The following letter is for use as a guide in conjunction with the considerations outlined in this ASIFI and will need to be varied according to individual requirements and circumstances.

"To the Board of Directors or the appropriate representative of senior management:

You have requested that we audit the statement of financial position of the Example Islamic Financial Institution as of ……… (end of period), and the related statements of income and cash flows (and the other financial statements specified in Financial Accounting Standard No. (1): General Presentation and Disclosure in the Financial Statements of Islamic Banks and Financial Institutions) for the period then ending. We are pleased to confirm our acceptance and our understanding of this engagement by means of this letter. Our audit will be made with the objective of our expressing an opinion on the financial statements.

We will conduct our audit in accordance with Auditing Standards for Islamic Financial Institutions (and refer to the relevant national regulations, legislation and standards or practices). Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements, in all material respects, are free of material misstatements. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. Our audit should not be relied upon to detect all defalcations or other irregularities that may have occurred, but their discovery, if they exist, may result from the audit tests we undertake and we will report such cases.

Because of the test nature and other inherent limitations of an audit, together with the inherent limitations of any accounting and internal control system, there is an unavoidable risk that even some material misstatements may remain undiscovered.

In addition to our report on the financial statements, we expect to provide you with a separate letter concerning any material weaknesses in accounting and internal control systems which come to our notice.

As management of the above Example Islamic Financial Institution, you are responsible for maintaining proper accounting records and preparing financial statements which give a true and fair view and have been prepared in accordance with Shari'a Rules and Principles as determined by your Shari'a supervisory board (and in accordance with the relevant legislation and regulations). You are also responsible for making available to us, as and when required, all the Example Islamic Financial Institution's accounting records and all other records and related information, including minutes of all management and equity holders' meetings, and all fatwas, rulings and guidelines issued by your Shari'a supervisory board.

We have a statutory responsibility to report to the equity holders of the Example Islamic Financial Institution whether, in our opinion, the financial statements give a true and fair view of the state of financial position of the Example Islamic Financial Institution as of ... (end of financial period) and the results of its operations and its cash flows for the period then ended in accordance with Shari'a Rules and Principles as determined by the Shari'a supervisory board of the Example Islamic Financial Institution, the accounting standards of the AAOIFI and comply with….

In arriving at our opinion, we are required to consider the following matters, and to report on any in respect of which we are not satisfied:

- Whether proper accounting records have been kept by the Example Islamic Financial Institution;

- Whether the Example Islamic Financial Institution's statement of financial position and income statement are in agreement with the accounting records;
- Whether we have obtained all the information and explanations which we think necessary for the purpose of our audit, and;
- Whether the information in the directors' report is consistent with that in the audited financial statements.

In addition, there are certain other matters which, according to the circumstances, may need to be dealt with in our report. For example, where the financial statements do not give details of directors' remuneration or of their transactions with the Example Islamic Financial Institution, (state the relevant legislation and regulations) require us to disclose such matters in our report.

We remind you that the responsibility for the preparation of financial statements including adequate disclosure and the Example Islamic Financial Institution's undertaking to operate in accordance with Shari'a Rules and Principles is that of the management of the Example Islamic Financial Institution. This includes the maintenance of adequate accounting records and internal controls, the selection and application of accounting policies, and the safeguarding of the assets of the Example Islamic Financial Institution. As part of our audit process, we will request from management written confirmation of oral representations which we have received from you during the course of the audit on matters having material effect on the financial statements/concerning representations made to us in connection with the audit.

We understand that the Example Islamic Financial Institution has a Shari'a supervisory board which, in accordance with the Example Islamic Financial Institution's memorandum and articles of association, is entrusted with ensuring that the Example Islamic Financial Institution complies with Shari'a Rules and Principles. We understand that we have the right to seek independent consultation with the Shari'a supervisory board.

We look forward to full cooperation with your staff and we trust that they will make available to us whatever records, documentation and other information as requested in connection with our audit.

Our fees, which will be billed as work progresses, are based on the time occupied and expenses incurred having regard to the degree of responsibility involved and the experience and skills required for the audit of the financial statements. For the year ending ... we estimate our fees to be (currency ...). Out of pocket expenses will be added to this fee. It is our practice to request an advance payment at the commencement of our work and one or more payments on account during the course of our work.

This letter will be effective for future years unless it is terminated, amended or superseded.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our audit of the financial statements.

Yours faithfully

Name of Auditor

Dated this day of : ___________________ .

Accepted on behalf of

Example Islamic Financial Institution

(signed)

....

Name and Title

Date

Appendix (B)
Example of Audit Re-Engagement Letter

Dear Sir

We are writing to confirm our re-appointment as auditors of Example Islamic Financial Institution for the year ending ... /... /...

1. We understand that this appointment is on the same terms as set out in our original letter of engagement dated ... / ... / ...
2. As explained in that letter our fees are charged on the basis of time occupied and expenses incurred having regard to the degree of responsibility, experience and skill involved. For the audit of the Islamic Financial Institution's financial statements for the year ending ... / ... /... we estimate our fee to be (currency ...). Out of pocket expenses incurred on your behalf shall be added to this fee.
3. It is our practice to request an advance payment at the commencement of our work and one or more payments on account during the course of our work.

Please sign and return the attached copy of this letter to indicate that it is in accordance with your understanding of the arrangements for our audit of the financial statements.

Yours faithfully,

Name of Auditor

Dated this day of : ___________________ .

Acknowledged on behalf of

Example Islamic Financial Institution

(signed)

……………………………………….

Name and Title

Date

Auditing Standard No. (4)

Testing for Compliance with Shari’a Rules and Principles by an External Auditor

Contents

Testing for Compliance with Shari'a Rules and Principles by an External Auditor

Introduction

1. The purpose of this Auditing Standard for Islamic Financial Institutions (ASIFI) is to establish standards and provide guidance on the subject of testing for compliance with Shari'a Rules and Principles by an external auditor in connection with the audit of the financial statements of a financial institution which conducts business in conformity with Shari'a Rules and Principles.
2. For the purposes of this ASIFI, the term "auditor" shall be used to refer to the external auditor only. The term "auditor" shall not apply to any internal audit function that may be associated with the IFI.
3. When testing for Shari'a compliance, the auditor shall obtain sufficient appropriate audit evidence that provides the auditor with reasonable assurance that the Islamic financial institution (IFI)[1] has complied with Shari'a Rules and Principles. As discussed in ASIFI (1), reasonable assurance is "the concept relating to the accumulation of the audit evidence necessary for the auditor to conclude that there are no material misstatements in the financial statements taken as a whole. Reasonable assurance relates to the whole audit process." ASIFI (1) also states that, "Reasonable assurance also means that the auditor has satisfied himself that the transactions he examined during his audit comply with Shari'a Rules and Principles as determined by the Shari'a [Supervisory] Board of the financial institution."

(1) The term (institution/institutions) is used to represent Islamic financial institutions, including banks.

4. The steps included below are relevant to the provisions that supports the requirements of this ASIFI.

Responsibility of an External Auditor for Compliance with Shari'a Rules and Principles

5. While the auditor is responsible for forming and expressing an opinion on the financial statements, the management of the IFI is responsible for ensuring that the financial statements and the IFI's activities comply with Shari'a Rules and Principles as determined by the Shari'a supervisory board (SSB) as set out in ASIFI (1) and ASIFI (2).

6. As explained in Governance Standard for Islamic Financial Institutions (GSIFI) No. (1), the responsibility to interpret the Rules and Principles of Shari'a lies with the SSB.

7. The auditor shall be knowledgeable about Shari'a Rules and Principles. However, he would not possess the same level of knowledge as that of SSB members and thus the auditor shall not be expected to provide interpretation of these rules and principles.

8. The fatwas, rulings and guidance issued by the SSB form the basis on which the auditor considers whether the IFI has complied with Shari'a Rules and Principles.

   The auditor shall use these as a basis for concluding whether the financial statements of the IFI have been prepared in accordance with Shari'a Rules and Principles.

Scope of the Auditor's Work

9. The responsibility of the auditor is to form an opinion on whether the transactions of the IFI are in compliance with the fatwas, rulings and guidance issued by the SSB of the IFI.

10. The auditor shall have no responsibility for assessing the competence of the members of the SSB.

11. The auditor shall satisfy himself that the IFI's process for introducing new products or modifying existing products includes appropriate

procedures for ensuring compliance with Shari'a Rules and Principles including reviews by IFI management, internal audit and the SSB.

12. The auditor shall include procedures in his examination to ensure that all new fatwas, rulings and guidance, and modifications to existing fatwas, rulings and guidance are identified and reviewed for each period under examination.

13. As part of his own scope of work, the auditor shall review available documents to ensure that all types of products offered by the IFI have been subject to a review by the SSB in accordance with GSIFI No. (2), and shall satisfy himself that the SSB has found these products to be in compliance with Shari'a Rules and Principles. The documents to be reviewed shall include the reports issued by the SSB to the IFI concerning the Shari'a compliance as well as the SSB's minutes of meetings. The auditor shall give consideration to the matters contained in these documents and their effect on the work to be carried out by him.

14. The auditor shall also verify that the transactions entered into by the IFI are consistent with the fatwas, rulings and guidelines of the SSB. This verification shall be carried out by the auditor on a test basis. The nature and extent of the testing is subject to the individual circumstances of the IFI and shall be determined by the auditor after careful consideration of these circumstances.

15. The auditor shall also review the findings of all internal reviews carried out by the IFI management, the internal audit, and as set out in GSIFI No. (3), by an internal Shari'a review. Consideration shall be given to the findings of these reviews and whether these findings effect the nature, timing or extent of the work carried out by the auditor during his examination.

Reference to the SSB's Report in the Auditor's Report

16. The auditor shall make available the auditor's report only after he has taken note of the SSB's draft report on the IFI's compliance with Shari'a Rules and Principles. If the SSB's draft report indicates that compliance with Shari'a Rules and Principles is lacking, and the

auditor decides, based on the SSB's draft report, to modify his draft report, he shall provide an adequate explanation of the nature of and reasons for the modification.

Making the Auditor's Draft Report Available to the SSB

17. Prior to issuance of the final report of the SSB, the auditor shall make available to the SSB his draft report and conclusions related to Shari'a compliance.

Effective Date

18. This Standard shall be effective for financial statements for the financial periods beginning 1 Muharram 1423 A.H. or 1 January 2002 A.D.

Adoption of the Standard

The Testing for Compliance with Shari'a Rules and Principles by an External Auditor standard was adopted by the Accounting and Auditing Standards Board in its meeting No. (19) held on 17 Safar 1421 A.H., corresponding to 21 May 2000 A.D.

Auditing Standard No. (5)

Auditor’s Responsibility to Consider Fraud and Error in an Audit of Financial Statements

Contents

Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements

Introduction

1. The purpose of this Auditing Standard for Islamic Financial Institutions (ASIFI) is to establish guidance on the auditor's responsibility when considering the risk of fraud and error in an audit of financial statements of an Islamic financial institution (IFI). The primary responsibility for the prevention and detection of fraud and error rests with those responsible for the corporate governance and management of the IFI. However, the auditor, when planning and performing the audit procedures and evaluating the results thereof, shall consider the risk of material misstatements resulting from fraud and error.
2. The standard shall provide the following:
   a) Guidance on the characteristic of fraud and error and the limitation of the auditor's responsibility in relation thereto;
   b) Define the minimum procedures that shall be applied by an auditor in case of indication, inquiries and discussions relating to any fraud and error in the financial statement of an IFI;
   c) Guidance to the auditors relating to management representations considering fraud and error in an IFI.
3. The standard shall be read in conjunction with all ASIFI's issued by the Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI). This standard complements the standards issued by the International Federation of Accountants on the consideration of fraud and error by fulfilling specific additional requirements relating to IFI.

Definition and Cases of Error

4. Error refers to an unintentional misstatement in financial statements, including the omission of an amount or a disclosure, such as:
   a) An incorrect accounting estimate as stated in Financial Accounting Standards arising from oversight or misunderstanding of facts;
   b) A mistake in the application of accounting principles and standards as stated in AAOIFI's Financial Accounting Standards relating to recognition, measurement, presentation and disclosure;
   c) An incorrect application and oversight of Shari'a rules and principles.

Definition and Cases of Fraud

5. Fraud refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage, such as:
   a) Breach of contracts between the IFI, investors and other third parties such as the misappropriation of funds of investment accountholders in the case of Islamic banks, and policyholders in the case of Islamic insurance companies (referred to hereafter as IAH and PA, respectively);
   b) Intentional misallocation of profits between the IFI and IAH/PA;
   c) IFI's misuse of IAH and PA funds including violation of contracts;
   d) Intentional non disclosure by management of some activities and relevant information to the IFI's Shari'a supervisory board, auditors, investors and shareholders;
   e) Intentional, consistent violation and misinterpretation of AAOIFI Shari'a standards and the IFI's Shari'a supervisory board's fatwas, rulings and guidelines;
   f) Intentional manipulation of documents and records to misrepresent the IFI's financial statements.

Responsibility of an Auditor

6. With due consideration to ASIFI No. (1), "Objective and Principles of Auditing," the objective of an audit of financial statements is to

enable the auditor to express an opinion as to whether the financial statements are prepared, in all material respects, in accordance with Shari'a rules and principles, the accounting standards of AAOIFI and the relevant national accounting standards and practices and legislation and regulation applied in the country in which the financial institution operates. An audit conducted in accordance with ASIFI and other recognized standards such as those issued by the International Federation of Accountants is designed to provide reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud and error. The fact that an audit is carried out may act as a deterrent, but the auditor is not and cannot be held responsible for the prevention of fraud and error.

7. However, the auditor shall be held responsible for negligence and misconduct if reasonable efforts are not seen to have been made in designing and planning the audit in order to detect fraud and error and/or it is shown that the auditor was aware of material fraud and error and did not take any necessary action to report it to the appropriate authority.

Professional Skepticism

8. The auditor plans and performs an audit with an attitude of professional skepticism in accordance with ASIFI No. (1), "Objective and Principles of Auditing" (paragraph. 6). Such an attitude is necessary for the auditor to identify and properly evaluate the following:
   - Management's compliance and application of all AAOIFI's Shari'a standards as well as the fatwas, rulings and guidelines laid by the IFI's Shari'a supervisory board. In addition, the Shari'a supervisory board's report shall not be the sole basis for the auditor's conclusion on the management's compliance with Shari'a rules and principles.
   - Matters that increase the risk of a material misstatement in the financial statements resulting from fraud and error (for example, management's characteristics and influence over the control environment, industry conditions, and operating characteristics and financial stability).

- Circumstances that make the auditor suspect that the financial statements are materially misstated.
- Evidence obtained (including the auditor's knowledge from previous audits) that brings into question the reliability of management representations.

9. With due consideration to the above, unless the audit reveals evidence to the contrary, the auditor is entitled to accept records and documents as genuine. Accordingly, an audit performed in accordance with ASIFI and other relevant standards issued by the IFAC rarely contemplates authentication of documentation, nor are auditors trained as, or expected to be, experts in such authentication.

Consideration of Fraud, Error and Audit Procedures

10. In planning the audit, the auditor shall assess the risk that fraud and error may cause to the financial statements as well as the assets, balances and income of the funds of IAH/PA, to contain material misstatement.

11. In addition to making inquiries from management, inquiries shall also include:
    - Discussions with members of the Shari'a supervisory board relating to professional judgement, interpretation, compliance and application of Shari'a rules and principles;
    - Discussion on how compliance with AAOIFI's Shari'a Standards, Financial Accounting Standards and the fatwas rulings and guidelines issued by the Shari'a supervisory board of the IFI are ensured by management;
    - The extent of the transactions covered by the Shari'a review for determining the adoption of the Shari'a rules and principles;
    - The extent of controls over the management and activities relating to investment of the assets, income and balances of the IAH/PA;
    - The introduction and application of effective internal control systems to safeguard assets, income and balances of the funds of IAH/PA, compliance with Shari'a rules and principles and the Financial Accounting Standards issued by AAOIFI.

12. The auditor shall inquire whether management, audit committee or members of the Shari'a supervisory board are aware of any fraud and errors that have been suspected, discovered, investigated and/or reported.

Considering the Effect of an Auditor's Report

13. When the auditor concludes that the financial statements are materially misstated as a result of fraud and error, the auditor shall consider the implications for the audit. The auditor shall then decide whether the audit shall be continued with the issuance of a qualified audit opinion or possible disclaimer in the audit report as stated in ASIFI No. (3), paragraphs (27-46).

Documentation

14. The auditor shall document fraud and error risk factors identified as being present during the auditor's assessment process and document the auditor's response to any such factors. If during the performance of the audit, fraud and error risk factors are identified that cause the auditor to believe that additional audit procedures are necessary, the auditor shall document the presence of such risk factors and the auditor's response to them.

15. The auditor shall document matters which are important in providing evidence to support the audit opinion, and that the working papers shall state the auditor's reasoning on all significant matters which require the auditor's judgement, together with the auditor's conclusion thereon. Because of the importance of fraud and error risk factors in the assessment of the inherent or control risk of material misstatement, the auditor shall document fraud risk factors identified and the response from management considered appropriate by the auditor.

16. The auditor shall document discussions held with the Shari'a supervisory board members, and conclusions of such discussions shall be supported by AAOIFI's Shari'a standards and the fatwas, rulings and guidelines issued by the Shari'a supervisory board.

Responsibility of Management and Corporate Governance Body

17. The primary responsibility for the prevention and detection of fraud and error rests with those charged with corporate governance and management of an IFI and the funds of the IAH and PA. Management shall set the proper procedures, create and maintain a culture of honesty and high ethics that are compatible with the Code of Ethics for Employees of Islamic Financial Institution issued by AAOIFI, and establish appropriate controls to prevent and detect fraud and error within the IFI. In addition, management shall set controls and procedures over the requirements of applying Shari'a rules and principles to all activities of an IFI.

18. It is the responsibility of those in charge of the governance of the IFI to ensure, through oversight of management, the integrity of the accounting and financial reporting systems and that appropriate controls are in place, including those for monitoring risk, financial control and compliance with the Shari'a rules and principles.

19. The auditor shall assess that management has developed an appropriate system of internal control that shall also include compliance with Shari'a rules and principles.

Management Representations

20. The auditor shall obtain written representations from management which shall include, inter alia, that:
    a) It has complied with all the requirement of AAOIFI's Shari'a standards and the fatwas, rulings and guidelines issued by the Shari'a supervisory board;
    b) It has disclosed and raised all matters of concern known by management relating to the fraud and error in the IFI;
    c) It has complied with all the provisions of the contracts of IAH/PA contracts;
    d) It has presented all Shari'a supervisory board's fatwas, rulings and guidelines to the auditors;
    e) It has placed the necessary controls over assets, income and balances of the IAH/PA.

Through management representations, management acknowledges its responsibility for the accounting and internal control systems designed to prevent and detect fraud and error.

Effective Date

21. This Standard shall be effective for financial periods beginning 1 Muharram 1425 A.H. or 1 January 2004 A.D.

Adoption of the Standard

The Auditor's responsibility to Consider Fraud and Error in an Audit of Financial Statement was adopted by the Accounting and Auditing Standards Board in its meeting No. (25) held in Bahrain on 3 Rabi' I, 1424 A.H., corresponding to 3 May 2003 A.D.